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Research Methods for Accounting & Finance

Siping Zhang

School of Economics Hubei Business College, Wuhan,China

Abstract: As the economic globalisation deepens, TP plays a more important role in the international transactions. In this report, the definition and objectives of TP have been introduced, and three research questions have been proposed and solved based on the theory of the TP. Research questions can help the audience to understand the key questions clearly what this report wants to discuss. Previous theoretical and empirical literature reviews show what efforts and researches have done by prior authors on TP. Moreover, research methodological has been outlined which is used to discuss how to investigate the problem of TP.

Keywords: Transfer pricing;Arm's Length Principle; Cost Sharing Agreement ; Shift profits; Accounting & Finance; Research Methods

1. Research Context

The purpose of this report is planning a research design for a scientific case study, a study focus on transfer pricing (TP) and its effect on corporate tax. This research will be divided into five main parts to be discussed and analysed, a coherent approach will be used. Tippet and Wright (2006) claims that with the development of economic globalisation, TP has become one of the agenda items which is associated with the modern accounting or cost management, and via deepening the relationship between countries and multinational enterprises (MNEs) has become an issue to be researched and studied.

2. Problem Discussion

Aim at the issue of TP and its effects on tax, this section will raise three questions on the base of effects that TP brought on the tax. The Arm's Length Principle (ALP) and Cost Sharing Agreement (CSA) are two main important theories in the process of TP, but it still cannot prevent MNEs to shift profits. Generally speaking, ALP is used to deal with fiscal transactions between the MNEs and related foreign subsidiaries, which are agreed upon the Organization for Economic Co-operation and Development (OECD) for tax purposes. The application of ALP is transparent among the tax administrations and other regulatory agencies when the transactions trade in basic products and services. It refers that other related market participants know the fair market prices easily and judge whether is it compliant. Nevertheless, the ALP will increase burdens both on the taxpayer and the tax authority because they need to estimate a great quantity of cross-border transactions (Kapnik, 2013).

In terms of CSA, if the parent firms and its overseas subsidiaries decide to share the risk and cost of researching and developing intangible assets such as intellectual property (IP), the rules of TP will be more sophisticated. They are also sharing future interests, which will be outlined clearly in the contract. Meanwhile, each relevant party have the right to share the income from the intangible assets. A great number of technologies and medical enterprise via CSA to transfer their IP rights to the lower tax rate countries, to make more profits and minimise taxes. Under the CSA, the application of ALP becomes harder to apply, and tax administrations cannot measure the fair value of these transactions easily and correctly because affiliates shared the risks (Barker, 2017).

Based on the discussions of the ALP and CSA, the weakness of these two key principles causes the condition of tax evasion becomes more serious. MNEs shift countless profits and avoid a great number of taxes through using the hard-to-value intangible assets, which cause both high and low tax rate countries lost tax revenues. Therefore, the first question intends to know the definition of intangible assets for TP purpose, which can distinct what is true intangible assets both direct and indirect. After understanding the definition of intangible assets, the goal of the second question is discussing any regulations have been set or not to remit this problem. Except using the weakness of intangible assets to avoid tax, there are many ways has been used by MNEs, so the third question attention to what illegal ways have been used.

2.1 How to identify the intangible assets for TP purpose?

Under the theory of TP, too narrow or too broad definition of intangible assets may lead to the government or taxpayers make mistakes in arguing what are intangible assets. The 2015 OECD guidance states that intangible assets in TP are not physical or financial assets, which can be controlled and owned for use in business operations, and used or transferred for compensation occurred in another transactions among the other parties. Main types of intangible assets involving IP, patents, trademarks, what can be registered, but also includes know-how skills, trade secrets and contractual rights (EY, 2015).

2.2 Any regulations have been proposed?

Actually, most of the countries around the world have legislated anti-avoidance regulations on the base of international standard of ALP regard to the situations of the inter-company trading. Since 2013, G20 countries pay attention to modify domestic and international tax rules to reduce tax avoidance, and then the OECD set up Base Erosion and Profit Shifting (BEPS) to help the government to promote tax rules and decrease tax avoidance opportunities. The recommendations suggested by the EPS project consists of three types: countries must comply with the minimum standards of tax rules; revised international standards should be included tax treaties and best-practice approaches (Miller and Popes, 2016).

2.3 Any other ways have been used by firms to avoid tax?

In order to generate more profits, MNEs have created many ways to avoid tax, but all tax avoidance skills are based on the location. Through establishing tax haven, manipulating prices and creating artificial structures to avoid tax. Furthermore, MNEs try to find the loopholes in the tax law, creating more subtle approaches to minimise tax. For example, some MNEs choose to found internal financing firms in low-tax rate jurisdictions to borrow money, and then loan it to their foreign subsidiaries. Consequently, subsidiaries can reduce their tax bills (Fair tax, 2013).

3. Literature reviewss

3.1 Theoretical literature

Transfer price can be identified as the price paid for the business transactions, no matter tangible assets, intangible assets or services among the companies is all under the control of the relevant parties (Abdallah, 2004).

3.2 Empirical literature

Some empirical studies have been recommended by some researchers to seek out managers' realised relevant importance of the different goals and restrictions in TP policies. Based on the surveys of 62 among the fortune 500 companies, Burns (1980) drew the conclusion that there are five necessary variable factors should be considered, including the condition of U.S. market, competitive levels in the overseas country, overseas subsidiary keeps rational revenue, taxation in the U.S. and the foreign country economic condition.

4. Methodological outlines

On the basis of the literature background of the problem, there are two common methods can be used in the research - qualitative and quantitative approach. Generally speaking, qualitative approach is analytical description proximity and sensitivity, while the quantitative approach is statistical generalisation distance and selectivity (Ryan et al, 2002). In terms of TP, on the basis of the ALP, several methods have been developed to decide the most appropriate transfer price among the large quantity of transactions. Therefore, the OECD guidelines have introduced the major five approaches which can be divided into two types: traditional transaction approaches and transactional profit approaches. The former published in 1979 contains comparable uncontrolled price approach (CUP), the resale price method (RPM) and the cost plus method (CP), the latter published in 1995 consists of transactional net margin method (TNMN) and the transactional profit split method (PSM). These five approaches all has its own drawbacks and strengthens, but identify which is the most proper method is depending on the character of the controlled transaction, the availability of responsible information and the level of comparability between the controlled and uncontrolled transactions. Traditional transaction approaches are identified as the most direct way because no matter commercial or financial activities are both relevant to the ALP. If traditional transaction method and transactional profit method both suitable to the equally reliable manner, MNEs are more preferable to choose the former (Kapnik, 2013). The following section will introduce these five methods briefly.

4.1 Comparable uncontrolled price approach (CUP)

The CUP method is used to compare the price charged for assets and services transferred in the uncontrolled transactions and price charged for the controlled transactions respectively. The fundamental demand of the CUP is the comparability among the different transactions and the comparability of the product will be strictly checked in the application of this method. The OECD has outlined a series of factors should be compared such as the quality of products, types of goods, availability and others (Lohse et al, 2012).

4.2 The resale price method (RPM)

According to the BPM which on the basis of the assumptions of all the products can do the gross margin comparable, the resale price will be declined by a proper gross margin generated by the franchiser in order to decide an appropriate arm's length price. On the process of transaction, unrelated affiliate corporations could find the proper gross margin via internal comparable. If not, just compare some similar goods of other individual franchiser gross margins, which belong to external comparable (Lohse et al, 2012).

4.3 The cost plus method (CP)

It looks similar for the CP and the RPM, but on the view of the manufactures sold similar goods to affiliated and unaffiliated firms. In order to find out the most proper arm's length price, the CP has added a proper cost comparing with the RPM, and then plus mark up to the expenses of the products. The problem with the CP is also similar as the RPM weakness, particularly in different products in different enterprise, whether the cost plus mark-up is similar and whether as a proper start point (Lohse et al, 2012).

4.4 Transactional net margin method (TNMN)

TNMN is used to check the net profits associated with the proper costs or assets that the taxpayer finds it out of the controlled transactions. Compared with the CUP, the profit level indicators are not easy to be impacted by the transactional differences in the TNMN. The profit level indicators will be impacted by the prices, because it will influence the business operation. The TNMN is suitable to use when two relevant parties have a series of transactions and one of the party control of the intangible assets which the arm's length price is hard to define(Kapnik, 2013).

4.5 The transactional profit split method (PSM)

The PSM is commonly used in the ex-ante or ex post profits, all the profits earned from the controlled transactions which will be spitted among all the related parties. This approach can be used to analysis more sophisticated business frameworks of TP. Both related companies of the transaction have provided valuable components, but it is hard to measure the total revenues because it has referred to the foreign subsidiaries. The major merit of the PSM is that it can provide solutions for highly integrated operations what traditional method cannot do it (Lohse et al, 2012).

5. Conclusion

The purpose of this report is planning a research design for a scientific case study, a study focus on transfer pricing (TP) and its effect on corporate tax. the definition and objectives of TP have been introduced, and three research questions have been proposed and solved based on the theory of the TP.

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