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Advisor: Professor Guttorm Schjelderup

# Transfer pricing practices in Norwegian multinationals

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A comparison of theory and practice

By  
Eyvind Alexander Pedersen

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double marginalization, agency theory, transaction cost economics

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# Executive summary

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During the last two decades there has been an increasing focus on transfer pricing both from firms and authorities. Today, many CFOs identify transfer pricing as their most important tax issue, and more and more countries realise that there are considerable tax revenues that could be collected from a stricter enforcement of the transfer pricing legislation. When looking at the academic literature, however, one will see that transfer pricing is an issue that spans much wider than the firm's tax report, and, if used correctly, it can be a very efficient tool for management control. With this background, this master thesis sets out to study the differences between the advice given about transfer pricing in the academic literature and the practices that can be observed in Norwegian multinational firms. Emphasis is put on how the practices are impacted by tax legislation.

Due to the current globalisation, transfer pricing is an issue that constantly increase in importance. The world is becoming more interconnected and both the number of multinational enterprises and the level of intra-firm cross-border trade are growing. This trend makes it both interesting and important to get an understanding of how firms approach the issue of pricing their internal transfers, in order to identify improvements that could increase the efficiency of firms and legislation.

In the first part of this master thesis we conduct a literature study to get a proper understanding of the transfer pricing problem and its implications. In the second part we turn our attention to the transfer pricing practices in Norwegian firms. Here, we first create a set of research hypotheses about the transfer pricing practices in Norway based on the literature study and former empirical studies of transfer pricing practices. We then test our hypotheses through a survey that is sent out to four transfer pricing advisory consultants. The consultants answer the survey based on their observations from more than 150 Norwegian firms. The result being that five out of the six research hypotheses are confirmed or partly confirmed. In the third and final part, the results from the study of practices are compared with findings from the literature study, to say something about the differences between theory and the practices in Norwegian firms.

The results of our analyses show that, when it comes to transfer pricing, there are considerable differences between the advice given in the academic literature and the practices observed in Norwegian multinationals. While theory suggests that a firm should use transfer pricing for both strategic optimisation, including management control, and tax optimisation, the study of practices shows that firms in Norway almost exclusively are concerned with complying with the tax legislation. Thus, our results show that tax legislation has a fairly big impact on the observed practices in Norwegian firms.

Important to notice here is that the transfer pricing legislation in Norway is quite new, and my research suggests that Norwegian firms could have had an even less structured approach to transfer pricing before the new legislation came into effect in January 2008.

When looking at the countries that are leading within transfer pricing, we can see that they have had legislation in the area for more than a decade. The development in these countries suggests that as time passes by and firms mature in their view and understanding of transfer pricing, strategic considerations are also adopted as a part of their transfer pricing policy. This leads us to believe that, in the long term, Norwegian firms will also adopt a more mature approach to transfer pricing, an approach that is more congruent with the advice given in the academic literature. As a conclusion to this master thesis, I make five proposals for improvements that will help accelerate the maturation process for Norwegian firms.

# Preface

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Writing this master thesis has been both an interesting and challenging experience. There have been days with very good progress, and days with negative progress. From the process of writing this thesis I have gained a lot of new insights both on a professional level and on a more personal level, and in the end I must say that I have enjoyed working on a project of this scale by myself. Transfer pricing is a topic that spans across several different fields of economic theory, and it is a topic of increasing importance in the global business and commerce. I hope that this thesis will contribute positively both as a source of information and as a motivation for positive change and future research.

Although I have been writing this thesis individually, I have had a lot of good help and advice along the way. In relation to this there are a number of persons I would like to highlight and show my appreciation to. I would like to give my thanks to:

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If you have any question about the contents or sources of this thesis, or if you want to discuss transfer pricing practices in Norway, please contact me on [Eyvind.pedersen@gmail.com](mailto:Eyvind.pedersen@gmail.com).

Bergen, December 9<sup>th</sup> 2011.

Eyvind A. Pedersen

# Transfer pricing – a central part of the management control system

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In 1983, Bellcore, the support organisation for the seven regional holding companies of U.S. AT&T, introduced transfer pricing as a way of allocating costs to its client companies. It started out well, but after a couple of years the transfer prices of certain support services had soared. E.g. the price per page for a typed document from the word processing department (secretary service) had risen to \$50. Although this was in the early 80's, \$50 was still a very high price for such a service, and, more importantly, it was higher than what external agencies would charge for the same service. The high transfer prices created incentives for the researchers and engineers (highly paid employees) to perform the support services themselves, in order to avoid the considerable strain the high transfer prices had on their business units' performance. Needless to say, this distortion led to an overall productivity drop for the whole company (Kovac & Troy, 1989). Something was obviously wrong at Bellcore, and, when analysing the situation more closely, managers at Bellcore found that the main reason behind this loss in productivity was not inefficiency in the service departments, but an unfair (non-optimal) allocation of costs. Bellcore was not using the true cost driver when allocating overhead costs to the different departments. By improving the method of cost allocation, total costs were cut by 19 % at the service centres suffering from the problem with too high transfer prices (efficiency improvements reduced costs by another 12 %). These cost reductions returned the transfer prices to a competitive level for the support services in question. Although the new cost allocation method led to cost and transfer price increases at some service departments, Bellcore's managers accepted the changes because of the increased fairness in the new system (Kovac & Troy, 1989).

Another example of the impact of transfer pricing came in September 2006, when one of the largest tax disputes in U.S. history was settled with GlaxoSmithKlein (GSK, pharmaceutical company) paying the American fiscal authorities \$3, 1 billion. At the core of this dispute was the internal transfer price charged for one of GSK's blockbuster drugs, which effectively divided the profits from the U.S. market between the U.S. and the British subsidiary of GSK. The product was developed in the U.K., but had most of its sales in the U.S. market. The American authorities did not agree with the transfer pricing practices of GSK and demanded that a larger share of the profits were taxed in the U.S., leading to a considerable strain on GSK liquidity. (The Economist, 2004; Mortished, 2006)

These two examples highlight the two main challenges with transfer pricing, avoiding double marginalization on transactions in a vertically integrated organisation (Bellcore) (Tirole, 1988; Pindyck

& Rubinfeld, 2009) and profit shifting/tax evasion in multinational companies (GSK) (Schjelderup & Sørsgard, 1997). They also show that transfer pricing has been and still is a very important topic within management control and industrial organisation. Operating with wrong transfer prices can, as we have seen from the two examples, both be very costly and lead to distorted incentives within a firm.

When looking at the effects of the on-going globalisation, a concept used to describe how the world is being tied closer and closer together (eNotes, 2011), transfer pricing is becoming increasingly important. In 2004, internal transfers within multinational companies accounted for as much as 60 % of the world's international trade, and since the early 1990's the number of multinational enterprises (MNEs) has almost doubled, and there has been an even larger increase in their number of foreign subsidiaries (size) (The Economist, 2004). Thus, it is not difficult to imagine that globalisation has had a huge impact on the use of transfer prices, as well as the way firms are organised, operate, and on the way goods and services are flowing across borders. In our globalised world, transfer pricing is usually a topic that comes up in relation to taxation issues, such as the case with GSK. This is because it is usually these cases that get media coverage due to the often vast sums of money involved. In addition to being one of the most important tools for optimising a firm's tax structure and complying with tax legislation, transfer pricing has also become an important tool for management control (e.g. cost allocation and performance management) in a world where decentralisation is becoming an increasingly popular strategy for competing in a globalised environment.

Transfer prices are the prices charged for goods and services internally in a firm between different departments, divisions or subsidiaries (BusinessDictionary.com, 2011; Pindyck & Rubinfeld, 2009; Horngren, et al., 2009). It was first introduced as a tool for decentralisation of decision-making authority in a vertically integrated organisation, transforming internal cost (or service) centres into internal profit centres (business units). Thus, making internal cost centres, such as an internal manufacturing department, much more efficient by improving the department's resource utilization and management incentives through a more result oriented focus (Dean, 1955; Helden, et al., 2001). Today, as we have seen above, transfer prices are also used to reduce tax liability in multinational enterprises (MNEs).

According to Hirshleifer, the optimal transfer price (TP) is considered to be the price of the good or service as if it was traded in a free/perfect market (price = marginal cost) (Hirshleifer, 1956). In most cases, however, this price is difficult to determine, and an approximation method have to be used. The three most used methods for approximation to the optimal transfer price are market-based prices, cost-based transfer prices and negotiated transfer prices (Horngren, et al., 2009). The preferred method is the market-based approach, as this is a simple method that yields both a price

which comes in close to marginal cost and a price which is in line with the arm's length principle (OECD, 2010), which is important with regards to taxation issues. Unfortunately, there are a lot of markets where the competitive situation is characterised by players with considerable market power. This is often the case for goods and services that are traded internally within firms, e.g. intermediate goods. In these cases the market price will be higher than marginal cost, and a market-based transfer price will therefore not be a good approximation to marginal cost (Pindyck & Rubinfeld, 2009). Thus, one will have to apply one of the other two methods for finding a transfer price which comes in closer to the optimal price. Negotiations between the transacting parties (divisions, departments, subsidiaries etc.) can be used as some sort of approximation to the transaction between the buyer and the seller in an open market, and thereby lead to a "market price" of some sort. The transfer price can otherwise be based on the internal supplier's costs of providing the good or service in question.

The interesting thing with transfer pricing in the academic literature is that you will find a chapter about transfer pricing in any proper management accounting textbook such as Horngren and Datar's "Cost accounting" (Horngren, et al., 2009), but the discussion of transfer pricing stops with a brief reference to the arm's length principle (the main principle for how to divide profits from and calculate tax on internal transfers) and a small discussion of international transfer pricing. There is fairly little information about how tax legislation and taxation issues impact transfer pricing, something which have given birth to a global multi-billion dollar industry for transfer pricing and international tax advisory. From what we can see from the globalisation trends, it is exactly these tax issues that business students are likely to encounter when they start working as controllers, auditors, accountants or the like. According to KPMG and Ernst & Young (two large advisory companies), transfer pricing and related taxation issues are also on top of the agenda of the CFO in any multinational company (Andresen & Basteviken, 2011; Larsen, 2011). Therefore it is, in my opinion, a little bit peculiar that there is not a bigger focus on taxation in the academic literature used for teaching purposes.

This is why this master thesis will try to shed a little more light on the impact different transfer pricing systems can have on multinational organisations with regards to resource utilisation and performance management, and how tax legislation impacts the choice of transfer pricing systems. Several interesting issues arise from this focus. First, you have the effects of the different ways of calculating/finding the transfer price, which impacts both profit centre performance and management incentives. Secondly, you have the effects created by the tax authorities, who impose regulations regarding which transfer prices that can be used, and, thereby, indirectly affecting resource utilization and performance management within multinational firms. Lastly, you have the

impact created by central management when designing the context (i.e. the management control system) of the transfer pricing system based on the organisation's strategy and environment.

All these issues and the relationship between them make transfer pricing an interesting topic to study. The current globalisation and growing control of transfer pricing practices by auditors and authorities are adding yet another dimension (Ernst & Young, 2010). In this thesis, I will first conduct a literature study, and then continue with a study of transfer pricing practices in Norwegian multinationals. Norway is a small open economy as well as a "high cost" country, and Norwegian firms are, thus, often involved in transactions with foreign counterparties, be it internally or externally, which are subject to scrutiny by tax authorities. After having conducted the literature study and the study of the practices in Norwegian multinationals, the purpose of this thesis will be to determine whether or not Norwegian multinational firms are using the transfer pricing systems suggested by the management accounting literature, as well as to see if tax regulation has any impact on their choice of transfer pricing system and transfer pricing practices. The proposed research question for this master thesis is therefore:

**What are the differences between the advices given in the transfer pricing literature and the transfer pricing practices in Norwegian multinationals, and how are the transfer pricing practices impacted by tax legislation?**

There has been relatively little research on transfer pricing practices in Norway and in general, and most of the academic literature focuses on more theoretical approaches where simplified models are used to study the effects of different transfer pricing systems and the effects of tax legislation (Rossing & Rohde, 2010). This research has given many important insights with regards to profit maximisation and optimisation of transfer prices, but it does not say much about how companies are solving the transfer pricing puzzle in real life. When it comes to studies of transfer pricing practices the main contribution is Tang's and Eccles' work on the topic. Eccles has created a framework based on observed practices, but, as he is more concerned with the organisational aspects of transfer pricing, he does not consider taxation issues. Tang, on his side, has conducted multiple empirical studies. When it comes to taxation issues and transfer pricing practices, tax advisors such as KPMG and Ernst & Young are among the main contributors, but their perspective is more concerned with minimising tax expenses and tax compliance than maximising overall profit. The problem of maximising total profit through transfer pricing when subject to tax have been studied quite extensively by Schjelderup and other scholars theoretically, but there are no studies about how this theory works in practice.



Based on the findings from studying the proposed research question, this thesis will suggest improvements that can increase resource utilisation and strengthen the alignment of incentives between managers and owners of Norwegian multinational firms while still complying with tax legislation.

The background for the literature study is organisational theory, theory on transaction cost economics, theory on the double marginalisation problem, and theory on the implications of tax on transfer pricing and tax regulations. The study of transfer pricing practices will be based on conversations with and surveys answered by managers in the big tax advisory companies such as KPMG and Ernst & Young, and the Norwegian tax authorities.

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# 1. Literature study

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A transfer price is merely one of the properties of an internal transaction, and the transfer pricing system or policy is just one of the pieces in the management control system. Although only a small piece, the transfer price is central in a number of different contexts, e.g. management incentives, profit centre performance, decentralisation, and vertical integration in a firm to name a few. Transfer pricing is, thus, a multi-disciplinary topic and many scholars have touched upon it from different angles. This literature study will provide an overview of the main discussions in the academic literature concerning transfer pricing, before we in the next part will move over to study the transfer pricing practices in Norwegian multinationals. The literature study will be divided into two sub-parts, first it will give an overview of the general literature on transfer pricing, and secondly it will dive deeper into the part of the literature focusing on taxation issues.

## 1.1 Vertical integration and the double marginalisation problem

Imagine an industry where a distributor sells its goods to the consumer market and buys the goods from an upstream monopolistic manufacturer. In this setting the upstream monopoly will sell the inputs to the downstream firm at a monopoly price, and the downstream distributor will sell its finished goods to the consumer at the market price. In this situation, both the upstream and the downstream firm will charge a price which equals their costs plus a profit margin. The size of the profit margin depends on the market power of the firm. This is a classic example of a situation where we have double marginalisation, both the upstream producer and the downstream distributor charges a profit margin and thereby increases the price to the final consumer. When the price increases, demand from consumers and profit for the upstream and downstream firms will, in most cases, fall (depending on the demand characteristics e.g. price elasticity of demand). When studying this problem analytically, scholars have discovered that if the producer and distributor co-operate in this setting, they would earn a higher profit together than the sum of their profit if they do not co-operate (Tirole, 1988; Pindyck & Rubinfeld, 2009). The solution is that the producer and distributor should set the price together based on the demand from the consumer market. By doing this, they will maximise profit across the value chain. An example of such co-operation is that the distributor provides the producer with its costs and demand data for the consumer market, and the producer sets the price to the distributor to maximise the profit based on end consumer demand and distribution costs.

After having maximised profit across the value chain by setting the price based on demand from the end consumer, it is not certain that the profit is divided fairly between the different parts of the value chain. Thus, the profit might have to be redistributed in order to achieve a fair profit distribution. Transfer pricing is an efficient solution to this profit distribution problem (Eccles, 1983). This fact has led to the transfer price being a central part in a vertically integrated value chain. An agreement on transfer prices, however, is difficult to set up between independent firms due to e.g. anti-trust law. This means that in order to achieve a global profit maximisation in a value chain, the whole value chain has to be operated by the same firm. The vertically integrated firm can take many forms, but it is usually referred to as a firm with a multidivisional structure. Despite structural differences, however, the purpose is usually the same, to avoid the double marginalisation problem, achieve a global instead of local profit maximisation and a fair profit distribution.

These facts have made vertical integration into a very popular strategy for maximising the profit of the whole or parts of a value chain. A good example of vertical integration happening in these days is the increasing popularity of so-called “private labels” in the grocery retail market. These “private label” products are a result of backwards integration, where large retail chains such as Tesco (U.K.) and Rema 1000 (Norway) are integrating backwards into the upstream producer market to improve both profit margins and overall profits on the products in their value chain (Egeland, 2006).

Researchers have, however, discovered that the transfer price has many other applications than merely functioning as a way to achieve optimal global profit and profit distribution. Transfer prices have important effects on the behaviour of managers and the performance of profit centres in a decentralised structure. A transfer price can e.g. lead to either co-operation or conflict between business units, and it can have huge impact on business unit profits and thereby incentives of managers in individual divisions, departments or subsidiaries (profit centres). In the next sections of this literature study, we will have a closer look at the different theoretical perspectives concerned with this part of the multi-faceted transfer pricing problem.

## 1.2 Transfer pricing and the principal-agent problem

In the last section we established that a value chain has to be integrated (co-operate) to achieve maximum profit, and that such integration is difficult without being a part of the same firm/organisation because of e.g. anti-trust legislation. Further, we saw that transfer pricing was an efficient tool for distributing the profit between the different parts of the value chain. Put together, these two findings show that the transfer pricing system/policy will play an important role in many organisations, as it is the key for determining profit centre performance and through that, often, management remuneration. Performance is usually linked to prestige or reputation, which is a powerful motivation factor in an organisation. Thus, transfer pricing affects both monetary and non-monetary incentives (Cook, 1955; Dean, 1955; Pindyck & Rubinfeld, 2005). A vertically integrated company is usually also a decentralised company with regards to responsibility and decision-making authority, where the transfer price functions as some sort of a control mechanism. The agency problem can create problems in such organisations if the control systems create opportunities for managers to act opportunistically, something which can create huge inefficiencies (Pindyck & Rubinfeld, 2005). It is, thus, very important to have a transfer pricing system/policy that avoids this problem as well.

From the short introduction to this section we can see that transfer pricing is fairly closely tied together with organisational theory. And many scholars have used this perspective of the literature to study transfer pricing. Transfer pricing is first and foremost related to the relationship between central management and profit centre (business unit) management. The key interest for the central management is to achieve maximum profit for the owners, and profit centre managers are a key input in reaching this goal. There are many ways to motivate managers in an organisation; among the most efficient are incentives and autonomy (Cook, 1955; Dean, 1955; Pindyck & Rubinfeld, 2005).

In multinational and multidivisional companies, where decision-making authority is delegated to achieve decentralisation and central management's ability to control business unit managers is limited, the conditions for observing opportunistic behaviour among business unit managers are met. This is basically a textbook example of a situation where you will observe the principal-agent problem (Pindyck & Rubinfeld, 2005). In this setting, central management would be the principal and business unit managers the agents. The only efficient way for controlling and monitoring the business unit managers is through the management control system. Here, incentives and transfer pricing can be used to motivate the managers to contribute the desired effort and show the right behaviour, while management accounts can be used to monitor their performance. As we will see when looking at

incentives, transfer prices and the transfer pricing policy play an important role in controlling the business unit managers.

To ensure that business unit managers are working towards the goals of the central management, they are provided with incentives such as salary, performance related bonuses, benefits such as a company car, free phone etc. It is also well-known that internal reputation and success and other more intrinsic motivational factors affects profit centre management's behaviour (Conger & Kanungo, 1988). Furthermore, these management incentives have to be aligned across business units to ensure that they do not function as sources of conflicting interests. If, e.g. the supplying and the buying division of a good or service have conflicting interests in the transaction of that good or service, the result could be conflicts or another non-optimal outcome such as a different than intended relationship between the two.

A firm's transfer pricing system has a considerable impact on business unit performance, and thereby performance related management incentives and internal success and reputation. When a control mechanism is so tightly connected to manager's motivation, it is crucial for overall firm performance that it induces the right behaviour. This is probably some of the explanation for why we have seen an increased focus on transfer pricing the last couple of decades. The transfer pricing system also governs the way business units interact with each other. Negotiated transfer prices will lead to a fairly close interaction, while market-based transfer prices could lead to no interaction at all, as external sourcing could be preferred to internal sourcing (Baldenius & Reichelstein, 2006). Eccles stresses the fact that transfer prices have to be perceived as fair throughout the organisation. This basically means that they should reflect the contribution to overall profit by individual profit centres (Eccles, 1983). If the transfer pricing system is perceived as unfair, it can be the source of conflict and other dysfunctional management behaviour.

In addition to incentives, autonomy or decision-making authority (empowerment) is a big motivational factor for profit centre managers (Cook, 1955; Dean, 1955; Conger & Kanungo, 1988). If the incentives related to business unit performance are to have the desired effect, the business unit manager has to have the proper authority to make decisions that have impact on business unit performance (Pindyck & Rubinfeld, 2005). Otherwise, the incentives would be of no use, as they do not depend on the manager's behaviour and effort. More recent literature also shows that autonomy or decision-making authority can be a powerful motivational factor in itself. This goes especially for highly educated managers. To be responsible for delivering a result, and being able to choose by oneself how to do it, turns out to be very stimulating for knowledge workers such as most business unit managers (Conger & Kanungo, 1988). It both shows that central management trust the business

unit manager and gives the business unit manager an opportunity to apply his knowledge to find solutions to problems.

Eccles has created a model for designing transfer pricing policies, where he tries to take most of the above mentioned factors into consideration. The model, "The Manager's Analytical Plane" (MAP), sets out to determine type of organisation based on the level of vertical integration and the level of diversification in the organisation (Eccles, 1985). By measuring these two levels on two different axes, we get a plane with four different "extremes": Collective (low vertical integration and low diversification), Cooperative (high vertical integration and low diversification), Competitive (low vertical integration and high diversification), and Collaborative (high vertical integration and high diversification). In this context vertical integration reflects *"the inclusion of activities within the firm that could be obtained externally, such as component parts, distribution channels and staff services"* (Eccles, 1985). Diversification on the other hand reflects *"the number of different businesses in which the company competes and how different these businesses are from each other"* (Eccles, 1985), this is also referred to as differentiation in the literature (Meer-Kooistra, 1994). These two concepts could easily be mistaken for representing the same as centralisation-decentralisation, which in this thesis is used to describe the distribution of authority and responsibility in an organisation.

The four extremes are characterised by a certain strategy and structure, control systems and processes, type of performance evaluation, and top management control. Based on these factors for each extreme type of organisation, Eccles proposes a transfer pricing policy. An illustration of the MAP framework can be found in appendix 1. It is very rare that a real-life organisation will fit perfectly with one of the extremes presented in Eccles' framework, but the idea behind the framework is that if it is combined with managerial experience it will provide a good tool for creating and evaluating transfer pricing policies. It will also provide some guidance on how to avoid the pitfalls related to the principal-agent problem.

As opposed to most of the other theory on transfer pricing, Eccles bases his theory and the MAP framework on empirical research. The framework is a result of an extensive study on managerial practices conducted among 150 executives in 13 American companies. The purpose of this study was to understand how managers solved the puzzle of transfer pricing in practice. Thus, the suggested transfer pricing policies are based on what Eccles observed in practice. Although not 100 % accurate, this research and the MAP framework was an important contribution to the transfer pricing literature.



### 1.3 Transaction cost economics

A different approach to solving some of the same challenges mentioned above is provided by the transaction cost economics theory. This approach puts the transaction at the centre of any organisational activity, arguing that it is the transactions that give rise to the organisation (Williamson, 1981). This is a fairly good argument, as an organisation can be seen as a way of putting a high number of transactions into a system.

According to Williamson a transaction and transaction costs can be defined as the following: *“A transaction occurs when a good or service is transferred across a technologically separable interface. One stage of activity terminates and another begins. With a well-working interface, as with a well-working machine, these transfers occur smoothly. In mechanical systems we look for frictions: do the gears mesh, are the parts lubricated, is there needless slippage or loss of energy? The economic counterpart of friction is transaction cost”* (Williamson, 1981).

Transaction cost economics differs from neoclassical economics in the behavioural assumptions made about humans as economic agents. In neoclassical economics, humans are assumed to be completely rational, always choosing the alternative that will maximise their utility function. Thus, as we saw in the last section, opportunistic behaviour can be avoided by providing a human agent with the proper incentives. Transaction cost economics, on the other hand, assumes that humans are subject to bounded rationality and that they might also act opportunistically. This means that the human agent not necessarily chooses to maximise his utility function, as factors other than utility motivate his decisions. Thus, while neoclassical economics gave birth to the *“economic man”* (homo economicus), transaction cost economics have given birth to the *“organization man”* (Williamson, 1981). This *“organization man”* is still assumed to be intendedly rational, but he does not have the same ability to process large amounts of information and solve complex problems, as was assumed for the *“economic man”*. Theoretically this bounded rationality could be overcome through contracting, but due to the risk of opportunistic behaviour (e.g. dishonesty) contracting would be incomplete for controlling a human agent. *“While organizational man is computationally less competent than economic man, he is motivationally more complex”* (Williamson, 1981). The purpose of transaction cost economics is therefore to find a way to ensure that the *“organization man”* acts in the interest of his principals, and thereby avoid transaction costs.

To provide a better understanding of transaction costs, I will provide an example that happened to me the other day. I was attending an event at a hotel where they had two different departments, one conference department and one hotel department. Each department had their own bar and their own payment systems. After the event I attended at the conference department had finished,

the conference department bar closed. Several of the participants at the event still had some of their drink vouchers left, and decided to go to the hotel department bar to spend them as they had done several times before. The bartender at the hotel department bar, however, did not want to accept the drink vouchers, as she claimed that they could only be used in the payment system of the conference department bar. The truth was that if she accepted the vouchers, she would spend more time when closing the sales accounts at the end of the evening. Since she wanted to finish as early as possible, she did not want to accept the vouchers. Thus, because the transaction was too “costly” to carry out for the bartender, it was not executed. This resulted in lower sales for the hotel<sup>1</sup>.

The transaction cost (or friction) depends on several of the properties of the transaction; Williamson presents the following three properties: (1) uncertainty, (2) frequency with which the transaction recurs and (3) the degree of transaction specific investments required to realise least cost supply (asset specificity). He further identifies asset specificity as the most important of the three, and divides it into site specificity (it is favourable to be located close to each other when conducting the transaction), physical asset specificity (investment in tangible assets that improves the efficiency of the transaction) and human asset specificity (arises from learning by doing) (Williamson, 1981). Later, marketing asset specificity (investments in the development and advertising of marketing concepts and brand names) are added to this definition by Meer-Kooistra (Meer-Kooistra, 1994). The theory can be applied in the following way: If a transaction has low uncertainty, happens seldom and has low asset specificity it is generally not efficient to have it as an internal part of the organization and, thus, it will not be subject to transfer pricing. If, however, uncertainty is high (e.g. with regards to quality, delivery etc.), the transaction happens frequently, or it is subject to a considerable degree of asset specificity, it could be more efficient to internalize the transaction, and, thus, implement a transfer pricing policy.

If the firm chooses to internalise the transaction, theory suggests a number of factors that affect the transaction, and that should be considered by the transfer pricing system. These factors can be divided into four general categories: organisational context, external environment, transaction and transaction parties (Meer-Kooistra, 1994; Helden, et al., 2001). A more detailed overview of the factors is provided in appendix 2.

When looking at these factors we can see some similarities with the characteristics established by Eccles in his framework, but we also find several, more transaction specific, characteristics that could be said to probably represent some of the managerial experience that Eccles mentions as a key input

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<sup>1</sup> Luckily, one of us knew the manager at the hotel, and after a quick phone call the bartender agreed to accept our vouchers.

to his MAP framework. This complementarity of the two models provided by Eccles and Meerkooistra suggests that a combination of multiple disciplines within the literature could provide an even better foundation for understanding and solving the transfer pricing puzzle. This is exactly what Emmanuel and Mehafdi did in their book *“Transfer Pricing”*, and their findings are presented in the next section.

## 1.4 A multi-disciplinary approach to transfer pricing

In the concluding chapter of their book *“Transfer Pricing”* (Emmanuel & Mehafdi, 1994), Emmanuel and Mehafdi set out to create a multi-disciplinary theoretical framework for designing and studying transfer pricing systems. After having conducted an extensive literature study, the authors combine all the different theoretical perspectives on transfer pricing into one framework. They base their model on the MAP framework presented by Eccles and Spicer’s “organisation theory model of transfer prices”, which is based on transaction cost economics theory. From what we have seen so far, this base seems as a very good starting point as it combines organisational theory with transaction cost economics. This is a good combination because it both considers strategy, structure and processes as well as the transactional properties at the same time. Into this base framework the two authors add factors from all the other different perspectives on transfer pricing (i.e. value chain and agency theory). On the next page you will find an illustration of the multi-disciplinary framework for transfer pricing proposed by Emmanuel and Mehafdi (Emmanuel & Mehafdi, 1994).

By adding ideas from all the different theoretical perspectives on transfer pricing, the proposed framework becomes very extensive. This extensiveness gives a great overview over the entire transfer pricing problem, but, at the same time it becomes very cumbersome to apply in practice, as it requires both complete overview of the organisation and a lot of free time to go through everything properly. It is probably only the central management in a firm that would have the required overview to use the framework, but central management in a firm is usually very busy and they could probably not afford to spend the required time to apply the framework. This is why the framework probably is a very good tool when designing new organisations<sup>2</sup>, for achieving the goals of a strategic change processes, and for studying transfer pricing systems from a research perspective (Rossing & Rohde, 2010). However, applying it to improve the transfer pricing practices in an existing organisation, without proper commitment from central management, could prove difficult.

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<sup>2</sup> A phase where central management does have the required time to apply the model.

Thus, for more operational decisions on transfer pricing, by both central and business unit management, a much simpler framework for analysis would probably be preferred. Under these circumstances, the framework presented by Meer-Kooistra (appendix 2) could be an efficient tool. Although it is much simpler, it still considers some of the most critical factors for deciding upon transfer pricing practice. This framework is therefore a good compromise where the overview and time required for applying the framework is reduced, while the framework still provides the most important insights for making qualified decisions about the transfer pricing system.

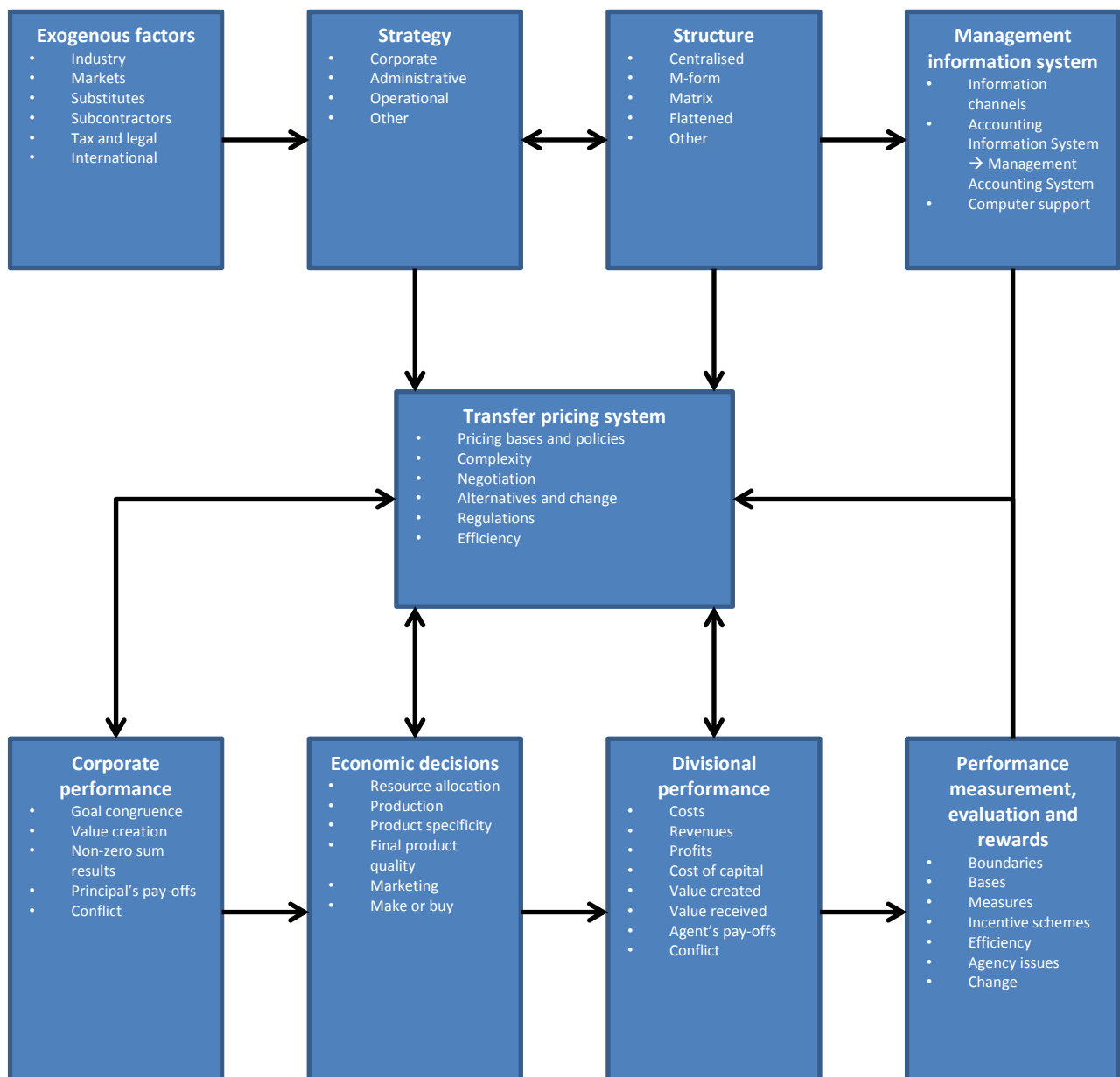


Figure 1 – Causes, effects, and purposes of transfer pricing (Emmanuel & Mehafdi, 1994)

Strategic variables	Organisational structure
<ul style="list-style-type: none"> <li>• Technology and change (AMT, JIT, ABC, Value chain considerations).</li> <li>• Diversification and differentiation (products and markets)</li> <li>• Competitors and market positioning</li> <li>• Vertical integration</li> <li>• Subcontracting</li> <li>• Competitive advantage (cost leadership, product quality, customer satisfaction)</li> <li>• Financial strategy</li> </ul>	<ul style="list-style-type: none"> <li>• Centralised vs. decentralised structure</li> <li>• Divisionalisation base (product/service, production process, regions, market served, multiple bases)</li> <li>• Types of responsibility centres (cost centres, revenue centres, profit centres, investment centres, mixture)</li> <li>• International subsidiaries</li> <li>• Intra-divisional structure (strategic sub-units, cost centres, etc.)</li> <li>• Management information system (accounting information system, management accounting system, customer support systems)</li> </ul>
Divisional autonomy	Human variables
<ul style="list-style-type: none"> <li>• Operating decisions (production, transfer prices, cost allocation, bargaining, personnel, performance measures and rewards, etc.)</li> <li>• Strategic decisions (setting divisional objectives, investment decisions, make-or-buy, new markets, pricing policy, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>• Bounded rationality and opportunism</li> <li>• Leadership styles</li> <li>• Information impactedness</li> <li>• Conflict (human vs. other causes)</li> <li>• Conflict management (learning and development)</li> </ul>
Dimensions of internal trade	Transfer pricing system
<ul style="list-style-type: none"> <li>• Product characteristics (product design and quality, asset specificity)</li> <li>• Volume significance (for company and each division)</li> <li>• Frequency (stability of internal trade)</li> </ul>	<ul style="list-style-type: none"> <li>• Objective of transfer pricing system</li> <li>• Existence of market prices</li> <li>• Cost vs. market (single vs. multiple, dominant basis)</li> <li>• Determination of profit mark-ups</li> <li>• Frequency of dominant basis (stability of transfer prices)</li> <li>• Internal regulations (implicit and explicit)</li> <li>• External regulations (taxation, inland revenue, host country)</li> <li>• Locus of decision (centralised, consultation, devolved)</li> <li>• Negotiation (rules, history, etc.)</li> <li>• Simplicity vs. complexity</li> <li>• Review and adjustment (reasons, frequency, aftermath cost vs. benefits)</li> </ul>
Performance measurement, evaluation and rewards	
<ul style="list-style-type: none"> <li>• Success factors (role of strategy)</li> <li>• Performance measures (accounting and non-accounting based, importance of profit, operating measures, short-term vs. long-term, divisional vs. company-wide, non-controllable factors)</li> <li>• Incentive schemes (flexibility, scope, fairness, performance related pay)</li> <li>• Budgetary considerations</li> </ul>	

Table 1 – Check-list of interacting variables (Emmanuel & Mehafdi, 1994)

We have now studied different theories and frameworks providing insights for how to design the transfer pricing system and for which basis to use for the actual transfer price. In the next section we will have a closer look at the different methods for setting the actual transfer price, depending on which basis the theory suggests.

## 1.5 Transfer pricing methods

According to transaction cost economics, a transaction should be carried out internally within the organisation if it happens with high frequency or is subject to high uncertainty, high asset specificity, or any combination of the three. Eccles argues that the type of organisation also affects the decision of whether or not a transaction should be conducted internally. And, Emmanuel and Mehaftdi provide an extensive overview over all the factors that either affect or are affected by the transfer pricing system, and therefore have to be taken into account when deciding upon transfer pricing practices. When looking at Emmanuel and Mehaftdi's framework, Transfer pricing can in a way be perceived as a key that opens the door which connects many of the different aspects of the organisation. This key needs to be shaped according to the reality of the organisation (exogenous factors, strategy, structure, systems) on one hand, and the desired outcome (performance, economic decisions), on the other hand. Differences in reality and desired outcome require differently shaped keys. The shape of the key in this allegory is the transfer pricing method applied.

When it comes to the actual transfer pricing, central management is usually involved in two main decisions: 1. which basis/method to use and 2. whether or not internal transfers should be mandatory (Eccles, 1985; Eccles, 1983). The presented frameworks in the above sections are designed to provide the necessary input for making these decisions. Mandatory internal transfers, basically means that business units are ordered by central management to use internal suppliers. The purpose of mandated internal transfers is usually to achieve the synergies available to a vertically integrated organisation such as learning, increased profit by avoiding double marginalisation, cooperation etc. The method applied depends both on the transaction in question and on factors such as the availability of an external market, taxation issues, incentive systems etc. There are three main bases for transfer prices; these are market prices, costs, or negotiations between the transacting parties.

### 1.5.1 Market-based transfer pricing

Market-based or marginal cost-based transfer pricing was established as the optimal way of pricing internal transactions by Hirshleifer in 1956. In his article he shows that internal transfers should be priced at market price in a perfectly competitive market, or, if the market for the intermediate good or service is imperfectly competitive, at marginal cost (Hirshleifer, 1956). Hirshleifer shows this by applying basic economics theory to the transfer pricing problem, and proves his results through a series of graphs outlining the supply, demand, marginal cost and marginal revenue curves of the two parties to the internal transaction. The only limitation to Hirshleifer's findings is that they do not hold for situations where you have technological dependence. Technological dependence is defined as a

situation where the *“operating costs of each division are dependent of the level of operations being carried on by the other”* (Hirshleifer, 1956). Technological dependence is a typical characteristic of highly vertically integrated organisations (also known as cooperative organisations in Eccles’ MAP framework), where mandated internal transfers leads to a situation where demand from the internal downstream divisions decides some of the activity-level in the upstream divisions. And, the internal upstream division’s capacity constraints limit the level of activity in the internal downstream divisions. Worth to notice here is that Eccles’ research on practices in companies has shown that in a situation with technological dependence (cooperative organisations) costs are the dominant bases for finding transfer prices (Eccles, 1985), thus Hirshleifer’s theory about market prices being a bad basis in this situation is somewhat confirmed by Eccles.

To price an internal transaction in the same way as the transaction would have been priced in a perfectly competitive market works well in theory, in practice however, it has proven difficult to replicate this pricing method (Eccles, 1985). This is either due to the lack of a comparable perfectly competitive market price, or because it is difficult to determine the firm’s/division’s true marginal cost. This difficulty of measurement has given rise to several approximation methods for arriving at a transfer price close to the optimal  $P = MC$ . When the market-based method for transfer pricing is applied, the most common approximation method is to use the market price observed in the external market for the intermediary good or service less a discount reflecting the savings of trading internally, such as savings in marketing and selling costs, no credit risks, avoidance of market imperfections, etc. (Eccles, 1983; Baldenius & Reichelstein, 2006).

Intuitively, this approximation method provides a good estimate of the marginal cost as long as the market for the intermediate good or service is fairly competitive. However, if the market for the intermediate good is fairly uncompetitive, the correct discount to arrive at the marginal cost becomes more difficult to determine because the market imperfections have an impact on the market price that can be difficult to calculate. This fact together with the fact that for many intermediate goods there does not exist any market at all, show the limitations of market-based transfer pricing. Thus, we can conclude that, if applicable, market-based transfer pricing is probably the easiest approach for finding the optimal transfer price for technologically independent internal business units. In many cases, however, the needed starting point, the external market price, will either not exist or be distorted by an imperfectly competitive market for the intermediate good or service. In these cases one of the other bases for transfer pricing will have to be used, we will first take a closer look at cost-based transfer pricing before moving over to transfer pricing based on negotiations.

## 1.5.2 Cost-based transfer pricing

A frequently used method when market prices cannot be used as the basis for transfer prices (e.g. due to imperfect external markets or technological dependence) is cost-based transfer pricing. This method uses product or service costs as the starting point for pricing the internal transaction. As we know from the management accounting literature, there are numerous ways to calculate product costs (full costing, standard costing, activity-based costing, direct/variable costing etc.) (Horngren, et al., 2009; Baldenius & Reichelstein, 2006; Eccles, 1983), and, thus, there is an equal number of transfer prices that can be calculated by using costs as a basis. This number is, however, effectively reduced by tax legislation, and, as we will see later, the only accepted method for internal cross-border transactions is full costing (OECD, 2010). The reason for this is that different costing methods give different product costs which further affect the taxable profit from the transaction. This leads to a situation where the tax authorities governing the selling party would prefer a method that yields a taxable profit in their jurisdiction that is as high as possible; while the firm itself might want to show most of the profit in the country of the buying party, because the tax legislation is more favourable there. Legislators that are members of OECD (the Organisation for Economic Cooperation and Development) have therefore agreed on using the cost plus method for determining cost-based transfer prices.

When using costs as the basis for transfer pricing, several sources of inefficiencies arise. First, you have the potential disagreements between the transacting parties arising from how costs should be calculated and which costs to include in the transfer price. Second, you have the potential for opportunistic behaviour in the reporting of costs, since the size of the costs affect the transfer price which in turn affects business unit performance and appraisal of the business unit manager. Thus, as we saw earlier, if designed in the wrong way, the incentive system could give business unit managers incentives to report costs higher than actual costs. Third, cost-based transfer pricing methods often require the involvement of central management, because decisions about allocation methods, allocation bases, etc. have to be taken centrally. This lowers both the autonomy and the ownership towards business unit results for business unit managers. This could further have a negative impact on the motivation of business unit managers.

### 1.5.2.1 Cost plus pricing

Cost plus pricing is a method where the selling party to the transaction receives a transfer price equal to its full product costs plus a fair profit mark-up on top of costs. Full product costs can be found through multiple methods, as we saw above, the most common today is some sort of activity-based costing (Andresen & Basteviken, 2011). Full product costs involve direct and indirect costs, and it is especially the calculation of indirect costs that can be subject to opportunistic behaviour, as these



can be varied depending on the allocation method used (as we saw in the Bellcore example in the introduction). The allocation method will probably also be subject to scrutiny by the tax authorities in the case of a transfer pricing audit (Rossing & Rohde, 2010).

Although fairly simple, the cost plus method is usually not a very good transfer pricing method as it often is a fairly bad approximation to marginal cost. Marginal cost is usually lower than full product cost, so when you in addition add a mark-up for profit on top of this it is obviously not the best approximation. When the transfer price is set higher than the optimal transfer price, it will lead to a situation where the volume transacted internally is less than optimal and, thus, also profit is lower than what it would have been with the optimal transfer price. Another problem that could arise from using the cost plus method is that, if accounting costs are used to determine the transfer price, the transfer price cannot be calculated until the end of the accounting period, which means after the transaction has taken place. This would lead to loss of some of the control mechanisms inherent in the transfer price, because managers would only know the transfer price after the transaction is performed. On the other hand, if budgeted costs or some type of cost standard is used to calculate the transfer price on beforehand, to maintain the control mechanisms inherent in the transfer price, you could both get problems related to opportunistic behaviour in the budgeting process and you could end up in a situation where the transfer price is not accepted by tax authorities if it is used for cross-border transactions. To achieve the highest possible transfer price, managers will have an incentive to either over-report costs or manipulate the cost standards. And, since budgeted costs often differ from actual costs, tax authorities might not accept a transfer price based on budgeted costs or cost standards.

A better performing cost-based method is the so-called “accountant’s rule”. We will therefore have a closer look at this method in the next paragraph.

#### **1.5.2.2 Accountant’s rule**

Although a product’s marginal cost is difficult to determine by looking at the firm’s costs, there is an approximation method suggested in the literature. This method, also known as the “accountant’s rule”, sets the transfer price of a product equal to its incremental/variable cost plus the opportunity cost of selling it internally (e.g. profit foregone) (Emmanuel & Mehafdi, 1994; Horngren, et al., 2009). This method will yield a transfer price equal to the market price in a typical competitive market situation, where the supplying division operates at full capacity. In a situation where the supplying division is not operating at full capacity, the opportunity cost is reduced because the supplying division, in this case, would not be able to sell an extra unit at the current market price (there would not have been available capacity otherwise). This could typically be the case in uncompetitive

markets. Thus, in this situation, the transfer price will be less than market price, which also is the case for the marginal cost. If the supplying division does not sell its product in an external market, it could be more difficult to determine the opportunity cost. Usually, in this case, opportunity cost is determined from looking at the best alternative use of the production capacity dedicated to the product in question (Emmanuel & Mehafdi, 1994).

From this short description we see that the accountant's rule in many cases is a good approximation to marginal cost (the optimal transfer price). Despite this seemingly good suitability as a transfer pricing method, also this rule has its shortcomings. First, the opportunity cost often depends on which perspective you have. This could lead to conflicts where the supplying division is arguing for one opportunity cost, while the buying division is arguing for a different opportunity cost (Emmanuel & Mehafdi, 1994). Second, the accountant's rule, as we will see later, can in most cases not be used to find an arm's length price. This means that its use is limited to internal transactions domestically. Third, division managers have control over the production resources in their divisions. As the opportunity cost depends on the scarcity of e.g. production capacity, division managers actually have the ability to manipulate the opportunity cost of a product by changing production capacity. Thus, if not controlled properly (e.g. through incentives/ performance evaluation), the application of this method could be a source of opportunistic behaviour (Emmanuel & Mehafdi, 1994).

Despite the shortcomings, the accountant's rule seems to be a good approximation method, especially in situations where the product traded internally is not sold in an external market. This makes it interesting to use in e.g. a dual pricing scheme as we will see next.

### **1.5.3 Dual pricing**

Due to the problems arising from using cost-plus pricing, researchers have tried to come up with a solution where you can still use the cost plus method for taxation purposes, but avoid the shortcomings of the method. The solution is dual pricing, to use two transfer prices instead of one. Dual pricing is a method that combines both market-based and cost-based transfer pricing or two other transfer pricing methods. It is designed to achieve the benefits of mandatory internal transfers in organisations with low vertical integration, such as the competitive organisation in Eccles' MAP framework, without losing the benefits of having autonomous business units (Eccles, 1983; Hyde & Choe, 2005). Later, it has also proved to be a good method for avoiding some of the inefficiencies of taxation. We will come back to dual pricing and taxation later.

When applying this method, the selling unit receives e.g. market price or cost plus for the goods or services transferred, while the buying unit only pays the costs determined by e.g. the accountant's

rule. The double counting of profit resulting from using this method is afterwards eliminated higher up in the organisation. The reasoning behind this way of pricing is that the seller is indifferent from selling externally and the buyer is compensated with only paying the costs when buying internally. The incentive of having a lower price internally will induce the buyer to use the internal sourcing alternatives, and thereby a higher integration between business units is achieved than otherwise would have been possible in this type of organisation. Such integration can, as we have seen earlier, release important positive synergies within the organisation such as cooperation and learning. Another benefit is that with this method the tax transfer price does not have to affect the internal resource allocation and performance evaluation. We will study this tax aspect more in detail later.

One immediate problem when applying this method is to correctly eliminate the double counting of profits. It can also be disturbing for the organisation that the profit of the whole company is lower than the sum of the profit reported by its parts, due to the double counting of profits from internal transactions. The incentive systems will also have to be adapted to accommodate for this double counting, to ensure that business unit managers are not too well awarded for their efforts. Similarly, issues can arise if the external sales of the selling unit drop and lead to increased internal transfers. In this situation profits reported could be maintained at the same level by increasing internal sales, thus, leading to no action being taken to counter the effect of reduced external sales. Another issue with dual pricing is that it removes some of the incentives for the buying and selling unit to control each other's performance, which is one of the strengths of an organisation with low vertical integration. Eccles states that these weaknesses of dual pricing probably is the reason for why it is only used periodically, and seldom applied to more than a few products out of strategic reasons (Eccles, 1983). For shorter periods of time, however, dual pricing is known to have a good effect when it comes to boosting internal transfers, and it can therefore be used as a tool to e.g. regain market shares or for other strategic reasons. For tax purposes it can also be used on a more permanent basis (Hyde & Choe, 2005).

#### **1.5.4 Negotiated transfer prices**

An alternative to both marked-based and cost-based transfer prices is to arrive at the transfer price through negotiations. There is a conflict of interests inherent in any transfer pricing decision. On one side you have the internal supplier, who wants the highest possible price for his product or services, and, on the other side, you have the internal buyer, who wants the lowest price possible to minimize costs. This is a fairly normal starting point for many negotiations, what is special with a transfer pricing negotiation is that both parties are, in theory, on the same side. Being part of the same organisation, both parties are working towards the same ultimate goal of maximising total profit of

the organisation. Whether or not they are actually working towards this goal depends, as we have seen earlier, largely on the incentives provided by the central management. An important thing to mention when it comes to these transfer pricing negotiations is that they usually involve more than just the transfer price; they normally include most of the properties related to an internal transaction such as quantities, quality, required investments (asset specificity), delivery and frequency (Emmanuel & Mehafdi, 1994).

Transfer pricing theory suggests that the relation between the transacting parties should be fairly complex if one is to use negotiations as a method for finding the transfer price (Helden, et al., 2001). Complexity is often the result of a close relationship between the two transacting business units; a close relationship can again be the result of a long history of transactions between the business units, or that the transaction itself requires close cooperation. Similar for these close relationships is that several intangible factors such as personal relations play a role in the transaction. Negotiations is perceived as the best way to cater for all these extra factors that would not play a role in transactions between business units with a more distant relationship. The reasoning behind why negotiations will work well in this setting is that, when such close relationships exist, the two parties to the transaction are likely to know each other very well. Hence, information asymmetry is lower than for other internal transaction, and there will exist personal/emotional “contracts” between the two parties due to the fairly close relation they have. These two facts reduce the risk for opportunistic behaviour. In such a context, it is most likely more efficient to let the parties decide the transfer pricing policy through a negotiation with little or no involvement by central management, rather than having the central management impose a certain set of rules to govern the transaction that could actually end up hurting the relation between the two parties.

A similar situation to the one above where the transacting business units have a close relationship arises when local information plays a crucial role for the efficiency of a transfer pricing policy or system. In this case, negotiations would most probably also be the most efficient way to determine the transfer pricing policy, as the central management has little or no access to the local information required for making a good transfer pricing policy. Examples of such local information are local market conditions, technical details of the product or service being transferred, cultural aspects (if the transaction happens in another country e.g. an emerging market), etc. Important differences between this situation and the situation presented above are that you do not necessarily have the same personal/emotional contracts and a similar low level of information asymmetry between the business units involved. Thus, involvement of central management in the negotiation process should be determined by the level of presence of these two factors (Helden, et al., 2001). In their article, Helden et al. refer to the type of negotiations where central management is involved as “constrained

*negotiations*". This concept suggests that the framework of the transfer pricing policy is set out by the central management (e.g. mandated internal transfers at a cost-based price), while the details of the transaction (volumes, timing, quality, technical specifications, etc.) are left to be decided upon by the transacting parties through a negotiation.

Although not mentioned as an option in e.g. Eccles' MAP frame work, negotiated transfer prices seems to make sense in certain situations. This assumption is supported both by the literature and by several studies of transfer pricing practices showing that usually 20-30% of companies use negotiations to determine transfer prices (Emmanuel & Mehafdi, 1994). When looking at the situations where negotiations are proposed as a method for finding the transfer price, we can see that the level of integration seems to be a key. In many ways, negotiations could prove as a good method for establishing a dialogue between two business units in an integrated organisation. Keeping this in mind, it looks as if negotiated transfer prices could solve some of the problems with cost-based transfer prices because negotiated transfer prices induce integration/cooperation at the same time as they provide a fair platform for sharing profit between business units. From the case study of Hoogovens Steel we also see that negotiations can work well in combination with cost-based transfer pricing e.g. in the form of "*constrained negotiations*" (Helden, et al., 2001).

Although solving some problems, negotiations also have some disadvantages. First of all, it is fairly easy to see that aspects such as bargaining power, negotiation skill and business unit reputation could affect the outcome of the negotiations. Another draw-back is that, if not monitored/followed-up correctly, negotiations could result in conflicts between the transacting business units. Conflict is a source of inefficiency in most organisations, especially integrated ones where cooperation between business units is an important success factor. Most of these inefficiencies can, however, be avoided by either using the concept of "*constrained negotiations*", where central management controls the areas where conflict can arise or bargaining power could be used, or by educating the transacting parties on e.g. integrative negotiation (Fisher & Ury, 1981).

## 1.6 Transfer pricing and tax

We have now seen the origin of transfer pricing, and learnt the basics about how it can be applied in an organisation. This gives us a good background for studying the relationship between transfer pricing and tax. As we saw from the introduction, transfer pricing is a topic that is associated more and more with taxation issues. It turns out that transfer prices are one of the most effective ways of transferring profits from a subsidiary to a parent company or vice versa. When a parent and a subsidiary (or two subsidiaries) are located in different countries with different tax rates, transfer pricing can be used to transfer profit to the entity in the country with the lowest tax rate, and, thereby, reduce total tax expenses and increase total company profit after tax. To illustrate this, you will find an example below. This example will be used as an illustration throughout this section on transfer pricing and tax:

Market price of good		100		
Cost of good		50		
Normal TP		85 (market price less a discount of 15 which reflects cost saving)		
Low TP		50 (full cost)		
High TP		100 (market price)		
Low tax rate		15 %		
High tax rate		30 %		
Volume transferred		1000		
		Base case: same high tax rate in both countries	Manufacturer pays a high tax rate, distributor pays a low tax rate - manufacturer sets a low TP	Manufacturer pays a low tax rate, distributor pays a high tax rate - manufacturer sets a high TP
<i>Distributor</i>				
Income	100000		100000	100000
Costs (TP)	85000		50000	100000
Profit before tax	15000		50000	0
Tax	4500		7500	0
Profit after tax	10500		42500	0
<i>Manufacturer</i>				
Income (TP)	85000		50000	100000
Costs	50000		50000	50000
Profit before tax	35000		0	50000
Tax	10500		0	7500
Profit after tax	24500		0	42500
Total profit after tax	35000		42500	42500
Tax saving compared to base case	0		7500	7500

Figure 2 - Example of tax saving with international transfer pricing

By using transfer prices the right way, it turns out that a multinational enterprise (MNE) effectively can shift its profits to the country with the lowest tax rate, and hence, minimise the tax expense. In

the example above, the MNE chooses to show profit in the country with the lowest tax rate, as long as it is a difference in tax rates in the countries the MNE operates. Tax authorities have, of course, become aware of this opportunity for MNEs operating in countries with different tax rates. Their response to these profit transfers has been to introduce legislation preventing the MNEs from shifting profits earned in one country to another. As we saw from the case with GSK in the introduction, the benefits from taxation can be huge for local country authorities.

The literature often mentions two different ways of determining taxable income for MNEs across countries: the “formula apportionment” approach and the “separate entity” approach (Hyde & Choe, 2005; OECD , 2010). “Formula apportionment” is a method where global profit of an MNE is allocated to each of its subsidiaries based on a formula. The profit in each subsidiary is thereafter taxed according to local tax legislation in the subsidiaries’ home-country. The “separate entity” approach, on the other hand, treats each affiliate of an MNE as if it was an independent entity for determining taxable income. The main challenge with the “formula apportionment” method is that the tax authorities in each country an MNE is present in would have to agree on the profit allocating formula applied. This would be very cumbersome as an MNE is usually present in more than two countries, something which implies that there would have to be a negotiation between the MNE and representatives from the tax authorities in several countries to arrive at a solution that would be accepted by all parties. This is probably one of the reasons for why the “separate entity” approach is the method preferred by tax authorities globally, and has become the method applied by OECD countries. Based on the “separate entity” approach, OECD has developed the “arm’s length principle”, which has become the de-facto global standard for international (cross-border) transfer pricing.

### 1.6.1 The “arm’s length principle”

*“[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly” (OECD , 2010).*

The interpretation of this paragraph is that the income of an MNE subsidiary should be taxed in the same way as if the subsidiary was a separate entity. In practice this translates into only taxing the value added by the subsidiary in question. The value added is defined as the difference between the cost of inputs and the price (KPMG, 2011; Investorglossary.com, 2011). The arm’s length principle requires that the cost of inputs purchased from another affiliate of the MNE is valued objectively

(unbiased). This translates into using market prices, when these are available/ applicable, and otherwise set the transfer price equal to the full cost of the inputs plus a reasonable mark-up for profit. The profit mark-up is key to the understanding of the principle here, because a separate entity only supplying the input would never set a long-term price that did not, at least, earn a profit equal to the cost of capital.

## **1.6.2 Transfer pricing methods yielding an arm's length transfer price and their implications**

The following transfer pricing methods are presented by OECD in the suggestion for transfer pricing legislation. All these methods are accepted as methods producing a transfer price in line with the arm's length principle (OECD, June 2011). Since the OECD rules are functioning as the de-facto global standard (e.g. you will find the same rules in U.S. tax code §1. 482, (United States Internal Revenue Service (IRS), 2011)), we can consider these methods to be required by the authorities in most countries. Although OECD legislation is the general rule, there are also local differences. To highlight some of these differences, one method from U.S. tax legislation, which is not a part of the methods proposed by OECD, will be presented. This is to show that even in important modern economies such as the U.S. there are local adaptations in addition to the OECD rules.

### **1.6.2.1 Comparable uncontrolled price (CUP)**

*"The comparable uncontrolled price method consists of comparing the price charged for property or services transferred in a controlled transaction to the price charged for property or services in a comparable uncontrolled transaction"* (OECD, June 2011).

This method can be compared with the market-based transfer pricing method presented earlier. However, we saw earlier that, given that the external market has less than perfect competition, it is usually beneficial to set the transfer price equal to market price minus a discount reflecting the cost savings of transferring or selling the goods or services internally. The CUP method does not allow for such discounts.

### **1.6.2.2 Resale price method**

*"The resale price method consists of comparing the resale margin that a purchaser of property in a controlled transaction earns from reselling that property in an uncontrolled transaction with the resale margin that is earned in comparable uncontrolled purchase and resale transactions"* (OECD, June 2011).

This method is set to govern the internal transactions in an MNE that produces a product or service in one country and sells it in another country through a distributor or sales agent (subsidiary). This is



similar to the situation in the example on how MNEs can shift profit to avoid tax expenses presented above. Thus, we see that when applying this rule to the example, the company would have to operate with the same profit margin as its competitors, something which would effectively limit the amount of taxes that could be avoided through shifting the profit from one country to the other.

### 1.6.2.3 Cost plus method

*“The cost plus method consists of comparing the mark up on those costs directly and indirectly incurred in the supply of property or services in a controlled transaction with the mark up on those costs directly and indirectly incurred in the supply of property or services in a comparable uncontrolled transaction”* (OECD, June 2011).

This is the method that was mentioned under the section on cost-based transfer pricing earlier. When comparing this method with the example on profit shifting, we see that this method will limit the profit shifting ability, as it requires a mark-up on top of total costs. This will increase the transfer price in the case where the manufacturer is situated in the low cost country. From what we saw under the section on cost-based transfer pricing, the company would have to choose between either using actual costs and lose some of the inherent control mechanisms in the transfer price or use budgeted costs or cost standards and risk both opportunistic behaviour and trouble with the tax authorities. Tax authorities are usually interested in the real situation, and not the budgeted one. This typically leads to tax authorities being sceptic towards anything that is not based on actual numbers. Therefore, if an MNE is in a situation where they have to use the cost plus method, they would have to either accept to use actual costs for calculating the transfer price and lose some of the inherent control mechanisms, or use two transfer prices to avoid this conflict of interests. Another issue with the cost plus method is that it is usually applied in situations where it is difficult to find a comparable uncontrolled transaction. This means that it is difficult to determine a fair mark-up, due to the lack of basis for comparison. Thus, in these situations the tax authorities would probably have a fairly high impact on the transfer price and thereby also internal resource allocation and performance (Schjelderup, 1999).

### 1.6.2.4 Transactional net margin method

*“The transactional net margin method consists of comparing the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that an enterprise achieves in a controlled transaction with the net profit margin relative to the same base achieved in comparable uncontrolled transactions”* (OECD, June 2011).

This method can, in some cases, be used as an alternative to the cost plus method, as it compares the profit margin on the internal transaction with the profit margin the firm has on a similar external

transaction. This method does also accommodate for setting the transfer price equal to market price minus a discount, as this will lead to a transfer price that has an equal profit margin as the price achieved in the external market, as long as the criteria for using market-based transfer pricing are fulfilled (competitive external market). In the example on profit shifting, the market price less a discount is the method applied in the base case where tax rates are equal.

#### 1.6.2.5 Transactional profit split method

*“The transactional profit split method consists of allocating to each associated enterprise participating in a controlled transaction the portion of common profit (or loss) derived from such transaction that an independent enterprise would expect to earn from engaging in a comparable uncontrolled transaction. When it is possible to determine an arm’s length remuneration for some of the functions performed by the associated enterprises in connection with the transaction using one of the [other] approved methods, the transactional profit split method shall be applied based on the common residual profit that results once such functions are so remunerated” (OECD, June 2011).*

This is clearly the most complicated of the OECD approved methods, which is reasonable since it also addresses the most complicated situation for internal transfers. In this situation the profit generated by the transaction is truly common profit, meaning that it is a result of the cooperation or transaction between the two parties involved, and that it could not have been achieved without this cooperation or transaction. An example of such a situation is where both parties contribute to the R&D process of a product or service. In this case it is not necessarily easy to determine how much of the benefits from this R&D process that should be allocated to each of the parties. The suggested way to do it, is to estimate the fair share of profit that an independent third party would have earned if it was subject to a similar situation.

#### 1.6.2.6 Comparable profits method

*“The comparable profits method evaluates whether the amount charged in a controlled transaction is arm’s length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances” (United States Internal Revenue Service (IRS), 2011).*

This method is not included in the OECD proposal for transfer pricing legislation, but it is approved as a method for finding the arm’s length price in the U.S. tax code. It is not very different from the CUP method, but rather than basing the transfer price on an observed market price it bases the transfer price on a profitability measure such as ROI, ROCE, or residual income. These figures can in many cases be easier to find than a comparable market price. This makes it easier both for MNEs and tax authorities when it comes to finding the arm’s length price.

### 1.6.2.7 Transfer pricing and risk division

An aspect that complicates the search for a comparable uncontrolled price is the difference in risk division between internal transactions and external transactions. In an uncontrolled (arm's length) transaction the division of risk is usually central to the pricing of the good or service being transacted. If the buyer accepts most of the risk (related to e.g. guarantees, transportation, payment etc.) he will demand a lower price. In the opposite case, the seller will require a higher price if she is going to take most of the risk. Thus, we can see that risk division have a considerable effect on the uncontrolled price (Andresen & Basteviken, 2011).

In an uncontrolled transaction risk division can be a difficult matter, especially if the transaction happens seldom, and it is usually subject to negotiations. In internal transactions, on the other hand, risk division is usually an easier matter, because the two parties to the transaction are working towards a common goal of maximising total company profit. Whether or not they are actually working towards this goal depends on the incentives provided by central management, but despite this fact it seems reasonable to assume that it is easier to reach an agreement on risk division and price in an internal transaction compared to an external one. Since it is easier to agree on risk division, we would probably, in some cases, observe a different division of risk in an internal transaction than in a comparable uncontrolled one. Thus, the transfer price will also be different than the comparable uncontrolled price. This reasoning shows that risk division matters complicates the determination of arm's length prices, and it can be used as an argument for a different transfer price than what tax authorities might suggest. This is why risk division gets a lot of attention from transfer pricing advisors such as KPMG (Andresen & Basteviken, 2011).

### 1.6.2.8 Advance pricing agreements (APA)

An advance pricing agreement, according to the OECD guidelines, is: *“An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional mechanisms fail or are difficult to apply”* (OECD , 2010).

An APA is, thus, an agreement between an MNE and the authorities on how transfer pricing of a set of internal transactions should be handled until a certain point in the future. As we see from the definition, an APA is an instrument that is meant to increase the transparency between the MNE and

the tax authorities with regards to transfer pricing. APAs are also designed to resolve potential issues with regards to taxation before they arise. An APA is therefore a very good tool for ensuring compliance with tax legislation for MNEs. The benefits of such agreements are to reduce risk for income assessment (audit) for taxpayers (MNEs), to provide the authorities with insights regarding the MNEs industry and ensure dependable future tax revenues. APA is a fairly new tool, as it was not introduced until 1999 (Ernst & Young, 2010; PWC, 2010). Due to its relatively young age, the dilution of APA in tax legislation around the world is still fairly limited, and only the countries that are leading within transfer pricing practices and legislation, such as the U.S., allow the use of this tool (Ernst & Young, 2010). APA seems, however, to be a tool that potentially could resolve some of the tax-related difficulties with transfer pricing in the future.

#### **1.6.2.9 Comments on arm's length approved methods**

Compared to the transfer pricing methods presented earlier we can see that tax legislation puts some constraints on the methods that can be applied to find a transfer price on internal cross-border transactions. One immediate conclusion that can be drawn when comparing the two sets of methods is that the optimal rule of setting transfer price equal to marginal cost is generally not allowed by the arm's length principle. The same goes for negotiated transfer prices, as the "comparable profits" method is the only method that could be used to argue in favour of negotiated transfer prices.

A dual pricing scheme can be applied to circumvent some of the limitations provided by the arm's length principle and tax legislation. This will require the firm to use two sets of books, one set for internal purposes (resource allocation and performance evaluation) and one for tax purposes. This alternative will be discussed more in detail below. We also saw that APA could be used reduce some of the difficulties with transfer pricing related to taxation, e.g. compliance. A general conclusion that can be drawn from this short comparison of arm's length methods and general transfer pricing methods is that tax legislation somewhat reduces a firm's ability to price internal transactions in an optimal way. The following implications can be found when comparing the two sets of transfer pricing methods:

- I. To use a transfer price which is approximately equal to marginal costs will in many cases be difficult.
- II. Negotiated transfer prices are not considered to be objective or unbiased, and can therefore not be used for taxation purposes in relation with internal cross-border transactions.
- III. When there is no external market for the good or service in question, the cost plus method have to be used to find a transfer price, even though it might not be a good approximation to marginal cost.

- IV. As MNEs seek to minimise tax expenses, they could be induced to use a transfer price different from what would be considered as optimal from a management accounting perspective. This can lead to distorted managerial incentives and inefficient resource utilisation.
- V. As MNEs seek to minimise tax expenses, they could be induced to apply an organisational structure different from what would be considered as optimal from an industrial organisation point of view. Something which again could lead to inefficient resource utilisation.

The discussion will now continue with presenting the optimal way to price internal transactions given the current tax legislation, as well as studying some of the impacts of the tax legislation on MNE behaviour.

### 1.6.3 Taxation and the optimal transfer price

Based on the fact that the legislation effectively limits the MNE's ability to apply the optimal transfer price to an internal cross-border transaction, Baldenius et al. discuss in their article how tax legislation affects resource utilisation in an MNE through transfer prices. They use a model where they assume a situation where a firm produces a good in a foreign country with a low tax rate ( $t$ ), and sells the good domestically subject to a high tax rate ( $t+h$ ) and Cournot (quantity) competition. Total after-tax corporate income is given by:

$$\pi(q) = (1 - t) \cdot [R(q) - c \cdot q] - h \cdot [R(q) - \bar{p} \cdot q]$$

Where  $q$  is volume transferred internally,  $R(q)$  is net revenue,  $c$  is unit cost, and  $\bar{p}$  is arm's length price. In this model they study the effects of using separate transfer prices for tax and internal purposes, and compare this to a situation where the same transfer price is used for both tax and internal purposes.

Their model shows that when using the same transfer price for both tax and internal purposes, the arm's length price will in most cases lead to a lower than optimal volume transferred internally for the firm as a whole for both cost and market-based transfer pricing (proposition 2 and 3). This is because the arm's length price usually will be higher than the marginal cost (Baldenius, et al., 2004). They also find that if a firm uses separate transfer prices and two sets of books, then the transfer price used internally ( $TP$ ) will still be affected by the applied arm's length transfer price ( $\bar{p}$ ) used for taxation purposes, as can be seen from the equations on the next page.

For cost-based transfer pricing:	For market-based transfer pricing
$TP = (1 - t) \cdot c + t \cdot \bar{p}$ <p>Where <math>t</math> is the foreign tax rate, <math>c</math> is the unit cost, and <math>\bar{p}</math> is the arm's length price that minimises tax liability.</p>	<p>For market-based transfer pricing the arm's length price (<math>\bar{p}</math>) will be derived from the market price, and, depending on the conditions, the optimal internal transfer price (<math>TP</math>) will either be equal to (<math>\bar{p}</math>), or to (<math>\bar{p}</math>) minus a discount <math>\Delta^*</math></p>

Table 2 - Optimal arm's length transfer price (Baldenius, et al., 2004)

As a response to these findings, the authors set out to find the optimal transfer pricing method given the restrictions provided by the arm's length principle.

When looking at a situation where the internal buyer<sup>3</sup> is subject to competition from a local firm, they find that for market-based transfer pricing the most favourable outcome will be achieved by setting the transfer price equal to the market price minus a discount (transactional net margin method or resale price method). By applying one of these methods the MNE both increases the volume transferred internally and reduces the tax liability compared to a situation where the transfer price is set equal to the market price (CUP method). The volume transferred internally is increased due to the lower transfer price, while the tax liability is decreased because the increased volume transferred internally induces the local competitor to reduce the volume he supplies to the market to increase the market price, the price which also functions as the arm's length price. The increased arm's length price will decrease the overall company tax expense as long as the tax rate in the internal seller's<sup>4</sup> jurisdiction is higher than the tax rate in the internal buyer's jurisdiction. The authors also show how to calculate the optimal discount (Baldenius, et al., 2004).

In a situation where there are no external market price to use as a starting point for transfer pricing, Baldenius et al. find that the optimal transfer price is achieved by setting the transfer price equal to the *“weighted average of the pre-tax unit cost and the most favourable arm's length price”* (Baldenius, et al., 2004). The most favourable arm's length price is the price that minimises tax expenses, and the proper weight to apply is derived from a ratio based on the tax rates in the two countries. This method differs from the cost plus method that we have seen before, and it can only be applied legally if the MNE operates with two transfer prices (a similar practice to dual pricing). This is because it will not fulfil the arm's length criteria as it requires to set the transfer price lower than the arm's length price. Thus, if the MNE wants to use a single transfer price and still comply with tax legislation, it will be obliged to use the most favourable arm's length price. Thereby, the MNE will have to accept a certain level of inefficiency.

<sup>3</sup> The distributor in the example presented earlier.

<sup>4</sup> The manufacturer in the example presented earlier.

From Baldenius et al.'s article we can see that there could be a trade-off between applying the “strategically optimal” transfer price and the transfer price minimising tax liability, and this trade-off will increase with the size of the tax differential between the two countries in question. Baldenius et al. refer to this trade-off as the “*cost of conformity*”, which is the cost of using the same transfer price for tax and internal purposes (Baldenius, et al., 2004).

#### 1.6.4 Transfer pricing, taxation, and firm strategy and organisation

Schjelderup and Sørsgard discuss the same trade-off between strategy and tax optimisation as Baldenius et al. touches upon, although from a somewhat different angle (Schjelderup & Sørsgard, 1997). Their starting point is the optimal rule for transfer pricing provided by Hirschleifer, transfer price = marginal cost, and they then compare this rule with how the transfer price is affected by different tax rates in different competitive settings. Schjelderup and Sørsgard assume a tax credit system, a common system applied by tax authorities to avoid double taxation, where tax paid on profit abroad can be deducted from the tax that has to be paid domestically if that profit is transferred to the domestic affiliate of the MNE (Schjelderup, 1999). Central to their findings is the relationship between the corporate tax rate in the manufacturer's country,  $t_m$ , the corporate tax rate in the distributor's country,  $t_d$ , and the import tax in the distributor's country,  $\tau$ . For determining the optimal transfer price one has to compare  $\theta = (t_d - t_m)/(1 - t_d)$ , the relative differential in tax rates between the importing and the exporting country, with  $\tau$  (Schjelderup & Sørsgard, 1997).

First, the authors show that with monopolistic national markets where  $t_m < t_d$  and  $\theta > \tau$ , profits will increase if the MNE charges a transfer price higher than marginal cost. If, on the other hand,  $\theta < \tau$ , then a transfer price lower than marginal cost is desirable. If  $t_m \geq t_d$ , a low transfer price is preferable, independent of the relation between  $\theta$  and  $\tau$ . This case with monopolistic markets basically shows how to minimise the tax liability through the transfer price given the foreign and domestic corporate tax rates and the import tax.

If competition is introduced into this model, the transfer price will also have implications on the MNE's strategy, i.e. how it adapts to the competition in the local market. Thus, the transfer price becomes both a tool for minimising tax liability (tax optimisation) and a tool for maximising pre-tax profit (strategic optimisation) given the competitive situation. Schjelderup and Sørsgard study both the case of Cournot (quantity) and Bertrand (price) competition, and show that when taxes does not play a role (i.e.  $\theta = \tau = 0$ ) the strategically optimal transfer price is lower than marginal cost for a situation with Cournot competition and higher than marginal cost for a situation with Bertrand competition (Schjelderup & Sørsgard, 1997).

The following table presents the insights provided on how the transfer price should be set in each case studied by Schjelderup and Sørsgard. Note that when  $t_m \geq t_d$ , full tax credit is awarded to the manufacturer, hence the size of  $\tau$  and the competitive situation are the only things that matter for the optimal transfer pricing strategy ( $\theta$  will be negative in this case).

When $t_m < t_d$ we have:			When $t_m > t_d$ we have:		
	<i>Cournot</i>	<i>Bertrand</i>		<i>Cournot</i>	<i>Bertrand</i>
$\theta = \tau = 0$	TP <sup>5</sup> < MC <sup>6</sup>	TP > MC	$\tau = 0$	TP < MC	TP > MC
$\theta > \tau$	? <sup>7</sup>	TP > MC	$\tau > 0$	TP < MC	?
$\theta < \tau$	TP < MC	?			

Table 3 - Optimal tax transfer price (Schjelderup & Sørsgard, 1997)

Another interesting aspect with the work of Schjelderup and Sørsgard is that, although being the first to show the relationship between differing tax rates and the optimal international transfer price, some of the scholars later discussing this problem fail to refer to their 1997 article. This goes e.g. for Baldenius et al. (2004). After having studied this article more in detail, it is in this case not a question of plagiarism. It is, however, reasonable to believe that the findings of Schjelderup and Sørsgard could have been useful insights for Baldenius et al. when determining the optimal transfer pricing method, both in the case with Cournot and Bertrand competition when the arm's length principle is taken into account. When discussing this matter with Professor Schjelderup he points to this as a problem arising several places in the academic world. Being an economics professor, Mr. Schjelderup applies this perspective in his research, and articles with an economics perspective are usually difficult to get published in e.g. accounting journals. This leads to a situation where accounting scholars, who are mainly concerned with the accounting literature, could miss out on important research published other places and vice versa. It is also difficult for scholars to inform other scholars about their research when discovering that this could be useful, because this could easily be interpreted as criticism, something that could lead to conflicts or negative relations. The result of this is that it is easy to observe a certain degree of duality in the research on typical multi-discipline problems such as transfer pricing (Schjelderup, 2011).

<sup>5</sup> Optimal tax transfer price

<sup>6</sup> Marginal cost

<sup>7</sup> Strategic objective and tax objective work in opposite directions, thus optimal TP depends on the relative size of the two



In addition to studying optimal transfer pricing, Schjelderup has together with Bo Nielsen and Raimondos-Møller studied how taxation affects the optimal organisation of an MNE. In their article they use modelling to study a situation where a parent and its subsidiary are located in different countries, and where the parent is monopolistic in its local market while the subsidiary is subject to Cournot competition. Further the model assumes that the internal transfers between the parent and the subsidiary are subject to only one transfer price, which is used for both taxation and other purposes.

Also in this article the authors show that there is, under some circumstances, a trade-off between the profit earned from tax optimisation and the profit earned from strategic optimisation (the situations marked with “?” in the table above). Further, they show that this trade-off affects the optimal organisation of decision-making authority, and that the optimal organisation of decision-making authority depends on the difference in tax rate between the parent and subsidiary’s countries (Bo Nielsen, et al., 2008). Thus, we see that tax legislation and tax differences also affect the MNE’s choice of organisation. A centralised decision-making will remove some of the subsidiary manager’s ability to impact his business unit’s results, and thus remove some of the effect of performance related incentives. The authors show that their findings hold for different ways of setting the transfer price and for Bertrand competition.

### **1.6.5 Keeping two sets of books – taxation and management evaluation**

In several of the above sections, references have been made to the practice of operating with more than one transfer price. In most of the literature that have been discussed so far, the practice of using two transfer prices, one for tax purposes and one for internal purposes, has been disregarded because a fairly small share of MNEs use this practice and because it is considered as illegal in some jurisdictions (Bo Nielsen, et al., 2008). When looking at the sources and statistics used to back up this argumentation you can see that the amount of MNEs using this practice is fairly small, but you can also see that there is a positive trend in the diffusion of this practice (Bo Nielsen, et al., 2008; Baldenius, et al., 2004; Hyde & Choe, 2005). You also have sources showing that several industry leaders such as Microsoft and Hewlett-Packard are embracing the practice of using two transfer prices (Springsteel, 1999). The positive trend and the fact that the practice of two transfer prices is used by many large MNEs<sup>8</sup> should be sufficient proof for putting more emphasis on this practice when conducting research on optimal transfer pricing practices.

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<sup>8</sup>In an AnswerThink survey from 1999, 77% of a group of companies with more than \$ 2 billion in revenues report that they have adopted the practice of two transfer prices (Springsteel, 1999).

These facts together with the lack of research on the practice of having two transfer prices, which also implies having two sets of books, led Hyde and Choe into taking the topic under closer scrutiny. In their article they study how an MNE optimally can apply the practice of two transfer prices in a simple model, and they discover that the tax transfer price and the incentive transfer price (the transfer price used for internal purposes) are independent when the tax transfer price is subject to the formula apportionment approach. For the separate entity approach, however, they find the same as Baldenius et al. 2004, namely that the incentive transfer price is affected by the differential tax rates and the arm's length price. Thus, although it is perceived as a way to avoid the unfortunate effects of tax legislation, even the practice of operating with two transfer prices will not be able manage this fully as long as the separate entity approach (arm's length principle) is the basis for tax legislation.

Hyde and Choe does not formally prove that two transfer prices are better than one, but, as two transfer prices are clearly increasing an MNE's (transfer pricing) opportunity set, it is fairly obvious that the practice of operating with two transfer prices instead of one is better. There is also support in the literature for two transfer prices being at least as well-performing as one transfer price (Bo Nielsen, et al., 2008). By having two transfer prices an MNE can apply any of the transfer pricing methods suggested earlier in this part (e.g. negotiated transfer pricing or dual pricing) for internal purposes, while at the same time comply with tax legislation by using one of the arm's length methods for the tax transfer price.

The biggest drawback of the practice of two transfer prices is the required use of two sets of books. This requires a lot of extra resources, and can be considered as fairly costly. Thus, in order to benefit from implementing the practice of two transfer prices, the MNE needs to be fairly large when it comes to volume transferred internally across borders. Another drawback is that the second set of books, the one used for internal purposes, could provide tax authorities with important evidence if the MNE is subjected to a transfer pricing audit. Thus, we see that small MNEs are probably better off with using the same transfer price for all purposes, because of the costs related to maintaining two sets of books.

## 1.7 Concluding remarks on the literature study

After having studied the literature written about the transfer pricing problem, we see that it is a fairly old phenomenon within management accounting. Scholars started to explore the concept on a theoretical level in the 1950s (Cook, 1955; Dean, 1955; Hirshleifer, 1956). This research was followed-up by a range of empirical and theoretical studies from the 1960s until the mid-1990s. Most of this research is summed up in Emmanuel and Mehaftdi's book "Transfer Pricing" (Emmanuel & Mehaftdi, 1994) and in Borkowski's 1996 article (Borkowski, 1996). Some of the most important insights during this period are the contributions by Williamson, Eden (Rugman & Eden, 1985) and Eccles, while Tang and Vancil have made important empirical contributions.

After the mid-1990s there seem to have been a change in how scholars approach the transfer pricing problem. Empirical research has more or less been replaced by research based on modelling (Baldeuius, et al., 2004; Schjelderup & Sørgard, 1997). Thus, instead of studying what MNEs do in practice, scholars have been more concerned with finding the optimal solution to the transfer pricing problem. One of the explanations for this change could be the growing attention international transfer pricing has gotten from tax authorities during the last 15 years. This growing attention has led to taxation having a considerable impact on transfer pricing practices, something which probably has created a need for finding the best way of incorporating taxes into the transfer pricing system. This is clearly reflected in the literature, where a big part of the newer research discusses the effects that taxes have on transfer pricing (Eden, 2007). One example of this tax-related research is the recent branch discussing transfer pricing and ethics found in e.g. (Mehaftdi, 2000) and (Eden & Smith, 2011).

Despite the increased focus on model-based research and on finding optimal transfer pricing systems after the mid-1990s, there have also been some studies of transfer pricing practices. These studies are mostly empirical studies conducted by the big tax advisory firms (KPMG, Ernst & Young, PWC and Deloitte), but they also include a few case studies and one empirical study that have been conducted by academic researchers. The problem with the empirical studies performed by tax advisory firms is that they are mostly focused on taxation issues linked to transfer pricing. Thus, they contribute very little knowledge on the transfer pricing strategies and practices that MNEs have. Therefore, they are not sufficient for saying anything detailed about MNE transfer pricing behaviour. On the other hand, the surveys provide some basis for studying the development of transfer pricing related taxation practices (KPMG, 2011; Ernst & Young, 2010). When looking at the case studies, e.g. Helden et al. (2001) and Rossing & Rohde (2010), they provide increased understanding about the processes related to transfer pricing on a micro- (firm) level, but they cannot be used to say anything about

general transfer pricing practices. The only academic empirical study presented after the mid 1990s was conducted by Tang in 1997-98 and presented in his 2002 book “Current trends and corporate cases in transfer pricing” (Eden, 2003). This study is a continuation of his former studies and provides a more general perspective on transfer pricing practices. Thus, although there are some sources of newer empirical research, it has been 14 years since the last academic empirical study on transfer pricing practices was conducted.

Another interesting thing discovered in this literature study is that, in some articles, it seems as if the authors do not have a complete overview of the transfer pricing literature. As stated earlier, the article written by Baldenius et al. in 2004 could probably have made use of the findings presented by Schjelderup and Sjørgard in 1997. By looking at the reference list of their article it does not seem as if they are aware of Schjelderup and Sjørgard’s article (Baldenius, et al., 2004). A reasonable explanation for this lack of reference could be the extensiveness of the transfer pricing literature, and the fact that it includes many different research disciplines (e.g. accounting, tax, economics, org. theory, etc.). This makes it difficult for scholars to get the overview of former research. Another aspect of this issue is that the integration between different research disciplines is sometimes quite low, because research with different perspectives is published in different journals (Schjelderup, 2011). An example of this issue is the Schjelderup and Sjørgard (1997) article, which is published in “International tax and public finance”. This journal is probably not the first place to look for research about transfer pricing for an accounting scholar, and research published here could therefore end up “under the radar” of other scholars.

Based on the findings from this literature study, a suggestion for future research is to conduct a new and extensive empirical study of transfer pricing practices such as those Tang has contributed (Emmanuel & Mehafdi, 1994). It is important that the study takes a broader perspective than those conducted by the big tax advisory firms, to enable more detailed insights on general transfer pricing practices and not only on those that are related to taxation. This would provide important insights on how MNEs are currently solving the transfer pricing problem, as well as provide a good basis for studying the development in transfer pricing practices the last 15 years. We also saw that it could be difficult to get an overview over the transfer pricing literature because it spans over many different disciplines. Thus, a full overview of the existing research could also be useful for future research.

## 2. Transfer pricing practices in Norway

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We have in the preceding part seen how the transfer pricing problem have been approached, discussed, and solved in the literature. Some of the approaches, discussions and solutions have been based on studies of transfer pricing practices, while others have taken the more theoretical approach basing the discussions and findings on theoretical models. In this part the purpose is to discover how MNEs are approaching and solving the transfer pricing problem in practice. A thorough empirical study of these practices, as suggested above, is beyond the scope of this master thesis, and a simpler method for gathering knowledge about transfer pricing practices will therefore be applied. When studying transfer pricing practices we will try to determine the actual transfer pricing practices used by MNEs, and to which degree the MNEs are following the advices given in the literature. Natural extensions of these questions are what kind of competences the MNEs have on transfer pricing, and which focus the firms and the tax/transfer pricing advisory firms have<sup>9</sup>.

Before going into detail on these questions, the general situation will be established. Here we will first discuss some former empirical studies of transfer pricing practices, and, thereafter, present the general situation in Norway based on the reports provided by Norwegian tax authorities (Skattedirektoratet) and the surveys provided by the big tax advisory firms. The discussion will then move over to transfer pricing practices in Norwegian companies with a focus on the questions mentioned above. The background for this discussion is a survey sent out to transfer pricing advisory firms and interviews with the Norwegian tax authorities.

### 2.1 Some statistics on international transfer pricing practices

During the last 40 years there have been numerous studies of transfer pricing practices in MNEs in different countries. Some of these studies have led to important findings, such as Eccles' MAP framework. Emmanuel and Mehafdi give an extensive overview of the empirical research that has been conducted up until the beginning of the 1990s (Emmanuel & Mehafdi, 1994), and Borkowski gives a good overview over empirical research on international transfer pricing for the same period (Borkowski, 1996). For research conducted from the mid-1990s and until today it is, however, more difficult to get the overview. The only usable overview is provided by Eden at her website (Eden,

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<sup>9</sup> from what we have seen so far it seems that they are mostly interested in taxation-related issues (Ernst & Young, 2010; KPMG, 2011)

2007). Here we can see that after Tang's 1997-98 study, there have not been any major empirical studies on transfer pricing practices, apart from the ones conducted by tax advisory firms<sup>10</sup>.

To give an introductory overview of what we know about transfer pricing practices in general, some of the most important studies in the available empirical research will be summed up and commented in this section. Although most of these studies have been conducted among U.S. firms, it is reasonable to assume that practices in European countries, such as Norway, are similar due to the similarity of legislation in this area. An important difference, however, is that U.S. tax authorities allow some transfer pricing methods that are not allowed in other countries, such as the comparable profits method. This could have impact on the practices observed in the U.S. compared to the practices in other countries. Another aspect, also mentioned above, is that some of these studies are fairly old, and they might therefore not be very relevant for the current situation. To try to counter this potential irrelevance, studies from different decades are presented in order to say something about the development in the area of transfer pricing practices.

We begin with a brief overview of empirical research where the use of different transfer pricing methods have been surveyed, under you will find a table presenting some of the most important contributions.

	Vancil (1978)	Tang (1979)	Borkowski (1990)	Tang (1992)	Cravens (1997)	Tang (1998)
<b>Number of respondents</b>	247	85	168	90	82	95
<b>Scope</b>	Domestic, USA	International, U.S. MNEs	Domestic, USA	International, U.S. MNEs	International, U.S. MNEs	International, U.S. MNEs
<b>Cost-based</b>	45,4 %	47,0 %	44,7 %	41,0 %	42,0 %	43,0 %
<b>Market-based</b>	30,0 %	39,0 %	32,7 %	46,0 %	33,0 %	36,0 %
<b>Negotiated</b>	21,5 %	14,0 %	22,6 %	13,0 %	18,0 %	14,0 %
<b>Dual</b>	3,1 %	-	-	-	7,0 %	-
<b>Other</b>	-	-	-	-	-	7,0 %

Table 4 - Empirical findings on transfer pricing practices (Eccles, 1985; Emmanuel & Mehafdi, 1994; Cravens, 1997; Borkowski, 1992; Borkowski, 1996; Eden, 2003)

<sup>10</sup> The surveys conducted by Ernst & Young are frequently used as references in the newer literature on transfer pricing (Baldenius, et al., 2004; Baldenius & Reichelstein, 2006; Bo Nielsen, et al., 2008; Chwolka, et al., 2010).

By comparing the numbers across the different surveys, we can see that there are some variations between the practices used for international transfer pricing and those used for domestic transfer pricing. This is consistent with the findings of Tang and Wu and Sharp (Wu & Sharp, 1979; Eden, 2003). We see that negotiated transfer pricing is more popular for domestic transactions than for international (cross-border) transactions (Cravens, 1997). A fact that somewhat confirms what we have assumed in the literature study with negotiated transfer pricing being more difficult to apply in international transactions due to tax legislation.

When looking at international transfer pricing, on the other hand, we can see a fairly large fluctuation in the use of market-based methods between the different international transfer pricing surveys. We would expect a certain difference between domestic and international transfer pricing practices, but we see that there are also considerable fluctuations between the different surveys of international transfer pricing practices. We know, however, that Tang used the same survey questions for all of his studies, and, according to his results, there is an increase in the use of market-based methods and a decrease in the use of cost-based methods between 1979 and 1992. Then we can see that from 1992 to 1998 there is a considerable change in the methods used for international transfer pricing in the U.S., we especially notice the large drop in the use of market-based methods. Cravens' 1997 study confirms Tang's results here. The most probable explanation to these large changes is a change in legislation or government policy in the same period. We know that it was from the beginning of the 1990's that authorities started to take transfer pricing under closer scrutiny (The Economist, 2004), something which both makes the observed changes plausible and shows that authorities and legislation have a considerable impact on transfer pricing practices. Our suspicion is further confirmed when looking at Levey et al.'s book *"Transfer pricing rules and compliance handbook"* where we can see from the table presented on page 6 that there were several important contributions to the U.S. transfer pricing legislation during the period between 1992 and 1998 (Levey, et al., 2006). This gives some support both for the general hypothesis of this thesis, namely that tax legislation impacts transfer pricing practices, and for our explanation of the changes in practices observed in the U.S. between 1992 and 1998.

When comparing Tang's results with Craven's results, we see that they are fairly equal, although some minor differences exist. This could be due to a different classification of methods in the two studies. Other factors that can lead to differing results in the studies presented above are both that they are based on different samples of firms and that they have different designs. Despite the variation in data samples, however, all the empirical studies presented above report to have a considerable share of their respondents coming from firms in manufacturing industries (Emmanuel & Mehafdi, 1994; Borkowski, 1996). We can also see that surveys conducted at the same point in time

(e.g. Cravens and Tang) report similar findings. Most of the variation between the studies is therefore probably explained by differences in practices for domestic and international internal transactions and a development from market-based to cost-based methods in international transfer pricing.

Since there seems to be a difficulty of comparison between the different studies presented above, Tang's studies will be used as the benchmark in the following discussion of transfer pricing practices in Norway. This is because Tang has conducted his study at three different points in time (1978, 1992 and 1997-98), which make his results the best to use as an indication of the trend. Since his last study is also the most recent one, Tang's results are in addition the best starting point for saying something about the situation today. For areas not covered in Tang's research, we will use Cravens' study as the benchmark.

When looking at the development in transfer pricing practices, we see that the practices for domestic transfer pricing have been fairly stable over time. This stability could indicate that, although 15 to 20 years old, the existing empirical studies might still have some relevancy today. For international transfer pricing, on the other hand, there have been changes over the period covered by the presented studies. This leads us to expect that a certain development has taken place during the last 15 years as well, thus, the existing empirical studies cannot be used to say much about the current situation for MNEs. When we in addition know that there has been a major development in taxation practices related to transfer pricing the last 15 years (The Economist, 2004), the need for new empirical research, discovered in the literature study, is reinforced.

Another interesting statistic that helps to increase our understanding of transfer pricing practices is the MNEs' objectives for using transfer pricing. In relation to her empirical study, Cravens also investigated this matter; her findings are presented in the two tables below.

<b>Taxation- related</b>	<b>51 %</b>	<b>Internal management-oriented</b>	<b>21 %</b>	<b>International or operational</b>	<b>28 %</b>
Manage tariffs	4 %	Equitable performance evaluation	7 %	Cash transfer restriction	2 %
Comply with tax regulation	7 %	Motivation	9 %	Competitive position	21 %
Manage tax burden	40 %	Promote goal congruence	5 %	Reflect actual costs and income	5 %

**Table 5 - Primary objective of international transfer pricing for MNEs (Cravens, 1997)**



<b>Manage tax burden and related objectives</b>	<b>28 %</b>
<b>Maintain competitive position</b>	<b>17 %</b>
<b>Promote equitable performance evaluation</b>	<b>11 %</b>
Promote goal congruence	10 %
Motivate employees	10 %
Manage tariffs (import tax) and related objectives	9 %
Comply with tax regulations	7 %
Other	8 %

**Table 6 - Weighted average of the three most important objectives of international transfer pricing (Cravens, 1997)**

This statistic gives some support to the contributions made by Schjelderup and his colleagues, as we can see that the two most important objectives for firms when it comes to transfer pricing is (1) to manage the tax burden (tax optimisation) and (2) to maintain the competitive position (strategic optimisation). Similar findings are also presented by Tang (Eden, 2003). Thus, Schjelderup and Sjørgard's thoughts about how to maximise profit through transfer pricing also seem to be the objective of MNEs in practice.

In the most recent study of global transfer pricing practices conducted by Ernst & Young, we are presented with the following information about the use of different arm's length methods.

Tangible goods		Services	
Cost plus	30 %	Cost plus	52 %
Comparable uncontrolled price (CUP)	27 %	Comparable uncontrolled price (CUP)	21 %
Profit-based methods (CPM and TNMM)	23 %	Transactional net margin method (TNMM)	11 %
Resale price method	12 %	At cost	7 %
Profit split	3 %	Value-based service fees	2 %
Other	6 %	Other	6 %

**Table 7 - Use of arm's length methods in MNEs (Ernst & Young, 2010)**

This survey confirms what we saw from Tang's studies above with cost-based transfer pricing being more common for international transactions than market-based pricing. For tangible goods, however, it becomes a question of classification, because the comparable profits method (CPM) and the resale price method also could be said to be some sort of a market-based method where you compare a firm's profits from an internal transaction with that of its competitors. By combining the numbers for the CUP method, comparable profits method (CPM) and the resale price method, you would get a total share for market-based transfer pricing methods that are higher than cost-based methods. Thus, contradicting Tang's findings. This being said, it is not a good base for making comparisons between the statistics presented here and the ones presented above. This is because this statistic looks at arm's length methods while the one above studies general transfer pricing

methods. What we can see from this survey, however, is that the practices for tangible goods and services differ considerably. The high use of the cost plus method for services could indicate a higher difficulty of finding comparables for internal transactions of services.

Another aspect that is relevant for understanding transfer pricing practices is to see where in the organisation decisions about transfer pricing are being made. Tang finds that the majority of transfer pricing policies are determined centrally in the organisation (59 %), while only a relatively small share of the companies leave the decision about policy to the division managers (22 %). These figures could both mean that transfer pricing is seen as a very important issue within an MNE and that transfer pricing practices have to be controlled centrally for e.g. taxation reasons. Comparing this with the literature, it is considered optimal to decide transfer pricing centrally in both cooperative (vertically integrated) organisations and collaborative (vertically integrated and diversified) organisations. This could very well represent around 59 % of the firms surveyed, thus theory and practice seems to be consistent in this matter.

After having gotten the general feel about transfer pricing practices, we will now move over to the situation and practices in Norway. In relation to this, it will be interesting to see whether or not the practices and situation observed in Norway differs from what was presented above.

## **2.2 The current situation in Norway**

Norway generally follows the OECD guidelines for transfer pricing, and beginning with the fiscal year of 2008 the Norwegian tax authority implemented mandatory reporting for firms with internal cross-border transactions (Deloitte, 2010; Skattedirektoratet, 2009). This new mandatory reporting was implemented through a new form (RF-1123), where internal cross-border transactions valued higher than NOK 10 million has to be documented. An interesting aspect of these new reporting procedures is that in November/December 2007, only months before the new reporting procedures were implemented, half of the leaders in MNEs operating in Norway said that they did not know about the new requirements that would soon come into effect (Jørgensen, 2009). After the introduction of the new reporting procedures, a transfer pricing group/task force was also created internally in the Norwegian tax authority to improve the focus on and follow-up of the new reporting procedures (Ernst & Young, 2010). An interesting aspect of the Norwegian transfer pricing legislation is that Firms that only report to have domestic internal transfers are subject to the same rules as those that also report internal cross-border transactions. This is to ensure that domestic firms do not get a competitive advantage relative to MNEs in Norway (Ernst & Young, 2010; Norwegian Ministry of Finance, 1999; Skattedirektoratet, 2011). Important to notice is also that the Norwegian tax

legislation do generally not allow for advance pricing agreements (APAs) (PWC, 2010). The authorities are, however, currently studying the effects of a potential introduction of APAs in Norway (Larsen, 2011). Since transfer pricing is a fairly new focus in Norway, we should expect that the practices in Norway differ from those countries where the focus on transfer pricing have been maturing longer, such as the U.S. where they have had transfer pricing legislation since the mid-1990s (Levey, et al., 2006).

Based on the new reporting procedures and the efforts of the internal group working with transfer pricing, the tax authority has issued an annual report the last two years. The report describes their work within the field of transfer pricing, and the general situation in Norway when it comes to internal transactions and transfer pricing related issues. To get a grasp of the situation in Norway these reports are a good place to start. For 2010 the tax authority reports that 3201 Norwegian firms stated to have internal cross-border transactions<sup>11</sup>. This is an increase of ten firms compared to 2009 (Skattedirektoratet, 2009). When looking at the firms that report to have internal cross-border transactions, almost half of them have annual sales of more than NOK 100 million and 20 % are firms with more than 100 employees. Further, the tax authority reports that most of the internal cross-border transactions were conducted with a counterparty in the EEA (European Economic Area) or another country that Norway has an information exchange agreement with. Only 7 % of the transactions had counterparty in a so-called tax-haven, a country that Norway does not have an information exchange agreement with. This is an increase of 5 % compared to 2009 (Skattedirektoratet, 2009; Skattedirektoratet, 2010). The internal cross-border transactions are quite evenly distributed across three of the four categories of transactions that the tax authority operates with, where operational transactions account for 31 %, asset transactions account for 6 %, financial transactions account for 26 % and debt account for 37 % (Skattedirektoratet, 2010).

In addition to the tax authority, Ernst & Young conducts a study of transfer pricing practices each year in their "Global transfer pricing survey" (Ernst & Young, 2010). This survey is mostly concerned with the tax aspects of transfer pricing, but it can give us some insights when it comes to the concerns of MNEs. In their 2010 survey there is a section presenting results for Norway. From these results we can see that transfer pricing has a high priority in MNEs, and we see that MNEs are concerned with the requirements for documentation of practices raised by the tax authorities. We also see that 60 % of the firms asked in this survey reports that tax risk management is one of the top priorities for the transfer pricing strategy.

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<sup>11</sup> This number is based on the number of firms that submitted tax form RF-1123, which concerns internal cross border transactions. Some firms are not required to submit this form either because they submit tax form RF-1045 or because their total internal cross-border transactions have a value lower than NOK 10 million (Skattedirektoratet, 2010).

Now that we are familiar with both the general trend for transfer pricing practices and the current situation in Norway, we will move on to study the transfer pricing practices in Norwegian MNEs.

## **2.3 Study of the transfer pricing practices in Norwegian MNEs**

The purpose of this study is to gather information about transfer pricing practices in Norwegian MNEs. This information will then be used in a comparison of theory and practice with regards to transfer pricing. The purpose of this comparison will be to see whether or not Norwegian MNEs are following the advice given in the literature, and to give advice on what can be done to improve the congruence between theory and practice with a focus on the issues arising from tax legislation.

### **2.3.1 Research methodology**

To gather data about transfer pricing practices in Norwegian multinationals this master thesis used a survey sent out to four transfer pricing advisory consultants, one at each of the big four audit and advisory firms (Ernst & Young, KPMG, Deloitte and PWC), and one Norwegian MNE. The consultants working at these four firms have very good insights into the transfer pricing practices of Norwegian multinationals, and are thus both a good and efficient source for gathering information. The answers from the MNE will provide some sort of benchmark or verification of the responses from the transfer pricing consultants.

The information gathered through this survey model is very well suited for qualitative analysis, but they can, however, not be used for quantitative analysis since we only have four respondents. Some might argue that this is a considerable weakness, but, since transfer pricing consultants give advice to a large number of firms each year, the survey model used in this thesis will still give a good indication on the practices in Norwegian MNEs. An additional strength of using transfer pricing advisory consultants, instead of representatives from MNEs, is that the consultants both have better knowledge in general about transfer pricing, something which ensures that they understand the concepts and terminology used in the questionnaire, and they are also more objective when it comes to the practices observed at their clients than the clients would be themselves. Thus, the bias in the answers is probably smaller than if the firms had been surveyed directly. On the other hand, one could argue that the consultants would not have as good insight into a firm's operations as the firm's employees. This is true for the general operations, but, in order to provide high-quality advisory services, the consultants need to have access to all the information within the area they are providing advice. Based on this argumentation it seems that consultants also have the necessary insights to be a good source of information.

When comparing the survey conducted for this thesis with the empirical research presented under section 2.1, you see that our survey has a somewhat different approach, as it targets transfer pricing consultants instead of firms directly. This could lead to problems when comparing the research conducted here with former research. Despite this potential difficulty of comparison, it is reasonable to believe that the trends and statistics derived from the research conducted in relation to this master thesis would be in line with the trends emerging from research with a different design. This is because the questions and purpose of the research are still similar. Thus, the study presented here should be able to say something about the practices in Norway, give an indication on the direction of development the past years, and be comparable with other research.

The survey is designed to gain insights about the practices transfer pricing consultants observe at their clients. The survey will also try to reveal the focus of transfer pricing consultants and the MNEs' motivation for transfer pricing. The survey questions are largely based on the empirical studies presented earlier in this part and other empirical studies of transfer pricing practices (Borkowski, 1996; Borkowski, 1992; Cravens, 1997; Emmanuel & Mehafdi, 1994; Wu & Sharp, 1979). The survey is designed to gather information about:

- Organisational structure of Norwegian MNEs
- Norwegian MNEs' knowledge level on transfer pricing and taxation
- Transfer pricing methods used by Norwegian MNEs
- Arm's length methods used by Norwegian MNEs
- Transfer pricing and transfer pricing policy decisions in Norwegian MNEs
- The motivation for using transfer pricing in Norwegian MNEs
- The size of the transfer pricing advisory market

A copy of the survey together with the results will be presented in the section "Research results". The consultants' comments to the questions are presented in the appendix section A3.2. After having presented the results, they will be used in a comparison of theory and practice in part 3.

### **2.3.2 Research hypotheses**

From the literature study, former empirical research and the current situation, we can draw out several hypotheses of what we expect to see from the survey with regards to how Norwegian MNEs approach and use transfer pricing. These hypotheses are the base for the questions in our survey, and the conclusions drawn from them will be used in the comparison of theory and practice in part three of this thesis.

We saw from the article written by an advisor at Deloitte that a high share of managers was not aware of the upcoming requirements for transfer pricing reporting in November/December 2007 (Jørgensen, 2009). This indicates that the knowledge about transfer pricing in Norwegian MNEs seems to be fairly low. Such a low level of knowledge would further lead us to believe that there is a fairly high demand for transfer pricing advisory services. This makes it interesting to study the general level of knowledge among firms when it comes to transfer pricing and tax related issues. Hence, we get the following hypothesis:

### **2.3.2.1 Norwegian multinationals generally have a low level of knowledge when it comes to international transfer pricing and tax related issues.**

From Baldenius et al. (2004) we derived the optimal rule for transfer pricing given  $t_m \leq t_d$ <sup>12</sup> and Cournot competition. In this case we would expect TP = market price minus a discount, or TP = most favourable arm's length price, when there is no market for the intermediate product. For the situation without a market for the intermediary product the only applicable arm's length methods will be the cost plus method, the resale price method, or the transactional net margin method. As we have seen earlier, the transactional net margin method could also be applied when market price minus a discount is being used to calculate the transfer price. For Bertrand competition we saw from Schjelderup and Sjørgard (1997) that the transfer price (TP) should be set higher than MC, to avoid aggressive behaviour from competitors. Thus, a TP equal to market price seems reasonable to expect here, which implies the use of the CUP method. From looking at table 6 we also see that the four expected methods from the argumentation above are the most popular methods on a global basis. Based on these expectations and observations we can write the following hypothesis:

### **2.3.2.2 The arm's length methods used by Norwegian multinationals are either CUP, Cost plus, resale price or Transactional net margin.**

Schjelderup and Sjørgard (1997) show in their article that there are two main objectives for transfer pricing: strategic optimisation and tax optimisation. They also show that there in some cases can be a conflict between these two objectives. Operating with two sets of books and two separate transfer prices, is discussed as one of the solutions to this conflict. Despite being a potential solution, both scholars and statistics show that the practices of dual pricing and two sets of books are fairly uncommon. By solving the conflict between strategic optimisation and tax optimisation, the practice of keeping two sets of books and using two separate transfer prices for each transaction could be

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<sup>12</sup> see example in figure 2, section 1.6

very valuable. This makes it interesting to check whether or not practice in Norway is different from elsewhere.

### **2.3.2.3 Relatively few Norwegian MNEs use two sets of books and two separate transfer prices for the same transaction.**

Since there also could be other reasons for why firms keep two sets of books, it is interesting to more specifically investigate the firms' behaviour relative to Schjelderup and Sørsgard's (1997) findings. We have seen from the literature study that transfer prices have implications for performance evaluation and management incentives within a firm. These two can be said to be tools for reaching strategic optimisation, thus we will include them under the strategic optimisation objective. Table 5 in section 2.1 confirms that tax optimisation and strategic optimisation are the most important objectives for transfer pricing. To see if this is also true for Norwegian firms we get the following hypothesis:

### **2.3.2.4 Norwegian multinationals are concerned with both tax optimisation and strategic optimisation when designing and using their transfer pricing system.**

We also saw from Bo Nielsen et al. (2008) that tax optimisation incentives could impact the way an MNE was organised. So far we have not seen any statistics that indicate whether or not this happens in practice, thus it is interesting to test if this is true.

### **2.3.2.5 Tax optimisation incentives affect the way in which Norwegian multinationals are organised.**

Since the survey used for gathering data about transfer pricing practices in this master thesis is being answered by transfer pricing advisory consultants, it is interesting to also try to get an understanding of how the transfer pricing advisory industry works. This is an industry that has come to life due to the lack of knowledge about tax and transfer pricing among MNEs and other firms. Thus, it is reasonable to assume that the objectives of MNEs depend on the objectives of transfer pricing advisors. Interviews and conversations with transfer pricing advisory consultants indicate that they are mainly concerned with tax optimisation (Andresen & Basteviken, 2011; Larsen, 2011).

### **2.3.2.6 Transfer pricing advisory consultants are first and foremost concerned with optimising MNE tax payments across countries and subsidiaries.**

We will now move on to see whether or not these hypotheses about Norwegian transfer pricing practices can be confirmed in a survey answered by transfer pricing advisory consultants and a business controller in a firm adhering to a large Norwegian multinational group.

### 2.3.3 Research results

After having gotten responses to the survey from the big four audit and advisory firms, we can present the following results<sup>13</sup>. The responses from the four firms are based on observed practices at more than 150 firms that are buying transfer pricing advisory services. Towards the end of this section on research results we will also present and comment on a set of answers to our survey provided by a Norwegian MNE, as some sort of control/verification of the responses provided by the big four audit and advisory firms.

Question 1 gives us an idea of what kind of firms that the observations are taken from when it comes to size and complexity of operations<sup>14</sup>. We can see that the firms are relatively evenly distributed between the different degrees of vertical integration. This indicates that the internal transactions happen both horizontally between business units in the same part of the value chain, and vertically between business units situated in different parts of the value chain. Further we see that the average degree of diversification is low, meaning that firms are operating in only one or two different industries. We also see that the degree of centralisation is medium to high, which indicates that business unit independence is fairly limited for the average firm in our study. To get an idea about how a transfer pricing policy could look like in such firms, we can try to place them in Eccles' MAP framework (Eccles, 1985). Here we see that a fairly low degree of diversification and a medium degree of vertical integration classifies the average firm in this survey in the intersection between a "collective" and a "cooperative" firm. An interesting characteristic of this type of firms is that they are moving from a point where they neither have the need for transfer pricing nor do they have a transfer pricing policy, to a point where they have a need for both. By using this classification of the average firm in our study as some sort of benchmark, we are lead to expect that the transfer pricing practices are not well-developed for the average firm in this survey (Eccles, 1985). The respondent from Ernst & Young confirms this expectation when he states that most of the firms he advises operate without any form of transfer pricing policy or systematic approach to transfer pricing<sup>15</sup>.

Question 2 tries to determine the knowledge level on transfer pricing and tax issues, and the demand for transfer pricing advisory services. Here we can see that the firms in this survey have a relatively high level of knowledge when it comes to tax issues, and a fairly low level of knowledge when it comes to transfer pricing. Based on this we can conclude that hypothesis 1, presented in the section on research hypotheses, is confirmed when it comes to knowledge about transfer pricing, but not

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<sup>13</sup> See the next pages for the survey responses.

<sup>14</sup> Question 1 is based on Eccles' MAP framework and transaction cost theory presented in the literature study and appendix A1 and A2.

<sup>15</sup> For reference see the comments to the survey from Ernst & Young in the appendix, A3.2.1.



when it comes to knowledge about tax issues. This is in line with what we would expect from the benchmark firm described above. The lack of knowledge about transfer pricing leads the firms to ask for advice in a relatively high share of transfer pricing-related issues, as we can see from the responses to question 2c. This can be seen as an indication on a relatively high demand for transfer pricing advisory services from Norwegian firms.

1. How are your TP advisory clients organised (organisational structure)?					
Distribute a total of 100 points according to percentage of clients at each level in a, b and c					
a. Vertical integration - how much of the entire value chain is controlled/owned by the company?					
	E&Y	KPMG	Deloitte	PWC	Average
<b>High</b> (more than two parts of the value chain, e.g. production, distribution, retail)	0%	80%	20%	50%	37,5%
<b>Medium</b> (two parts of the value chain, e.g. production and distribution)	40%	20%	50%	50%	40,0%
<b>Low</b> (one part of the value chain, e.g. production)	60%	0%	30%	0%	22,5%
b. Diversification - how diversified are your clients?					
	E&Y	KPMG	Deloitte	PWC	Average
<b>High</b> (operates in more than two different industries)	0%	10%	5%	0%	3,8%
<b>Medium</b> (operates in two different industries)	20%	40%	25%	20%	26,3%
<b>Low</b> (operates in one industry)	80%	50%	70%	80%	70,0%
c. Centralisation - how centralised are your clients?					
	E&Y	KPMG	Deloitte	PWC	Average
<b>High</b> (Most operational decisions are taken by central management)	30%	60%	50%	20%	40,0%
<b>Medium</b> (Both central and business unit management makes operational decisions)	55%	30%	45%	30%	40,0%
<b>Low</b> (Most operational decisions are taken by business unit management)	15%	10%	5%	50%	20,0%
2a. What is you TP advisory clients' level of knowledge of transfer pricing?					
Distribute a total of 100 points according to percentage of clients at each level					
	E&Y	KPMG	Deloitte	PWC	Average
<b>High</b> (the client have extensive knowledge about transfer pricing)	5%	10%	30%	30%	18,8%
<b>Medium</b> (The client have good knowledge in some areas)	25%	30%	50%	10%	28,8%
<b>Low</b> (The client has generally little knowledge about transfer pricing)	70%	60%	20%	60%	52,5%
2b. What is you TP advisory clients' level of knowledge of taxation and tax related issues?					
Distribute a total of 100 points according to percentage of clients at each level					
	E&Y	KPMG	Deloitte	PWC	Average
<b>High</b> (the client have extensive knowledge about taxation and tax related issues)	80%	20%	15%	40%	38,8%
<b>Medium</b> (The client have good knowledge in some areas)	15%	60%	70%	50%	48,8%
<b>Low</b> (The client has generally little knowledge about taxation and tax related issues)	5%	20%	15%	10%	12,5%
2c. How frequently do your TP advisory clients ask for advice?					
Distribute a total of 100 points according to percentage of clients at each level					
	E&Y	KPMG	Deloitte	PWC	Average
<b>Often</b> (The client asks for advice in most of the issues concerning transfer pricing)	60%	10%	5%	40%	28,8%
<b>Some times</b> (The client asks for advice in important issues related to transfer pricing)	20%	50%	70%	30%	42,5%
<b>Seldom</b> (The client only asks for advice in critical issues related to transfer pricing)	20%	40%	25%	30%	28,8%
3a. What is the primary transfer pricing method used by your clients?					
Distribute a total of 100 points according to percentage of observed use					
Market based methods					
Market price	0%	10%	5%	20%	8,8%
Market price minus a discount	30%	0%	5%	0%	8,8%
Cost based methods					
Full cost	0%	0%	5%	20%	6,3%
Full cost plus profit margin	60%	30%	75%	30%	48,8%
Variable cost plus opportunity cost	0%	0%	0%	0%	0,0%
Other methods					
Dual prices (one transfer price for tax purposes and one transfer price for internal purposes)	0%	10%	0%	0%	2,5%
Negotiations between buying and selling business unit	10%	50%	10%	10%	20,0%
If they use other methods than those mentioned above, please specify					
Resale price	0%	0%	0%	20%	5,0%
3b. How many of your clients use two sets of books, one for tax purposes and one for internal purposes?					
Distribute a total of 100 points according to the number of clients in each category					
	E&Y	KPMG	Deloitte	PWC	Average
Have only one set of books for financial accounting and tax purposes	70%	80%	80%	100%	82,5%
Have a set of books for internal purposes in addition to the set of books used for financial accounting and tax purposes	30%	20%	20%	0%	17,5%

Figure 3 - Answers to question 1 to 3 of the transfer pricing practices survey

4. What is the primary arm's length method used by your clients?					
Distribute a total of 100 points according to percentage of observed use					
	E&Y	KPMG	Deloitte	PWC	Average
Comparable uncontrolled price (CUP)	5%	5%	5%	20%	8,8%
Resale price	35%	0%	10%	20%	16,3%
Cost plus	50%	25%	25%	60%	40,0%
Transactional net margin	0%	50%	50%	0%	25,0%
Transactional profit split	10%	20%	5%	0%	8,8%
If they use other methods than those mentioned above, please specify					
Discounted cash flow model	0%	0%	5%	0%	1,3%

5a. Who decides the transfer pricing policy (which transfer pricing method to use)?					
Distribute a total of 100 points according to practices used by your clients					
	E&Y	KPMG	Deloitte	PWC	Average
Central management (CEO, CFO, etc.)	33%	50%	85%	70%	59,5%
Business unit (division, department, etc.) management	33%	20%	10%	20%	20,8%
Cooperation between central and business unit management	33%	30%	5%	10%	19,5%

5b. Who sets the actual transfer price?					
Distribute a total of 100 points according to practices used by your clients					
	E&Y	KPMG	Deloitte	PWC	Average
Central management (CEO, CFO, etc.)	20%	20%	60%	20%	30,0%
Selling business unit (division, department, etc.) management	30%	10%	20%	30%	22,5%
Buying business unit (division, department, etc.) management	10%	10%	0%	0%	5,0%
Cooperation between buying and selling business unit	20%	50%	10%	40%	30,0%
Cooperation between central and business unit management	20%	10%	10%	10%	12,5%

6a. What is the primary focus/motivation of your TP advisory clients with regards to transfer pricing?					
Distribute a total of 100 points according to percentage of clients with each focus					
	E&Y	KPMG	Deloitte	PWC	Average
Minimise tax burden (corporate and import taxes)	5%	30%	30%	20%	21,3%
Comply with tax legislation	75%	50%	50%	80%	63,8%
Maintain competitive market position	0%	10%	10%	0%	5,0%
Equitable (fair) incentives and performance evaluation	10%	10%	5%	0%	6,3%
Goal congruence (cooperation between business units)	10%	0%	5%	0%	3,8%

6b. What is your clients' main objective with transfer pricing?					
Distribute a total of 100 points according to percentage of clients with each main objective					
	E&Y	KPMG	Deloitte	PWC	Average
Compliance and tax optimisation	70%	80%	75%	80%	76,3%
Optimise resource allocation and performance management across business units	15%	0%	0%	20%	8,8%
Both of the above mentioned	15%	20%	25%	0%	15,0%

6c. Does tax optimisation efforts affect how your clients are organised (org. structure)?				
	E&Y	KPMG	Deloitte	PWC
yes	yes	yes	yes	yes

6d. If yes on 6c., how?	
KPMG: There are so many possible answers to this questions. Generally, any restructuring (and also tax optimisation) requires a change in how the taxpayer is organised. If there is no change, there is no basis to alter the distribution of profits.	

7. What is the primary focus of TP advisors when serving clients?					
Distribute a total of 100 points according to percentage of clients with each focus					
	E&Y	KPMG	Deloitte	PWC	Average
Minimise tax burden (corporate and import taxes)	15%	30%	40%	60%	36,3%
Comply with tax legislation	60%	60%	60%	30%	52,5%
Maintain competitive market position	0%	0%	0%	0%	0,0%
Equitable (fair) incentives and performance evaluation	10%	10%	0%	0%	5,0%
Goal congruence (cooperation between business units)	15%	0%	0%	10%	6,3%

Figure 4 - Answers to questions 4 to 7 of the transfer pricing practices survey

Question 3 tries to determine the most popular transfer pricing methods used by Norwegian firms. The expectation, based on the empirical research presented in section 2.1 - table 3 and on our benchmark firm presented above, is that cost-based and market-based methods would be dominating here. This expectation is confirmed, but the share of firms using cost-based methods is somewhat larger than expected; while Tang reports that 43 % in his latest study use cost-based methods (Eden, 2003), more than 55 % of the firms in our study apply cost-based methods. What we also see here is that almost all of the firms using a cost-based method are using full cost plus a profit margin for finding the transfer price. It is reasonable to assume that this practice is affected by the arm's length principle and transfer pricing legislation, which requires a mark-up on top of costs for a

transfer price to be considered as arm's length. Question 3 also shows another interesting aspect related to transfer pricing methods; we see that although a small share of the firms operates with two sets of books (17.5 %), almost no one use dual pricing<sup>16</sup>. This is a bit unexpected, when we know that keeping two sets of books and using two separate transfer prices probably is the best way of achieving the multiple benefits that transfer pricing offers (Hyde & Choe, 2005). This is something that further confirms the low level of knowledge and immaturity when it comes to transfer pricing in Norwegian firms, as well as the benchmark we derived by applying Eccles' framework. Based on the answers to question 3, hypothesis 3 is confirmed.

In question 4, concerning arm's length price methods, our expectations as stated in hypothesis 2 are met<sup>17</sup>. We see, however, that the resale price method is more common than what was initially expected from looking at table 6 in section 2.1. A reason for this could be the fact that the transactional net margin method (TNMM) is difficult to use in practice. According to Ernst & Young it is very difficult for a firm to determine the margins charged by their competitors on single transactions. This has led to a practice that resembles the comparable profits method described in section 1.6.2.6, where the profit margin applied is derived from the general profit margin of the competitor. It is interesting that a method that does not seem to function properly in practice is included in the OECD guidelines for transfer pricing legislation, while a method, such as the comparable profits method, that works very well, judging from the practices observed in Norwegian firms with regards to TNMM, is left out of the OECD guidelines. This could indicate that there are some weaknesses in the proposed legislation from OECD, something which explains why e.g. the U.S. has chosen to also allow for other methods than those approved by the OECD<sup>18</sup>. By comparing the answers to question 4 with the Ernst & Young study from 2010 (table 6, section 2.1), we see that the practices in Norway are more or less in line with the global average, except for a lower use of the CUP method. Based on the answers to question 4 we can say that hypothesis 2 is confirmed, and we also note that, despite the reported difficulties of applying TNMM in practice, it is fairly common to apply as a method for finding the arm's length price. It is, however, used a bit differently than what was intended, when comparing the comments from Ernst & Young with the quote in section 1.6.2.4.

In question 5 the purpose is to determine where the responsibility for transfer pricing lies in the organisation. Here we can see that the central management is usually highly involved when it comes

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<sup>16</sup> Only 2.5 % of the total sample of firms report to use dual pricing, which constitute 14 % of those who report to use two sets of books.

<sup>17</sup> See section 2.3.2 on research hypotheses, and table 6 in section 2.1.

<sup>18</sup> For reference see the comments to the survey from Ernst & Young in the appendix, A3.2.1.

to creating the transfer pricing policy/rules about transfer pricing<sup>19</sup>, something which is in line with what Tang finds in his most recent study (Eden, 2003). Further we see that the determination of the actual transfer price is usually conducted by either central management, the selling business unit, or in a cooperation between the two. Here it is interesting to notice the comment from KPMG, which states that this cooperation in many cases rather takes the form of a negotiation between the two parties<sup>20</sup>. The answers to question 5 somewhat confirm the high level of centralisation that was observed in question 1c.

Question 6 studies the motivation for transfer pricing in Norwegian MNEs. Here we can see that more than 85 % of the firms have a primary motivation that is related to tax (compliance or optimisation). This is very high when comparing the numbers to e.g. Cravens' results from her 1997 survey (table 4, section 2.1), where only 51 % reported to have tax related issues as their primary concern. Another big difference encountered when comparing our results with Cravens' results is that while the firms in Cravens' study reports that managing the tax burden is the most important motivation when it comes to taxation issues and transfer pricing, Norwegian MNEs are mostly concerned with compliance with the tax legislation. Compared to both Cravens' study (Cravens, 1997) and the findings of Schjelderup and Sjørgard (Schjelderup & Sjørgard, 1997), we also see that the strategic dimension of transfer pricing is not at all considered by Norwegian multinationals. This can be seen from only 5 % saying that maintaining a competitive market position is a primary motivation for transfer pricing. Based on the answers to question 6 we can say that hypothesis 4 is rejected, as Norwegian firms in general only are concerned with tax compliance and tax optimisation when it comes to transfer pricing. These objectives and motivations seem quite immature when comparing practices in Norway to those observed in e.g. the U.S. The most probable explanation to this difference in maturity is that the transfer pricing legislation in Norway is fairly new, whilst the U.S. has had legislation since the mid-1990s. This could indicate that firms will gradually achieve the benefits from transfer pricing (Hyde & Choe, 2005), as practices mature after legislation has been implemented.

Question 6 also tries to determine whether or not tax optimisation and compliance issues affect the way a Norwegian MNE is organised, where our expectations, based on the findings of Bo-Nielsen et al. (2008), are that taxation issues affects MNE organisation. All the respondents to the survey answer that tax optimisation and compliance efforts affect the organisational structure of Norwegian MNEs, but few details are given on how. KPMG states that "in order to alter the

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<sup>19</sup> When looking at the comments from Ernst & Young in appendix A3.2.1, it seems that "transfer pricing policy" is a bit misleading when talking about the systems related to transfer pricing in Norwegian firms, but from question 5 it seems as if the firms have some sort of rules governing internal transfer pricing.

<sup>20</sup> For reference see appendix A3.2.2.

distribution of profits, there has to be a change in the structure in some way". Thus, we can say that hypothesis 5 is confirmed, but, beyond the fact that tax issues seems to affect MNE organisation, insights gained in relation to this question is limited. A suggestion for future surveys is to go deeper into this effect of transfer pricing legislation, to uncover how it affects firms more specifically.

Question 7 studies the transfer pricing advisory services offered to Norwegian MNEs. With a generally low level of knowledge about transfer pricing in Norwegian MNEs, the focus and objectives of transfer pricing advisory consultants could have a considerable impact on the motivation and focus of MNEs when it comes to transfer pricing. Important to mention here, however, is that the advisory firms are somewhat also limited by the MNEs' knowledge level, because they can only supply advisory services that MNEs demand and are willing to pay for. This means that as long as MNEs only focus on tax-related issues, transfer pricing advisory firms will only sell and have focus on tax-related advisory services. According to Sveinung Larsen, Senior Manager at Ernst & Young, the MNEs have to realise that transfer pricing can be used for more than just tax compliance, before they start demanding other types of transfer pricing advisory services. From his point of view, transfer pricing could have a considerable impact in Norwegian MNEs if it also was considered in e.g. the performance evaluation systems. Thus, there is a large potential for selling more advisory services for the advisory firms, given that MNEs realise that transfer pricing can be used for more than compliance with tax legislation. This is why Mr Larsen and his colleagues also have a focus on educating the clients when they provide transfer pricing advisory services<sup>21</sup>. The answers to question 7 suggest that the focus of transfer pricing advisory consultants is somewhat coinciding with the focus of MNEs, which is also what was expected from the relatively low level of knowledge about transfer pricing observed in Norwegian firms. Thus, hypothesis 6 is confirmed, but we have to bear in mind the insights contributed by Mr Larsen to this question.

Initially, a question about total revenues from selling TP advisory services and TP advisory market share was included in the survey. After looking at these figures and discussing the matter closer with Mr Per Frode Sundby from PWC, it turns out that it is very difficult to accurately define the market for TP advisory services. In addition to the big four audit and advisory firms, there are also some other firms<sup>22</sup> that has a position in the market for transfer pricing advisory services. It is also very difficult to define the total market, because many different parts of the big four audit and advisory firms are involved in TP related questions. These difficulties led to the decision of not including the information gathered about the TP advisory market in the presented research results. When it comes

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<sup>21</sup> See appendix A3.2.1 for the complete comment from Mr Larsen, and appendix A3.2.2 for comments from KPMG.

<sup>22</sup> This Include both consultancies and legal advisory firms.

to market shares it seems as if Ernst & Young and PWC are about the same size when looking at total revenue from transfer pricing advisory services, and that Deloitte and KPMG are somewhat smaller than these two. There are, however, several different segments of the TP advisory market, and the different firms have different positions in each segment<sup>23</sup>.

What we can say about the TP advisory market is that it is relatively small compared to the total market for audit and advisory services, as our research suggests that its total size is somewhere between NOK 50-150 million<sup>24</sup>. It is, however, a niche that has a considerable growth potential when considering the growth of internal cross-border trade in MNEs, the increased scrutiny by tax authorities, and the potential demand for additional services related to e.g. performance evaluation systems (Hyde & Choe, 2005). Thus, a good position in this market today could prove to be a good asset for advisory firms in the future.

To get a different perspective on the transfer pricing practices in Norwegian multinationals and to provide some sort of verification or control of the responses from the transfer pricing advisory firms, a business controller at a firm adhering to a large Norwegian multinational group has also answered a slightly adapted version of the survey<sup>25</sup>. Her answers confirm the observations reported by the transfer pricing advisory consultants on most of the questions raised in the survey. She also reports that the controllers spend a considerable amount of time on transfer pricing issues, confirming that transfer pricing is an important issue for Norwegian MNEs. Despite the general congruence between the answers provided by the controller and those provided by transfer pricing advisory consultants, there are two interesting deviations that are worth noticing. First, we can see that the firm is reporting to use two sets of books, and it is, thus, separating management accounting from financial accounting. From the responses provided by the transfer pricing advisory consultants we saw that a minority of Norwegian firms operate with this practice. The practice with two sets of books is probably more common in large groups than in smaller firms, and this could be a reasonable explanation for why we observe such a practice in firm X. Second, and more interesting, is that the controller reports that the structure of the company she works for is not affected by tax considerations. They have a structure with sales offices in many countries and are therefore well-positioned to exploit opportunities for tax saving as shown in the example in the literature study (section 1.6). This structure is, however, motivated by strategic considerations and not tax, according

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<sup>23</sup> For reference see appendix A3.2.3.

<sup>24</sup> According to proff.no (Norwegian website for company information) the total revenues of the big four (PWC, Ernst & Young, Deloitte and KPMG) was NOK 5.65 billion in 2010.

<sup>25</sup> The firm wishes to remain anonymous, thus their name and industry cannot be mentioned here. The firm will therefore be referred to as firm X. The answers provided by the firm can be found in appendix A3.1.

to the controller. Thus, even though the answer to question 6d was no, the firm is still positioned to take advantage of opportunities to reduce tax expenses.

### 2.3.3.1 Summary of research results

We can summarise the results of the survey in the following table:

<b>Hypothesis 1</b> - Norwegian multinationals generally have a low level of knowledge when it comes to international transfer pricing and tax related issues.	<b>Confirmed</b> , when it comes to knowledge about TP
<b>Hypothesis 2</b> - The arm's length methods used by Norwegian multinationals are either CUP, Cost plus, Resale price or Transactional net margin (TNMM).	<b>Confirmed</b>
<b>Hypothesis 3</b> - Relatively few Norwegian MNEs use two sets of books and two separate transfer prices for the same transaction.	<b>Confirmed</b>
<b>Hypothesis 4</b> - Norwegian multinationals are concerned with both tax optimisation and strategic optimisation when designing and using their transfer pricing system.	<b>Rejected</b> , Norwegian MNEs are only concerned with tax issues
<b>Hypothesis 5</b> - Tax optimisation incentives affect the way in which Norwegian multinationals are organised.	<b>Confirmed</b>
<b>Hypothesis 6</b> - Transfer pricing advisory consultants are first and foremost concerned with compliance and optimising MNE tax payments across countries and subsidiaries.	<b>Confirmed</b> , but consultants have to adapt to the focus of their clients

Table 8 - Summary of research results

The general conclusion of the survey conducted in relation to this master thesis is that Norwegian multinationals have a fairly low level of knowledge about transfer pricing, and that they are mainly concerned with the taxation issues related to transfer pricing. This is a relatively narrow focus when comparing it to the focus of e.g. American multinationals, which also considers the effects on competitive position and performance evaluation when using transfer pricing (Cravens, 1997). The narrow focus observed in Norwegian firms can be explained by the fairly new focus on transfer pricing from the Norwegian authorities, where specific reporting procedures for internal cross-border transactions was introduced as late as in 2008. The Norwegian tax authorities have only had a structured focus on transfer pricing after this implementation of specific reporting procedures (Ernst & Young, 2010).

We also saw that one of the arm's length methods, TNMM, does not work as it is intended in the legislation due to the difficulty of obtaining the required information for applying the method properly. Instead we observed a practice that more resembles the comparable profits method used in the U.S. This indicates that it probably is some potential for improvements in the current legislation concerning transfer pricing both in Norway and internationally (OECD).

The narrow focus and low level of knowledge observed in Norwegian firms leads us to believe that transfer pricing still has a considerable potential as a management control tool in most Norwegian multinationals. This potential could lead to increased earnings both for Norwegian MNEs and transfer pricing advisory firms in the future. The challenge restraining the potential of transfer pricing as a management control tool in Norwegian MNEs is the current level of knowledge about transfer pricing. The research in this thesis shows that in order for the potential to be released, MNEs need to learn about the opportunities of transfer pricing. Their main source of input in this matter is transfer pricing advisory consultants. Our findings suggest that it is in the consultants' best interest to educate the market on the opportunities of transfer pricing, and try to get MNEs to implement transfer pricing as a part of their management control system.



## 3. Theory versus practices in Norway

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In this third and final part we will compare the findings from the literature study (part one) with the practices observed in Norwegian firms in part two. The purpose of this comparison will be to uncover whether or not Norwegian multinationals follow the advices about transfer pricing given in the academic literature, and to take a closer look at how the observed transfer pricing practices are being impacted by legislation. We have already seen from our study, presented in section 2.3, that most of the research hypotheses we made about the transfer pricing practices in Norway was confirmed. These hypotheses were partly based on the findings from the literature study, and partly based on results from empirical research in other countries. Thus, we already know that there are considerable differences between the theoretically optimal way of conducting transfer pricing and the transfer pricing practices in Norwegian multinationals. In the following sections we will go deeper into the findings from our study and compare them with the findings from the literature study to determine the strengths and weaknesses with the current practices. Based on the results of this comparison we will make several propositions for improvements that can lead to higher congruence between theory and practice in the future.

### 3.1 The multi-disciplinary approach to transfer pricing

As described in section 1.4, Emmanuel and Mehafdi presented a model of the transfer pricing problem based on several different theoretical disciplines in their 1994 book (Emmanuel & Mehafdi, 1994). This is the most extensive model in the literature, and it gives a good overview of all the factors that have to be considered in what we can call an optimal transfer pricing system or policy. The model is fairly “hands-on”, and it should be quite intuitive for managers to understand and use when designing transfer pricing systems. An issue that was highlighted in part 1.4 is that it could be very time consuming to create a transfer pricing system in line with the model in existing organisations, because it is likely that changes would have to be made in a number of different areas. This led us to believe that the model would probably not be a popular tool for existing organisations, and it was proposed that such organisations instead made use of simpler models, such as Meer-Kooistra’s model<sup>26</sup> (Meer-Kooistra, 1994), to improve their transfer pricing system/policy. Emmanuel and Mehafdi’s multi-disciplinary model could, however, be a very good tool to apply in strategic change processes or when designing new organisations.

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<sup>26</sup> See appendix A2.

When looking at the transfer pricing practices, both generally and specifically in Norway, it does not seem that firms are applying a model as extensive as Emmanuel and Mehaftdi's multi-disciplinary model when designing their transfer pricing system. Most firms, especially in Norway, are only concerned with external regulations, which is only one of the numerous points mentioned as variables that affect the transfer pricing system in the multi-disciplinary model. This narrow perspective on transfer pricing leads to MNEs missing out on many of the benefits of using transfer pricing as a management control tool, such as improved goal congruence across the organisation, improved performance evaluation, and improved incentives (Hyde & Choe, 2005). In fact, our research suggests that many Norwegian firms might not even consider transfer pricing to be a management control tool, they rather perceive transfer pricing to be a phenomenon that occurs when they transfer goods and services across the organisation. This can be seen from the large focus on compliance among Norwegian firms. Such a focus indicates that the firms are treating transfer pricing as a limitation rather than an opportunity for their organisation. This underlines the considerable potential transfer pricing has as a control tool mentioned in section 2.3.3. If Norwegian firms manage to see transfer pricing as an opportunity for increased internal efficiency instead of an external threat that could potentially lead to expensive law suits from tax authorities<sup>27</sup>, considerable savings and increased profitability could probably be achieved<sup>28</sup>.

As mentioned in part two, the narrow focus of Norwegian MNEs could probably be explained by the generally low level of knowledge about transfer pricing that was discovered in our survey. We also discovered that a higher level of knowledge could lead to firms achieving more of the benefits inherent in a proper use of transfer pricing. To increase the firms' knowledge, transfer pricing advisory consultants was identified as a good channel for education, since they are the ones that firms turn to when they need additional knowledge or advice about transfer pricing. It could seem strange that these consultants should actually put down an effort to educate their clients, as there is a risk that firms with more knowledge might demand less advisory services; something which would lead to reduced revenues for the advisory firms. For transfer pricing, however, our analyses show that this is not the case. We have seen that a higher level of knowledge about transfer pricing would most probably lead to a desire for achieving more of the benefits that a proper use of transfer pricing offers, and thereby also a higher demand for transfer pricing advice required for achieving these benefits. Thus, an investment of time in education of clients will probably yield a good ROI (return on investment) for the advisory firms.

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<sup>27</sup> Such as the case with GSK presented in the introduction to this thesis.

<sup>28</sup> Such as what we saw from the Bellcore case presented in the introduction to this thesis.

## 3.2 Taxation and transfer pricing methods

In the literature study numerous transfer pricing methods, both general methods and the arm's length approved methods, were presented. We also saw that the arm's length principle effectively limits the selection of methods that a firm can apply to price internal transactions. Based on the selection of arm's length approved methods, scholars have tried to find the optimal method for pricing an internal transaction subject to the current transfer pricing legislation. Schjelderup and Sjørgard found in 1997 that the optimal transfer price both depends on tax rates and the competitive situation in the market of the buyer of the internally transferred goods or services. They also provided proof that indicated how an internal transaction should be priced relative to marginal cost in different scenarios for tax rates and competitive situations<sup>29</sup> (Schjelderup & Sjørgard, 1997). Baldenius et al. went one step further in their 2004 article and showed the optimal pricing method in different scenarios for tax rates and competitive situations. Here they find that either market price minus a discount or the most favourable arm's length price will be the optimal pricing methods, depending on the existence of market prices. They also show that under the separate entity approach<sup>30</sup> the transfer price used for internal purposes will depend on the tax transfer price when a dual pricing scheme is applied (Baldenius, et al., 2004). This somewhat reduces the efficiency of the dual pricing scheme, which is perceived as a solution for avoiding the negative impacts that tax legislation have on transfer pricing.

Although there is a lot happening in the literature with regards to optimal transfer pricing and the arm's length rules, one cannot say that these research results have been transferred to MNEs. While firms in countries such as the U.S. are maturing in their knowledge about and use of transfer pricing, Norwegian firms are still mostly concerned with compliance. Although empirical research show what we could call more mature usage of transfer pricing in some countries (Cravens, 1997), it does not look like any firm in any country have reached a level where they are applying the theoretically optimal transfer pricing methods. There is, however, a trend that more and more firms are starting to experiment with methods such as dual pricing (Hyde & Choe, 2005), which can be seen as a big step in the right direction. Norwegian firms, on the other side, are satisfied as long as their transfer pricing systems fulfil the legal criteria in order for them avoid any additional taxes. There are no indications in our research on Norwegian firms having reached a point where they are looking at more optimal uses of transfer pricing, something which again underlines the considerable potential for transfer pricing as a management control tool in Norwegian multinationals.

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<sup>29</sup> See table 2 in section 1.6.4 for more details.

<sup>30</sup> The separate entity approach is idea/principle behind the arm's length principle.

When trying to explain why we observe this “immaturity” among Norwegian firms, we again start with the legislation and the enforcement of the legislation by the Norwegian authorities. While the OECD standards have existed as a part of Norwegian legislation for a while, it is only quite recently that the Norwegian authorities have realised the potential tax revenues that can be collected by enforcing the legislation more rigidly. The last couple of years the authorities have collected almost NOK 400 million in additional tax revenues after having conducted transfer pricing audits that have increased taxable income of Norwegian MNEs by a total of NOK 1.4 billion (Skattedirektoratet, 2009; Skattedirektoratet, 2010). With such a dramatic change of behaviour by the authorities<sup>31</sup>, it is not surprising that the focus and motivation of Norwegian firms suddenly became compliance. It would be interesting to know how the transfer pricing practices in Norwegian firms were before this sudden change of tax authority behaviour in 2008. Judging from the practices we observe today, it is likely that Norwegian firms had even less knowledge about transfer pricing before 2008 than what they have today. The impact of the change of legislation in 2008 is, however, an issue that could be studied in a master thesis of its own, and I will therefore not consider it more in detail here.

### **3.3 Taxation, strategy, structure and transfer pricing**

From Schjelderup and Sjørgard’s 1997 article we also saw that, in some cases, there is a trade-off between a transfer price minimizing the tax expenses (tax optimisation) and a transfer price that maximizes the profit in a given competitive situation (strategic optimisation). If one of these is easier to achieve than the other, it could lead to a situation where the firm accepts a certain loss in efficiency to capture extra profit. Since tax optimisation is something that does not involve a third party (except for maybe transfer pricing advisory consultants), but a process that happens internally; it is reasonable to believe that tax optimisation is easier to achieve than strategic optimisation, which often involves adaptation to several external factors (Porter, 1985). If this is the case, then a focus on tax optimisation will lead to a situation where firms operate less than optimal with regards to e.g. volumes produced and sold in the market, which further leads to a higher than optimal market price due to a lower than optimal volume supplied. We will expect this behaviour from a tax optimising firm because a higher market price will also lead to a higher arm’s length approved transfer price, which translates into a higher share of the profit from the firm’s activities transferred across the border without being subject to taxation. Thus, we can see from this short reasoning that the tax legislation might actually end up hurting consumers through artificially high prices on goods and services, because firms might have an incentive to increase the internal transfer price through a reduction of sales volume and increase of market price.

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<sup>31</sup> They have both introduced new reporting procedures and created a transfer pricing group/task force.

Another inefficiency pointed out in the literature study, and related to the one presented above, is that tax legislation could impact the way decision-making authority is delegated in an organisation (Bo Nielsen, et al., 2008). In this article, the authors show that decentralisation of decision-making authority partly depends on the tax differential between the MNE's home country and the country of its subsidiaries. In a situation with a large tax differential it might be preferable with centralisation. In such a situation, the central management has to make more of the decisions at the expense of business unit management, and the business unit management would lose some of the influence over the results they are responsible for producing. This could lead to business unit management being less responsive towards the incentive schemes they are subject to. Thus, a source of inefficiency is created, as the managers contribute less effort than what they would have contributed with more influence over their own results due to weaker incentives. Another inefficiency that also results from increased centralisation is delay in decision-making. Central management does only have a certain decision-making capacity, and, if they have to make more decisions, the queue of decisions that are waiting to be made will increase; resulting in longer waiting time from proposal is being made until decision is taken. Since business unit management will have to wait until decisions are made by the central management, their productivity will be lower than what it would have been if they could make the decision themselves.

From our survey we have observed that Norwegian firms are more or less only concerned with taxation issues when it comes to transfer pricing. We also saw that most firms strive for compliance and not tax optimisation. First of all, this leads us to believe that there could be considerable gains for Norwegian firms if they started to focus more on tax optimisation instead of only tax compliance. Further, if they also started to consider strategic optimisation when designing their transfer pricing systems, efficiency gains resulting from such optimisation could benefit both the firms and Norwegian consumers. There is, however, a long way to go before reaching this "optimal" state.

A factor that confirms the distance between practices in Norway and the "optimal" state is the level of centralisation discovered in our survey. One simple question about how transfer pricing policy decisions are being made and about who decides the actual transfer price, is not enough to draw any wide conclusions about the level of centralisation in Norwegian MNEs, but the answers to our survey indicate a fairly high level of centralisation in Norwegian firms. A high level of centralisation will, as we saw above, contribute with more inefficiencies of both tangible and intangible nature.

Again, it seems as if education on transfer pricing is the best solution to this problem of inefficiencies. By educating firms on the benefits of optimising transfer pricing for tax and strategic purposes, or, probably even more effective, the opportunity cost of non-optimisation, we could probably achieve

reduced inefficiencies in Norwegian multinationals. This would benefit the firms themselves, but it might also benefit consumers. This could be used as an argument for having the authorities to contribute in the education of firms on transfer pricing. Another solution for reducing inefficiencies created by transfer pricing legislation could be to alter the legislation in such a way that efficiency would increase. This could be done by e.g. adapting the approved TP methods in a way that made it easier for MNEs to achieve strategic optimisation. An increased focus on strategic optimisation could lead to a higher supply of goods and services, and, following from this increased supply, lower prices. Thus strategic optimisation would both lead to higher profit for MNEs<sup>32</sup> and benefit consumers through lower prices. Thus, the authorities actually have some incentives for improving the legislation, both in form of increased consumer surplus due to lower prices and increased tax revenues as a result of increased firm profits. Despite these incentives for changing the legislation it still seems that education of Norwegian firms is an easier and more realistic approach, as it does not depend on the political and bureaucratic aspects of a legislative process.

### **3.4 Proposed improvements**

Throughout the analysis in this master thesis there has been made several proposals for improvements to transfer pricing research, transfer pricing systems, and tax legislation that can benefit scholars, firms and consumers. Some of the proposals are more important and more realistic than others. In the following paragraphs I will present five proposed improvements that I consider to be both realistic to achieve and feasible on a medium term basis. We will concentrate on these five because this makes the proposal for improvements both tangible and to the point. Other proposals than these five could probably be made, but, based on the analyses in this thesis, the five proposals described below are among the most relevant.

#### **3.4.1 Advance pricing agreements**

From the literature study we saw that advance pricing agreements (APAs) can be used to solve some of the potential tax-related issues with transfer pricing, both with regards to which method to use and compliance in general. By clearing up in compliance issues, an APA would also give firms more time to spend on improving their use of transfer pricing as e.g. a management control tool. From the study of transfer pricing practices we saw that Norwegian authorities generally do not allow for APAs. When looking at Ernst & Young's 2010 transfer pricing survey, we can see that APAs are quite popular in the countries that are leading within the field of transfer pricing, such as the U.S. and the U.K. (Ernst & Young, 2010). This leads us to believe that APAs could also be a useful tool for

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<sup>32</sup> Volumes will not be increased unless it is profitable for the MNE.

Norwegian firms when it comes to e.g. compliance with tax legislation. The opportunity to enter into an APA could e.g. reduce the dependency on transfer pricing advisory services for compliance purposes, as it would be easier for Norwegian firms to enter into direct dialogue with the tax authorities. On the other hand, it would probably require the tax authorities to dedicate more resources to transfer pricing, if they were to offer the option of APAs to multinationals operating in Norway.

Norwegian authorities are currently looking closer into what the introduction of APAs would require with regards to resources and what sort of benefits Norwegian MNEs would have from APAs. With the current development of increasing focus on transfer pricing from the tax authorities, it seems, from my point of view, reasonable that they should offer the option of APAs to Norwegian firms. It is not completely fair to suddenly increase enforcement of the legislation without making it easier for firms to comply with the legislation at the same time. From the point-of-view of an external, it also seems that APAs could be implemented fairly easy.

### **3.4.2 Comparable profits method as OECD standard**

From the discussion of research results in section 2.3.3 we saw that the transactional net margin method (TNMM) does not quite work as intended in all cases. It turns out that it is very difficult to find the margins/ratios used by a third party in a comparable uncontrolled transaction. Thus, the method can only be applied properly by firms that sell the product or service in question both externally and internally, since this is the only way that a firm would have access to the required information. Often this is not the case, something which has led to a practice where database searches in company information databases are being used to determine overall profit margins for other companies/competitors with similar transactions<sup>33</sup>, and then use these to find an arm's length mark-up on costs. This practice is quite similar to the comparable profits method used in the U.S., and, judging from the practice related to the use of TNMM, the comparable profits method is also ad-hoc accepted by Norwegian tax authorities.

An improvement that would both make the legislation more transparent and make it easier for MNEs to find an arm's length price is therefore to introduce the comparable profits method into the Norwegian transfer pricing legislation. Since the method is already being applied in practice and accepted by tax authorities, it should not be very difficult for the Norwegian authorities to, at least, include the comparable profits method in Norwegian transfer pricing legislation.

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<sup>33</sup> For reference see appendix A3.2.1.

It is reasonable to believe that the same problem and solution with regards to TNMM that we observe in Norway can be observed in other countries. We also know that the comparable profits method is accepted as an arm's length method in the U.S., one of the countries that are leading within the area of transfer pricing<sup>34</sup>. Thus, we have several good arguments for why the comparable profits method also should be included into the OECD proposal for transfer pricing legislation, and not only in Norway. It does not seem as if it can cause much harm, as it already is used and accepted on an ad-hoc-basis as we can see from the practices observed in Norway. An introduction of the comparable profits method in the OECD proposal for transfer pricing legislation, will, however, require more effort than an introduction into the local legislation in Norway.

### 3.4.3 New empirical research

In the literature study (part one) it was concluded that there is a need for new empirical research on transfer pricing practices, as it is around 14 years since the last academic empirical study was conducted. We have seen that during the last 14 years there has been a considerable development both with regards to transfer pricing practices and the enforcement of transfer pricing legislation. I believe that it would be of great benefit both for MNEs and scholars to conduct a new study of transfer pricing practices, and thereby gain an understanding of how transfer pricing practices have evolved since the mid-1990s. Such an understanding would provide valuable input for authorities when designing new legislation, and for scholars, when conducting transfer pricing related research. When designing legislation it is important to know how the behaviour you want to control looks like, and without such an overview there is a risk that the created legislation does not have the desired effects. And, if you want to produce good research, it is important to have the best possible understanding of the problems/issues you are trying to solve. These two arguments highlight some of the benefits that a new study of transfer pricing practices would contribute with.

From the literature study we saw that there actually has been conducted empirical research on transfer pricing after the last study contributed by Tang. This research has been conducted by the audit and advisory firms, and it has provided some input for this master thesis. The audit and advisory firms are, however, forced to produce research that customers demand, and the existing research is therefore focused solely on taxation issues related to transfer pricing. This focus is too narrow to be of any real value for scholars and legislators. I therefore propose to engage in a broader study that looks at all the aspects of transfer pricing, which includes both tax and strategic<sup>35</sup> aspects, instead of a study solely focusing on the taxation issues of transfer pricing. To get the best possible

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<sup>34</sup> The U.S. has had transfer pricing legislation since the mid-1990s (Levey, et al., 2006)

<sup>35</sup> In this master thesis the strategic aspects of transfer pricing is defined to also include transfer pricing as a management control tool, since management control is related to achieve a desired goal/strategy.



comparability with former research, I suggest that the proposed empirical research is based on the same model as Tang uses in his studies.

#### **3.4.4 Dialogue between scholars and consultants and education of MNEs**

The study of transfer pricing practices in Norwegian firms uncovered that Norwegian firms did not follow the advice given in the academic literature on transfer pricing related to e.g. optimal transfer pricing and the use of transfer pricing as a management control tool. This is probably mostly due to the “immaturity” that we observed among Norwegian firms when it comes to transfer pricing. Our analyses show that the best way of contributing to the maturation of Norwegian firms and ensure higher congruence between observed practices and the academic literature is to educate Norwegian firms on transfer pricing. We further identified transfer pricing consultants as the most appropriate channel for such education.

Another reason for the observed incongruence between practices and the literature could also be the weak link between the academic literature and global business and commerce. To ensure that the ideas from the academic literature reach the MNEs, I therefore suggest to start some sort of structured dialogue between scholars and transfer pricing advisory consultants, who are the ones educating the firms on transfer pricing. This would to a larger extent ensure that new ideas were transferred to firms, and it could also be a good channel for transferring needs and ideas for new research the opposite way. Thus, it seems like it would actually be a “win-win” situation to establish such a dialogue between scholars and practitioners.

#### **3.4.5 Literature overview of research from 1990 to 2011**

Another proposal that was made in the conclusion to the literature study was to create a complete overview of the literature on transfer pricing from 1990 and until today. We saw in the literature study that the period before 1990 is already well-covered by e.g. Emmanuel and Mehafdi (Emmanuel & Mehafdi, 1994), but for the period from 1990 and until today the only useful overview is provided on Lorraine Eden’s transfer pricing website (Eden, 2007). As Professor Schjelderup pointed out, it is very difficult for scholars to have the complete overview of transfer pricing, because research on transfer pricing is published in a large number of different journals<sup>36</sup>. This lack of overview can lead to situations where scholars miss out on already existing research results that could be valuable inputs for their own research, as was pointed out in the case with the article written by Baldenius et al. in 2004. With a proper literature overview, new research could probably be conducted on a more efficient basis and with higher quality because all parts of the existing literature would be considered.

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<sup>36</sup> This fact can be seen from studying the reference list in this master thesis.

### 3.5 Concluding remarks

As mentioned in the introduction, the five proposals stated above is not a complete list of actions that could be taken to improve transfer pricing practices in Norwegian firms. They are, however, believed to be among the most efficient ones. Thus, if they are implemented, I am convinced that they will have a positive effect on transfer pricing practices in Norwegian multinationals, meaning that they will induce Norwegian firms to move a couple of steps up the transfer pricing staircase and start to use transfer pricing also as a tool for management control and for achieving their overall strategies.

Implementation is always a critical point for the findings of any study, and when considering implementation we want to be absolutely sure that the proposed action steps have the desired effect. This master thesis starts out with a fairly extensive study of the existing transfer pricing literature, something which provides a solid foundation for conducting a good study of transfer pricing practices in Norwegian multinational firms. The study of practices itself can by some be considered to be based on a research methodology that is a bit too simple, and the qualitative second-hand research results could therefore be argued to be too weak for drawing any wide conclusions. I agree that that the qualitative nature of the research results is a weakness when it comes to describing transfer pricing behaviour in Norwegian MNEs. On the other hand, the research methodology in this master thesis bases itself on the experience and observations of four independent experts on transfer pricing, and their responses are based on observations of practices in more than 150 Norwegian firms. This number of firms is on the same level as most of the empirical research presented in section 2.1, thus, it should be possible to draw some conclusions on this material. I consider this to be good arguments for why the presented results and proposals are still valid, despite the somewhat simple research methodology.

An improvement that could make the research results more robust than the research methodology used here, is to conduct a complete first-hand empirical study with preferably more than 100 respondents. This could be done either as a master thesis, but it could also be included as a part in a dissertation for a doctorate on transfer pricing.

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# Appendix

## A1 The Manager's Analytical Plane (MAP)

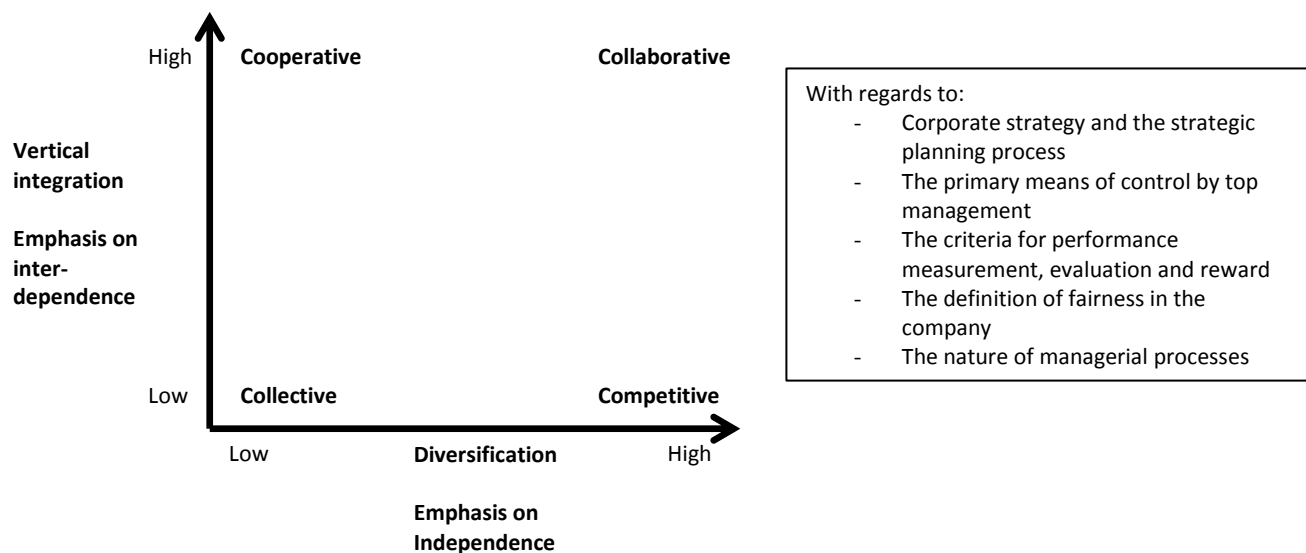


Figure 5 – The manager's analytical plane (MAP) (Eccles, 1985)

	<u>Collective</u> “Low diversification and low integration, typical of small and new firms that focus on one or a few functions (e.g. the company is either a manufacturer or a distributor) or one or a few products. The organisation is typically led and managed by an entrepreneur, which is also the owner.”	<u>Competitive</u> “Highly diversified organizations that have little vertical integration between business units. In its purest form, a competitive organization would have no transfer pricing policy, leaving the business units free to establish trading relationships as companies in the open market.”	<u>Cooperative</u> “Vertically integrated organizations where cooperation is the key to success, and business units are mostly organized as cost centres. Because transfer prices strictly refer to exchanges between profit centres, in its purest form a cooperative organization would have no transfer prices.”	<u>Collaborative</u> “Companies that are collaborative emphasize both the interdependence of vertical integration and the independent of the business units as diversified businesses. Here the transfer pricing policy will combine required internal sourcing with market-based transfer prices.”
<b>Strategy</b>	Implicit in vision of entrepreneur	Aggregate of divisions' strategies	Total company strategy	Mutually defined total company profit centre perspectives
<b>Structure</b>	Non-existent to rudimentary specialisation	Multidivisional (basic unit is division)	Functional or a few high-level profit centres (basic unit is function)	Matrix or very complex multidivisional (basic units are functions and profit centres)
<b>Systems</b>	Non-existent to very simple	Profits and ROI; budget and external; objective	Costs, revenues, physical measures; internal and historical; subjective	Combination of financial and physical measures; budget, historical, internal and external; objective and subjective
<b>Processes</b>	Vertical directive; horizontal interpersonal	Vertical bottom-up; horizontal distributive bargaining	Vertical top-down; horizontal integrative bargaining	Vertical iterative; horizontal mixed-mode bargaining
<b>Top management control</b>	Individual involvement	Through systems on outcome	Through structure on actions	Through processes balancing structure and systems
<b>Method of manager's fairness evaluation</b>	Personal code	Impartial spectator	Shared fate	Rational trust
<b>Suggested transfer pricing policies<sup>37</sup></b>	No transfer pricing	Exchange autonomy (free to choose sourcing and transfer pricing policy)	Mandated full cost	Mandated Market-based

Table 9 – Characteristics of the MAP organisation types (Eccles, 1985)

<sup>37</sup> See the section “transfer pricing methods” for an elaboration about these different policies.

## A2 Factors affecting the coordination of internal transactions

Organizational context	External environment	Transactions	Transaction parties
<ul style="list-style-type: none"> <li>• Division of authority and responsibility;</li> <li>• Performance measurement and evaluation;</li> <li>• Reward system;</li> <li>• Information system;</li> <li>• History</li> </ul>	<ul style="list-style-type: none"> <li>• Uncertainty;</li> <li>• Market size and type of market transactions;</li> <li>• Availability of market information</li> </ul>	<ul style="list-style-type: none"> <li>• Size and frequency;</li> <li>• Asset specificity;</li> <li>• Complexity of production processes and technical interfaces</li> </ul>	<ul style="list-style-type: none"> <li>• Local and personal knowledge/information;</li> <li>• Information asymmetry;</li> <li>• Risk attitude;</li> <li>• Bargaining power</li> </ul>

Table 10 – Factors influencing the coordination of internal transactions (Meer-Kooistra, 1994; Helden, et al., 2001)

## A3 Survey questions and comments from transfer pricing practices study

### A3.1 Questions and responses from controller in firm X

<b>1. How is your company organised (organisational structure)?</b>	
Mark your choice with an "X"	
<i>a. Vertical integration - how much of the entire value chain is controlled/owned by the company?</i>	
High (more than two parts of the value chain, e.g. production, distribution, retail)	
Medium (two parts of the value chain, e.g. production and distribution)	X
Low (one part of the value chain, e.g. production)	
<i>b. Diversification - how diversified are you?</i>	
High (operate in more than two different industries)	X
Medium (operate in two different industries)	
Low (operate in one industry)	
<i>c. Centralisation - how centralised are you?</i>	
High (Most operational decisions are taken by central management)	
Medium (Both central and business unit management makes operational decisions)	X
Low (Most operational decisions are taken by business unit management)	
<b>2a. What is your company's level of knowledge of transfer pricing?</b>	
Mark your choice with an "X"	
High (we have extensive knowledge about transfer pricing)	
Medium (we have good knowledge in some areas)	
Low (we have generally little knowledge about transfer pricing)	X
<b>2b. What is your level of knowledge of taxation and tax related issues?</b>	
Mark your choice with an "X"	
High (we have extensive knowledge about taxation and tax related issues)	
Medium (we have good knowledge in some areas)	
Low (we have generally little knowledge about taxation and tax related issues)	X
<b>2c. How frequently do you buy/acquire TP advisory services?</b>	
Mark your choice with an "X"	
Often (we ask for advice in most of the issues concerning transfer pricing)	
Some times (we ask for advice in important issues related to transfer pricing)	X
Seldom (we only ask for advice in critical issues related to transfer pricing)	

Figure 6 - Answers to question 1 and 2 from firm X's controller



3a. What is the primary transfer pricing method used by your company?	
Mark your choice with an "X"	
<b>Market based methods</b>	
Market price	
Market price minus a discount	
<b>Cost based methods</b>	
Full cost	
Full cost plus profit margin	X
Variable cost plus opportunity cost	
<b>Other methods</b>	
Dual prices (one transfer price for tax purposes and one transfer price for internal purposes)	
Negotiations between buying and selling business unit	
If you use other methods than those mentioned above, please specify	
-	
-	
<b>3b. Is your company using more than one transfer pricing method?</b>	
	no
<b>3d. Does your company use two sets of books, one for tax purposes and one for internal purposes?</b>	
Mark your choice with an "X"	
Have only one set of books for financial accounting and tax purposes	
Have a set of books for internal purposes in addition to the set of books used for financial accounting and tax purposes	X
<b>4a. What is the primary arm's length method used by your company?</b>	
Mark your choice with an "X"	
Comparable uncontrolled price (CUP)	
Resale price	
Cost plus	X
Transactional net margin	
Transactional profit split	
If you use other methods than those mentioned above, please specify	
-	
-	
<b>4b. Is your company using more than one arm's length method?</b>	
	no
<b>5a. Who decides your transfer pricing policy (which transfer pricing method to use)?</b>	
Mark your choice with an "X"	
Central management (CEO, CFO, etc.)	X
Business unit (division, department, etc.) management	
Cooperation between central and business unit management	
If you use other methods than those mentioned above, please specify	
-	
-	
<b>5b. Who sets the actual transfer price?</b>	
Mark your choice with an "X"	
Central management (CEO, CFO, etc.)	X
Selling business unit (division, department, etc.) management	
Buying business unit (division, department, etc.) management	
Cooperation between buying and selling business unit	
Cooperation between central and business unit management	
If you use other methods than those mentioned above, please specify	
-	
-	

Figure 7 – Answers to question 3, 4 and 5 from firm X's controller

6a. What is your primary focus/motivation with regards to transfer pricing?	
Mark your choice with an "X"	
Minimise tax burden (corporate and import taxes)	
Comply with tax legislation	X
Maintain competitive market position	
Equitable (fair) incentives and performance evaluation	
Goal congruence (cooperation between business units)	
If you have a differing primary focus from those mentioned above, please specify	
-	
-	

6b. What is your secondary focus/motivation with regards to transfer pricing?	
Mark your choice with an "X"	
Minimise tax burden (corporate and import taxes)	X
Comply with tax legislation	
Maintain competitive market position	
Equitable (fair) incentives and performance evaluation	
Goal congruence (cooperation between business units)	
If you have a differing secondary focus from those mentioned above, please specify	
-	
-	

6c. What is your main objective with transfer pricing?	
Mark your choice with an "X"	
Optimise tax payments across countries and subsidiaries, and tax compliance	X
Optimise resource allocation and performance management across business units	
Both of the above mentioned	

6d. Does tax optimisation efforts affect how your company is organised (org. structure)?	
	no

7a. What is the primary focus of TP advisors when serving your company?	
Mark your choice with an "X"	
Minimise tax burden (corporate and import taxes)	
Comply with tax legislation	X
Maintain competitive market position	
Equitable (fair) incentives and performance evaluation	
Goal congruence (cooperation between business units)	
If they have a differing primary focus from those mentioned above, please specify	
-	
-	

7b. What is the secondary focus of TP advisors when serving your company?	
Mark your choice with an "X"	
Minimise tax burden (corporate and import taxes)	X
Comply with tax legislation	
Maintain competitive market position	
Equitable (fair) incentives and performance evaluation	
Goal congruence (cooperation between business units)	
If they have a differing secondary focus from those mentioned above, please specify	
-	
-	

Figure 8 – Answers to question 6 and 7 from firm X's controller

## A3.2 Comments to the survey from the respondents

### A3.2.1 Comments from Ernst & Young

- Question 3:

It is difficult to say that one only employ one type of pricing. The reason for this is that the price usually is depending on the type of transaction. Market price is usually an expression that is misunderstood in relation to TP [Transfer Pricing] – if everyone sells at market price, the competitiveness of the last part of the value chain will be very low, ref. to the accumulation of prices [double marginalization].

- Question 4:

Usually database searches, which is a modified version of the TNMM. Because it is almost impossible to try to determine the margin that an independent third party has on a transaction due to lack of data, one rather tries to determine the general profit margin of a firm and apply that to find the arm's length price.

- Question 5:

Firms normally have very little control with TP and no formal transfer pricing policy, this leads to large discussions about how internal transactions should be priced. This often leads to high transactional friction between the parties to the transaction. Who sets the actual transfer price has to be seen in relation to what is being sold. It could be that the buying business unit is a cost center that holds the contract with the independent customer – where they decide much of the actual pricing higher up in the value chain.

- Question 6:

Since the rules are so new, Norwegian firms have, naturally, been very concerned with compliance. On the contrary we see that when the firms' management, usually also CTO, understands the range of transfer pricing, they wish to use it more proactively for management and control purposes. The firms that are leading on TP wishes to get more than compliance out of it, while the firms who are far behind only have interest for compliance. This is usually also different depending on whether the group is Norwegian or foreign, e.g. American. As mentioned above, I think that very few Norwegian firms are in a position where they think about tax optimisation – there has not been a tradition for that in Norway. When it comes to foreign MNEs, it is probably more focus on this.

- Question 7:

Comply with tax legislation – to begin with it is probably this one. Usually the client has to go on a journey and discover for themselves what TP can contribute with [, before demanding advisory services for TP issues other than compliance].

### A3.2.2 Comments from KPMG

- Question 1:

In question 1a, it is difficult to perceive how transfer pricing would be an issue if the taxpayer is only involved in one part of the value chain (would there be any intra-group transactions?). We have thus stated 0% (and not taken into consideration e.g. possible services performed between two production companies).

- Question 3:

There are arguments for stating that "market price" and "negotiations" is the same principle (since market prices are derived from negotiations) - our percentages have thus been allocated to both based on our experience in how taxpayers tell us which method they use.

- Question 5:

We would prefer the word "negotiation" rather than "cooperation" [under 5b] - it is seldom peaceful cooperation when internal negotiations take place.

- Question 6:

A large majority of our clients still see transfer pricing as a tax related issue. In that case I think that 80 % would be a correct indication; the remaining 20 % see benefits in relation to the other parameters as well. There has generally been a growing maturity among Norwegian firms; for a few years ago, transfer pricing was not a topic that was considered very important; now, there are many firms that contact us because they realise that transfer pricing might be their most important tax issue.

It is of course simpler to get a firm foundation for everything that transfer pricing can offer if you have a client that really understands how important this is, but my experience is that we in many cases have started with a pure compliance project and when that is finished the client reports that this was a really useful exercise (and thereby they have, by conducting the compliance project, understood that transfer pricing is more than a document "that just have to be in place")

### A3.2.3 Comments from PWC

- After discussing the size and structure of the TP advisory market closer with Mr. Per Frode Sundby from PWC, it turns out that it is very difficult to properly define the market for TP advisory services. In addition to the big four audit and advisory firms, there are some other firms (consultancies and legal advisory firms) that has a position in the market. It is also very difficult to define the total market because many different parts of the big four audit and advisory firms are involved in TP related questions. This makes it difficult to retrieve total revenues for each company. According to Mr. Sundby, PWC and Ernst & Young are about the same size when looking at total revenues from TP advisory, but they are positioned differently in the different segments of the market. KPMG and Deloitte are smaller than these two. Some of the large segments of the TP advisory market are documentation, tax advisory and audit related TP services.

### A3.2.4 Comments from firm X's controller

- Question 6:  
The organizational structure (I'm referring to our offices in different countries), is built up to handle sales. In addition we have over time acquired many firms and kept their offices, production facilities and systems in the local markets. It is, however, possible that the org. structure of our group is designed with regards to tax, which I don't know. I think that we are e.g. owned by firm Y (another firm in the group), but I don't know the background for or consequences of this ownership structure.
- Question 7:  
Our group has several internal support functions, e.g. our own department of SAP consultants. There is especially one "transfer pricing guru" that works in the support organization, which amongst other things advices all subsidiaries on transfer pricing questions/issues. This autumn I have spent around one week on transfer pricing, and I probably will have to spend another week. In addition to this, one other controller has spent two weeks, and we also had a summer intern which spent five weeks on transfer pricing. The manager has probably also spent a couple of days on transfer pricing issues.