

TRANSFER PRICING UNDER A DYNAMIC TARIFF SCHEME

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Abstract. A dynamic tariff scheme is proposed to deal with the transfer pricing practices among subsidiaries of a MNE. The tariff, using only accounting records of sales and the previous period's tariff amount, builds in a tariff concession in every period that is shown to incentivize the firm to truthfully report costs.

Keywords. Transfer pricing; tariff; MNE; incentive compatible; nonlinear system

AMS (MOS) subject classification: 49N30

1 Introduction

A transfer price is the price associated with the exchange of goods or services across borders between subsidiaries of the same multinational enterprise (MNE). It is a pricing strategy most often used by MNEs to reap extra after-tax profits. For example, when the subsidiaries of a MNE are incorporated in countries with different tax rates, a MNE has the incentive to set the transfer price to shift profits from a high tax country to a low tax country². Empirical evidence of such pricing behavior is abundant since early 1970s. Horst (1971) and Copithorne (1971) for example, have comprehensive reviews of early work on evidences of transfer pricing practices by MNEs.

Although the transfer pricing phenomenon is largely an internal accounting issue, and seems to have no immediate bearing on production and consumption decisions, it does cause the government to suffer huge losses of tax revenues. If the tax revenue is counted as part of the consumer surplus that would be spent on social projects benefiting the general public, there is no doubt that a firm's extra profit seeking via transfer pricing is an unethical business practice that should be prevented.

In the US, IRS Code Section 482 requires that transfer prices between related entities of the same parent company be at the arm's length. In practice, the Code repeatedly mandates the step to "locate two unrelated

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² In this paper, we only consider the tax structure of corporate profit taxes. The issue of sales tax or value-added tax complicates our analysis, and is the subject of future research.