INTERNATIONAL

Increased Transfer Pricing Regulations: What about the Managerial Role of Transfer Pricing?

Martine Cools[1]

1. INTRODUCTION

This article is based on a recently completed dissertation on the management accounting role of transfer pricing in an international environment.[2] The research aims at narrowing the gap between "management accounting" and "fiscal" studies of transfer pricing. In studies on management accounting and control in multinational enterprises (hereinafter: MNEs), "tax" has been identified as one of a variety of aspects influencing the transfer pricing decision for MNEs, but in-depth studies on transfer pricing in MNEs remain lacking. Therefore this article will focus on the prominent role that taxes have started to play in the MNE's decision-making process concerning transfer pricing. Tax accounting articles have mostly approached the regulatory environment as an incentive for transfer pricing manipulation and income shifting, while pure tax law studies discuss the different regimes in national tax jurisdictions or the optimal transfer pricing approach.[3] International tax specialists have only very recently started to state in the literature that transfer pricing issues go "beyond fiscal matters".[4] These contributions are inspired by the management control systems literature, mainly by Eccles[5] and Emmanuel and Mehafdi.[6]

The social relevance of this topic is significant. Reference has been made to the following three reasons why transfer pricing has become an important issue in international taxation over the last few years:[7]

– the higher degree of globalization creates integrated business opportunities for MNEs through cross-border transfers, while corporate income tax systems remain nationally based;
– national governments react to this trend by formulating tighter regulations to reduce the opportunities for MNEs to manipulate transfer prices and reduce taxes; and
– due to the international conflict resulting from the different strategies of various national tax authorities to protect and enhance their revenue base, MNEs are under pressure to satisfy different tax authorities at the same time.

Recent surveys confirm the need to study transfer pricing in an international context. One example is the 2001 Ernst & Young transfer pricing survey.[8] It reveals that 85% of the responding tax and finance directors rank transfer pricing as the most important current international tax issue. The survey also indicates that transfer pricing audits are generating more adjustments now than in 1999, and nearly two-thirds of the survey respondents report that they were audited for transfer pricing somewhere in their organization in the past two years.

This article also aims at providing insights regarding the practical implications of the new transfer pricing regulations: do the new regulations reduce the distortions between the fiscal and managerial transfer prices? Or do the stricter regulations push MNEs to rely on fiscally-determined prices in their internal decision-making processes – prices that would not coincide with managerially useful transfer prices? In such cases, the reach of the arm's length principle is clearly overextended.[9]

Because empirical data on the use of transfer pricing for management purposes are scarce,[10] an elaborate set of data has been gathered in the context of this study. The information is highly triangulated, which means that different data sources are incorporated, such as interviews at various levels within the MNEs, published company information, internal company documents, and industry data. The author is very grateful for the cooperation received from the MNEs that were involved, especially at the company

1. University of Antwerp, Prinsstraat 13, 2000 Antwerp. Tel.: 32-3-2204107, fax: 32-3-2204799, e-mail: martine.cools@ua.ac.be. The author is a research associate at the IBFD, Amsterdam.

2. M. Cools, "International Transfer Pricing: Tensions between tax compliance and management control in multinational enterprises" (unpublished dissertation), University of Antwerp, September 2002.

3. S. Picciotto, "International taxation and intrafirm pricing in transnational corporate groups", 17 *Accounting, Organizations and Society* 8 (1992), at 759-792; D. Swenson, "Tax reforms and evidence of transfer pricing", *National Tax Journal* (2001), March, at 7-25.

4. T. Tsiopoulos, P. Gendron, and A. Uceda, "Beyond fiscal issues", 3 *Tax Planning International: Transfer pricing* 2 (2002), at 3-9; M.C. Durst, "Management versus tax accounting in intercompany transfer pricing", 31 *Tax Management International Journal* 2 (February 2002), at 95-103.

5. R. Eccles, *The Transfer Pricing Problem : A Theory for Practice* (Lexington MA: Lexington Books, 1985).

6. C.R. Emmanuel and M. Mehafdi, *Transfer Pricing* (London: Academic Press Ltd., 1994).

7. L. Eden, M.T. Dacin, and W.P. Wan, "Standards across borders: crossborder diffusion of the arm's length standard in North America", *Accounting, Organizations and Society* (2001), Vol. 26, at 1-23.

8. Ernst & Young, "Transfer Pricing 2001 Global Survey: Making Informed Decisions in Uncertain Times – Practices, Perceptions and Trends in 22 Countries" (December 2001). The Ernst &Young survey polled international tax managers at 638 MNE parent companies and 176 subsidiaries in 22 countries.

9. L. Eden, *Taxing multinationals: Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 1998), 757 pages.; H. Hamaekers, "Arm's length: how long?", 8 *International Transfer Pricing Journal* 2 (2001), at 30-40.

10. J. Van der Meer-Kooistra, "The coordination of international transactions: The functioning of transfer pricing systems in the organizational context", *Management Accounting Research* (1994), vol. 5, at 123-152; T. Boyns, J. R. Edwards, and C. Emmanuel, "A longitudinal study of the determinants of transfer pricing change", *Management Accounting Research* (1999), at 85-108.

where the in-depth case studies have been undertaken. The names of the companies are not disclosed in order to protect their proprietary information.

This article is structured as follows. The first two sections refer to the extant literature: the current fiscal environment is briefly described in 2., while in 3. the management control role of transfer pricing is focused on. This role of transfer pricing has been studied and discussed extensively in the management accounting literature. Taking into account the fiscal situation on the one hand, and the internal management function of transfer pricing on the other hand, a number of potential tensions between both roles of transfer pricing are presented in 4. The next two sections report on an empirical study that has been undertaken in a limited number of MNEs: in 5., the insights that were derived from the pilot study are discussed, while the insights that were gained through the study of a number of cases within one selected MNE are discussed in 6.

2. FISCAL ENVIRONMENT

Since the introduction of fiscal transfer pricing rules, the arm's length principle has been the central requirement; transfer prices between interrelated parties are acceptable for the tax authorities if the same prices would have been chosen for the same or a similar transaction between independent parties.[11] While arm's length continues to be the main principle, it cannot be denied that the fiscal requirements have become increasingly strict and detailed over the last decade. In 1994, the US Internal Revenue Service (hereinafter: IRS) published a new version of its transfer pricing regulations.[12] In doing so, the United States confirmed its position of being the most strict and demanding tax authority with regard to transfer pricing issues. Because of the strong voice of the United States in the OECD, the rest of the world has followed the US example quite closely. By July 1995, the OECD member countries had reformulated the OECD Transfer Pricing Guidelines (1995, 1996 and 1997), which have been implemented by a large number of national tax authorities. Since 1995, an increasing number of countries have been (and still are) preparing specific transfer pricing rules. They have also strengthened their administrative resources in this area.

For MNEs the revised OECD Transfer Pricing Guidelines, and especially their insertion in the legislation of a growing number of countries, have significant consequences. The companies must justify explicitly that their transfer pricing policy does not violate fiscal rules and that it is based on sound business grounds. The stricter fiscal requirements also entail a drastic increase in the administrative burden for the MNEs because extensive contemporaneous documentation needs to be provided. The documentation should contain a functional analysis and comparables. The better the documentation sustains the MNE's transfer pricing decision, the more the tax authorities are inclined to accept the policy. Increasingly, national tax authorities have started to monitor transfer pricing practice by means of audits. Moreover, a number of tax administrations, headed by the United States, have introduced considerable penalties when appropriate documentation is lacking. On the other hand, more and more tax administrations offer the possibility to MNEs to enter into advance pricing agreements (APAs), such that they can reach an agreement with the tax authorities before the transactions actually occur. APAs give them the certainty that a particular transfer pricing policy will not be disputed during a certain period of time, as long as the facts and circumstances do not change substantially.

3. MANAGEMENT CONTROL ROLE OF TRANSFER PRICING

Transfer pricing is not only relevant for MNEs, but more broadly plays a role in every multi-divisional firm. It has a management control function that is intensively researched in the management accounting literature. Although management control has been defined in many ways, the common idea in all definitions is that it is "the process of guiding organizations into viable patterns of activity in a changing environment".[13] The management control system is a purposive system that aims at providing useful management information that can influence the behaviour of "organizational participants so that some overall organizational goals are achieved".[14] The central control problem in organizations is to motivate managers to act so that, while pursuing their personal goals, they are also contributing to the fulfilment of organizational goals. When this is the case, "goal congruence" is achieved.[15] A crucial aspect of the management control system is that goal congruence is stimulated by influencing the behaviour of the actors within the organization.[16] One of the main instruments in this regard is the performance measurement and evaluation system within the company.

Over the last decades, many companies began to grow larger, to become more diversified, and to be organized into several decentralized divisions. These divisions began to operate autonomously and as such to be evaluated as responsibility centres.[17] Each individual centre is supposed to have the objective to help to implement the strategies of the organization as a whole. Several types of responsibility centres can be distinguished:[18,19]

– a responsibility centre is referred to as an expense centre if only its costs are measured for its evaluation, and as a revenue centre if only its revenues are measured;

11. The arm's length principle is incorporated in Art. 9 of the OECD Model Tax Convention.

12. US transfer pricing rules are incorporated in Para. 482 of the IRS Regulations and related paragraphs.

13. A. Berry, J. Broadbent, and D. Otley, *Management Control: Theories, Issues and Practices* (London: Macmillon Press, 1995), at 4.

14. Id., at 4; D. Otley, "The contingency theory of management accounting: achievement and prognosis", 5 *Accounting, Organizations and Society* 4 (1980), at 413-428.

15. R.N. Anthony and V. Govindarajan, *Management Control Systems* (Chicago: Irwin, 1995).

16. R.N. Anthony, *The Management Control Function* (Boston: Harvard Business School Press, 1988).

17. A responsibility centre is an organizational unit headed by a manager who is responsible for its activities (Anthony 1988, at 13).

18. Criteria for deciding which type of responsibility centre is appropriate for a given type of activity are discussed at length in the Management Control System literature (Anthony 1988).

19. Anthony, note 16; Anthony and Govindarajan, note 15.

– a profit centre is evaluated on both its costs and revenues. A strategic business unit (hereinafter: SBU) is considered as a profit centre, which often consists of a number of smaller profit centres; and
– investment centres are profit centres in which the amount of assets employed is equally taken into account for the evaluation of these centres. Following the literature regarding management control systems, investment centres are not discussed as a separate category any further, but are considered as a particular type of profit centre.

The degree of control that a manager of a profit centre has, is quite high as compared to the control basis in expense and revenue centres; the idea of a profit centre is that it is run more or less as a separate business and managers have significant discretion over both the unit's revenues and costs. However, the amount of actual autonomy of the managers varies significantly and the management control system can be used to communicate the restrictions on autonomy imposed by top management. In any case, the profit reported at the profit centre should be perceived as fair by the managers. In broad terms this means that the higher the amount of profit reported is, the better the profit centre has performed. A disadvantage of establishing profit centres is that the competitive spirit they create can have dysfunctional consequences to the organization as a whole; profit centre managers may refuse to cooperate with other responsibility centres because they are evaluated on their own result, which may impede goal congruence from being reached.[20] It is also logical that the benefits of the profit centre concept should be greater than the additional record keeping and the other costs involved, compared to other forms of responsibility centres.

When responsibility centres trade or transfer goods and services amongst each other, transfer pricing comes into the picture; the price for intra-firm transactions has an important impact on the costs and revenues recorded by autonomous subunits.[21] Within multi-divisional firms, transfer pricing is an instrument that at the same time enhances differentiation as well as integration between the different divisions.[22] On the one hand, transfer prices enable the creation of decentralized responsibility centres. Decentralization is valuable because it increases the development and motivation of management and it enables the overcoming of the limited processing capabilities of centralized management.[23] On the other hand, coordination between divisions and central management can become difficult and the subunit manager could undertake actions that are detrimental to overall firm profits. From this perspective, transfer pricing provides a mechanism to coordinate the activities of the autonomous divisions; it can be a means to communicate relevant information to guide or influence managerial decisions, e.g. for evaluating the profitability of products. Because transfer prices determine divisional profits, they can also lead to coordination through achieving a proper evaluation of the divisions involved, i.e. to evaluate the effectiveness of managers.

In sum, transfer pricing is crucial within multidivisional enterprises because transfer prices are used to measure the value of goods or services that are transferred between responsibility centres in an organization. Transfer prices therefore have an influence on the profitability of these centres. In literature regarding the management control systems, transfer pricing is primarily considered not as an accounting tool but as a behavioural tool to motivate managers to take goal congruent decisions; the behaviour of the responsibility centre managers involved on both sides of the transfer is influenced by the way in which transfer prices are structured. The transfer pricing system should therefore provide appropriate information about relevant company revenues and costs. Moreover, it should be sufficiently easy to understand and administer.[24]

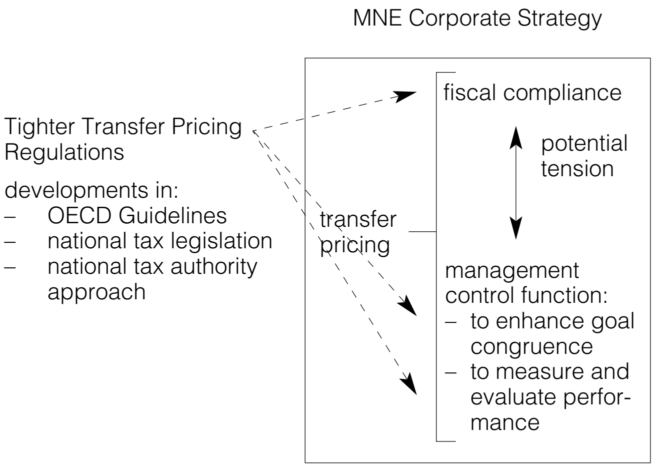
4. RECONCILING THE TAX AND MANAGEMENT CONTROL ROLES OF TRANSFER PRICING

The previous section of this article considered the management accounting perspective, along which transfer pricing is considered as a part of the management control system of the multi-divisional company with two main objectives: the promotion of goal congruence and the design of a suitable system for performance measurement and evaluation. The different roles of transfer pricing for the management control system give an indication of the complexity of the issues involved. In a multinational environment, the complexity is even greater; the transfer pricing policy must satisfy an additional set of goals, including profit maximization; cash flow, sales, and marketing goals; minimizing taxes, duties, and tariffs; and achieving socio-political goals related to financial restrictions, currency fluctuations, and host country relations.[25] For a description of recent developments in the fiscal requirements for international transfer pricing, see 2.

In an international environment, the design and use of transfer pricing as a management control instrument seem to be significantly restricted. In soundly managed enterprises, where the transfer pricing policy continues to be driven by business motives, tax variables have started to play an increasing role. The growing spread of specific legislation after 1995 and the stricter fiscal transfer pricing approach are increasingly forcing MNEs to reconcile their internal transfer pricing objectives with the fiscal requirements. This leads to the following question: *What is the influence of the tighter fiscal requirements on the management control function of transfer pricing?* To get more insight into this issue, a number of selected MNEs were studied. The pilot study with four large MNEs is discussed in 5., while the conclusions from a number of in-depth

20. Anthony, note 16; Anthony and Govindarajan, note 15.
21. Eccles, note 5.
22. D.J.H. Watson and J.V. Baumler, "Transfer pricing: a behavioral context", *The Accounting Review* (July 1975), at 466-474; S. Grabski, "Transfer pricing in complex organizations: a review and integration of recent empirical research and analytical research", *Journal of Accounting Literature* (1985), at 33-75; W. Kim and R. Mauborgne, "Making global strategies work", *Sloan Management Review* (Spring 1993), at 11-27.
23. Top management expects that decentralized profit centre managers will rationally try to optimize divisional profits.
24. Eccles, note 5; Anthony and Govindarajan, note 15.
25. R.A. Leitch and K. S. Barrett, "Multinational transfer pricing: Objectives and constraints", *Journal of Accounting Literature* (1992), Vol. 11, at 47-92; J. Dunning, "Toward an eclectic theory of international production: some empirical tests", *Journal of International Business Studies* (1980), Vol. 11, at 9-31.

case studies within one of these MNEs are presented in 6. In advance, a clear influence of the regulatory developments was expected in terms of the MNEs' fiscal compliance. In addition, the fiscal requirements were expected to put pressure on the role of transfer pricing to enhance goal congruence, and on its role within the performance measurement and evaluation system of individual managers. The illustration below depicts the different aspects of this topic, and reveals potential tensions between the fiscal and management control role of transfer pricing.



5. PILOT EMPIRICAL STUDY

In 1999 and 2000 a pilot study was undertaken to gain the first insights into the research topic in practice. This pilot consisted of exploratory interviews with fiscal transfer pricing specialists in MNEs. Four large MNEs were selected. Larger MNEs were chosen because they became aware of the importance of the changes in the fiscal requirements over the last decade – in contrast to smaller corporations, which have only started to adjust their transfer pricing policy over the last few years and could therefore not be used for this study.[26] The research could not be limited to one particular sector because of the sensitivity of transfer pricing issues and the reluctance of top management to be compared to their competitors.

The four companies of the preliminary study therefore belong to different sectors. Three companies (A, B, and C) can be classified as being in the manufacturing environment; the other company (D) provides services. Companies A and D are active in the business-to-business market, while the B and C are present both in the business-to-business market and in the individual consumer market. A, B, and C are large, multidivisional MNEs. In contrast, D is smaller and not structured into multiple product divisions. Moreover, A, B, and C are "older" companies, having been engaged in cross-border transactions for a long time. D is quite young, and has only begun to engage in international transactions during the last decade. The selected companies did not have major problems with the local tax authorities. In addition, they only used one set of books for transfer pricing. Transfer pricing experts in the corporate tax department of each selected MNE were interviewed. In companies A and C, the interviews were held at the divisional level, with the tax directors of a major product division. For companies B and D, the interviews were held at corporate level.

The main conclusions of the preliminary study can be summarized as follows.[27] When being interviewed about fiscal compliance, all interviewees focused on the pressure on their companies to comply with the demanding rules. The corporate and divisional tax department had to prepare extensive documentation, including a functional analysis and comparables. Moreover, they had to prove that the MNE's transfer pricing system respected the transfer pricing methods that were allowed by the tax authorities. Setting up a detailed transfer pricing document was not sufficient; in order to provide comparables, high costs had to be incurred. The in-house tax department, external brand lawyers, and external consultants were resorted to, in order to make sure that the fiscal requirements were respected. Despite the MNEs' efforts, much uncertainty remained about the behaviour of the tax authorities, as well as regarding the proper interpretation of the regulations and concerning the appropriate amount of documentation. At the time of the interviews, three of the four companies were still working out how to comply with the requirements of the OECD and local governments. The other company, B, had already set up an appropriate and detailed transfer pricing policy document. In other words, the tax managers, especially of the older, manufacturing MNEs, incurred high expenses related to compliance. There were not only the internal costs and efforts, but also the high costs incurred to provide suitable comparables that had to belong inevitably to the fiscal documentation in an increasing number of countries. The costs related to the comparables search were particularly burdensome because they could not be related to any direct business need.

With relation to the management control system, it was found that all four MNEs used centrally imposed transfer pricing policies within their product groups. This means that the price setting autonomy of the responsibility centres involved was close to zero. A clear interaction between the fiscal role and the management control role of transfer pricing has been observed; in the four cases the fear of audits and penalties had a large influence on the choice of the transfer pricing policy. Strategy objectives could often not be fulfilled using transfer pricing, but instead needed to be worked out through alternative mechanisms. Moreover, the role of transfer pricing for performance measurement and evaluation was significantly reduced. This transfer pricing policy could not be developed solely by the business people in the product divisions, but was guided and followed up by corporate management.

Corporate and product division tax managers were not always aware of the exact implementation of the transfer

26. In the search for suitable MNEs for this study (in the period of 1998-99), the small and medium-sized MNEs that were addressed could not be used because most of them had not yet reacted to the stricter transfer pricing regulations.
27. An elaborate description of the observations and analyses made, falls outside of the scope of this article.

pricing policy at the lower levels, logically due to the task division in MNEs. This observation indicates that it was indispensable to involve more people than only the tax managers in the discussion, especially because the influence of transfer pricing on management control was investigated. One MNE was selected for the next phase of the research. Operational, financial, tax and human resources managers were interviewed at different levels of this MNE. The major conclusion of the exploratory study is that the stricter fiscal rules indeed have a major influence on the management control system function of transfer pricing in MNEs. The following in-depth study of a number of transactions in the chosen MNE was used to gain insights as to how this influence works and how both roles of transfer pricing have to be understood.

6. IN-DEPTH EMPIRICAL STUDY

Company B was selected out of the four original MNEs because it complied with the fiscal requirements in the most proactive way. The corporate tax department gave detailed information about its well developed transfer pricing policy and documentation. Therefore, B was the most useful subject to go one step further than compliance, to investigate the interaction between tax aspects and management control. The chosen MNE was a large, highly divisionalized manufacturing company, operating in both the business-to-business market and the final consumer market. Moreover, this case study took place in one product division, the most global one, characterized by the most elaborated transfer pricing policy and by the largest variety of transactions. The activities of the product division were focused on the industrial, business-to-business market. The study was limited to one product division in order to come to a more profound understanding. Within this setting, a multi-case investigation took place; the transfers of three different types of products and of a number of services were studied within the selected product division of the chosen MNE.

As in the preliminary study, the main method to gather the information consisted of in-depth interviews. This time, however, the study was not limited to the corporate level, but the researcher was able to obtain access to 23 persons at many levels in the organization; corporate, product division and subunit managers could be interviewed. In addition, a wide variety of managers were involved; controllers, general managers of production plants, human resources managers, logistics managers, internal tax auditors, quality managers, industrial planners and tax people. In this way, an overall picture could be formed about both the tax and management control aspects of the MNE's transfer pricing policy. Triangulation was an important aspect to increase the objectivity, reliability and internal validity of the analysis. This means that apart from gathering interview data, a large number of archival and other documents were studied (internal documents such as pricing models, organizational organigrams, official transfer pricing documentation, balanced scorecards, performance agreements and financial statements).

The main conclusions of the in-depth multi-case investigation, building upon the preliminary study, are the following.[28] The most direct influence of developments in the tax rules was felt at the corporate strategic level. Because of its size and success, the investigated company felt it could be one of the first targets of transfer pricing audits by the national tax authorities. In order to avoid economic double taxation, the transfer pricing policy was set up in a transparent and understandable way. The MNE also agreed with the requests by the tax authorities for a clear and transparent transfer pricing policy; management understood the need for documentation and experienced the documentation requirement as a positive development. The transfer pricing documents could help the tax authorities to obtain better insights into complex businesses under investigation, as well as to help the authorities to better understand what was going on. For companies that had a fair transfer pricing policy, documentation was considered as a useful instrument to prove to the tax authorities that the transfer pricing policy was motivated by real business functions. In addition, the MNE found it important to make sure that its transfer pricing policy was consistently implemented.

However, the company felt that the interpretation of the OECD Guidelines and the emphasis on the rules could significantly differ across national tax authorities. It meant that for this MNE, the compatibility between the corporate transfer pricing policy and the different requirements was felt to depend on the degree of consensus in terms of transfer pricing matters between the national tax authorities involved.

A remarkable observation was that distortions between the fiscal and management control roles of transfer pricing did not seem to be created by the fact that fiscal transfer pricing methods were imposed. Managers within the MNE reported how they felt that the flexibility of the tax authorities had increased over recent years. The interviewed tax specialists confirmed that when the chosen prices were influenced by a clear functional analysis, the methods were indeed accepted by the tax authorities. In other words, a better understanding of business economics by the tax authorities had led to a better interpretation of the arguments used by the MNE in the functional analysis.

However, it was also determined that the tax regulations created a tension between fiscal compliance and the management control role of transfer pricing. The requirement to have extensive documentation available and in accordance with practice at every moment, seemed to increase the rigidity of the transfer pricing system. The experience was that it was difficult to have every aspect of the transfer pricing policy documented in detail, while for business reasons, pricing decisions should be able to be taken in a quick and dynamic way. This contemporaneous documentation requirement created pressure on the internal transactions that, under pure business circumstances, were governed in a more flexible way.

The study of different types of products led to the conclusion that the pressure from the fiscal requirements on the

28 As for the preliminary study, an elaborate description of the observations and analyses made, falls outside of the scope of this article.

internal managerial function of transfer pricing depended highly on the strategic focus of the product being transferred. The requirement to fulfil the arm's length principle on the internal governance needs of the transactions was especially difficult to comply with for unique processes and products. Instead, the pressure was significantly less for standard products that are available on the market and for which the MNE focused on cost competitiveness. Still, in the cases under investigation, the production and transfer of standard products was kept internal for strategic reasons; these standard products provided the basic knowledge for research and development of the unique products. It meant that standard processes that were kept within the MNE could have a different meaning than the same processes on the market. In this way, comparability with outside market products decreased.

With the analysis of the cases, it became clear that changes in the transfer pricing tax rules led to significant adjustments in the functioning of the management control system over a longer period of time; a tension was created between the need for centralization and structure of the transfer pricing policy for tax reasons on the one hand, and the need for decentralization for management control reasons on the other hand. Entrepreneurship of the divisions was reduced because, due to the stricter transfer pricing rules, divisional managers were hardly involved in pricing and sourcing decisions. Moreover, their ability to control their unit's financial results was low. Within the MNE, this pressure could be mitigated by using alternative performance measures. Since 1998, the balanced scorecard (BSC) had been available for evaluating employees. This scorecard emphasizes different aspects of performance on which the manager under evaluation is scored; the measures focus on internal business processes, financial measures, learning and growth measures, and customer satisfaction and service measures.[29] By increasing the weight of non-financial performance measures, the influence of centrally imposed financial transfer prices is reduced in the performance evaluation system for the manager.

A major problem was created by the fact that for tax reasons, all divisional units had to be treated as profit centres. However, for management control reasons the organization could benefit from treating its divisional units as different types of responsibility centres. (See 3.) In this way, tax rules again put pressure on the management control function of transfer pricing, and companies have to come up with solutions. In the investigated MNE, the product division was organized along a matrix structure. In a matrix, each organizational unit has a place along two axes, the functional axis and the product axis. Within the MNE, the functional axis was organized along the different legal entities that followed the business flow. Hence, this was the axis that was relevant for tax issues. The management control system, however, focused on the product axis. Along this axis, all units were classified as different responsibility centres, and also evaluated according to the type of responsibility centre they were. This organizational structure and the related set-up of the transfer pricing policy were crucial for the product division to be able to cope with the tension between the tax role and the management control systems role of transfer pricing.

7. CONCLUSIONS

This transfer pricing study is situated at the nexus between the management control and international tax literature. In the accounting literature, transfer pricing is considered as a part of the management control system of the company with two main objectives: the promotion of goal congruence and the provision of a suitable system of performance measurement and evaluation. In an international environment, MNEs have to cope with fiscal rules that have become significantly more strict and detailed. A large number of countries have followed the 1995 OECD Guidelines, which were revised as a reaction to the severe US regulations implemented in 1994. Today, compliance with the fiscal rules on international transfer pricing has become a dominant concern for the corporate tax departments of MNEs. The research question was refined based on a literature review of both the management accounting and the international tax literature. Moreover, the OECD Guidelines and a number of national tax rules, especially the severe US rules, have been investigated. Consequently, this article has focused on the following research question: *How do MNEs cope with the pressure of the fiscal requirements (including compliance requirements) on the management control function of transfer pricing?*

The empirical findings confirm that, because of the real threat of audits and penalties, the tax requirements of transfer pricing play a prominent role in the MNE's decision-making process. Several authors have begun to wonder about the implications of this international transfer pricing environment:[30] do the stricter regulations reduce the distortions between the fiscal and managerial roles of transfer pricing, or do they push MNEs to use fiscally determined transfer prices that are at odds with useful managerial prices? Based on the insights from the in-depth case studies, some tentative answers can be provided. Further research involving a wider group of companies from different sizes and sectors is necessary to improve the reliability of the observations made.

As suggested in 6., the stricter fiscal rules have not created distortions between the fiscal and managerial transfer prices. A first reason is that a larger group of transfer pricing methods is described in the revised 1995 OECD Guidelines; the transactional profit methods are included to cope with situations in which the traditional transactional methods are not appropriate. Second, tax authorities have become more flexible in accepting a wider variety of methods; they tend to accept the OECD methods implemented in particular MNEs as long as a clear functional analysis is provided. It has been observed in the cases that the functional analysis incorporates a number of concepts that also make sense for the set-up of the transfer pricing policy in a management control environment. On the other hand, the stricter approach by the local tax authorities has significantly increased the cost of compliance for MNEs. The administrative costs for the companies are clear; contemporaneous documentation needs to be provided. Comparables searches need to be undertaken, and in most cases

29. Kaplan and Norton, *The Balanced Scorecard* (Harvard Business School Press, 1996).
30. Eden, note 9; Hamaekers, note 9.

the MNE does not have access to relevant information, nor does it have the expertise to provide suitable comparable prices and margins. This means that external consultants and lawyers usually have to be involved.

However, the analysis and conclusions of this study indicate that the cost of compliance goes beyond the administrative costs; the fiscal environment imposes a large cost on MNEs in the sense that the tax requirements hinder the optimal use of transfer pricing within the management control system. To comply with the arm's length principle, all divisional units should be set up as profit centres. But at the same time, the impact and potential negative effects of the tax rules are so threatening that corporate management cannot take the risk to leave transfer pricing issues in the hands of divisional managers. The consequence is that large MNEs are forced to keep all transfer pricing decisions centralized. The case studies revealed that central management and the corporate tax department have a major say in the sourcing and pricing decisions related to intra-firm transactions. Therefore, the controllability and entrepreneurship of the managers in the profit centres are reduced. This situation leads to the question of what is the remaining significance of organizing an MNE into profit centres.

This conclusion seems worthwhile to be considered by the OECD and the national tax authorities. They should realize that preventing MNEs from misbehaving tax-wise imposes a cost on MNEs in terms of the optimal use of the management control system. In this sense, the arm's length principle seems to be indeed overextended. While the arm's length standard serves as an international yardstick towards correct and fair transfer pricing in each jurisdiction, the tax authorities should handle it with care. This thought brings the discussion again to the usefulness of the arm's length principle, which falls outside of the scope of this article.

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