A Comparative Analysis of Legal Measures and Policy Recommendations for MNCs Regarding Transfer Pricing

Junda Zhu *

Department of Law, Shanghai University, 20044, Shanghai, China

* Corresponding Author Email: 1169223504@shu.edu.cn

Abstract. As the global economy continues to expand, the rapid expansion of multinational corporations (MNCs) has spawned tax avoidance issues that must be resolved. This paper analyzes the challenges MNCs face with transfer pricing and investigates the legal implications of these practices under international law. The study examines transfer pricing hazards, U.S. legislative measures pertaining to transfer pricing, and the primary characteristics of U.S. tax audits. In addition, the paper provides recommendations for strengthening the international legal framework by highlighting the need for enhanced international tax supervision, cooperation, and transfer pricing management expertise. In order to achieve a balance between export tax revenue interests and sustainable development, the paper also advocates promoting innovation and providing tax assistance to global MNCs. It highlights the importance of MNCs adhering to international tax regulations in order to avoid potential tax penalties and reputational harm.

Keywords: Transfer Pricing; Multinational Corporations; International Law; Tax Audits; International Tax cooperation.

1. Introduction

Transfer pricing has become an essential issue in the global economy, especially for MNCs operating in multiple tax jurisdictions. The Xilinx case, which involves a tax dispute between the world's leading provider of programmable logic solutions, its Irish subsidiary, and the Internal Revenue Service (IRS) of the United States, has attracted significant interest from international tax law scholars, national tax authorities, tax practitioners, and MNCs [1]. This decision has far-reaching implications for the transfer pricing decisions and practices of MNCs.

The dispute revolves around Xilinx's decision to allocate a portion of its research and development (R&D) expenses to its Irish subsidiary between 1998 and 1999, while deducting the complete cost of stock options granted to the R&D personnel of the Irish subsidiary at its US headquarters but not in Ireland. This strategy effectively reduced the global tax liability of the corporation. The case has been litigated before the United States Tax Court and the Ninth Circuit Court of Appeals, which initially ruled, with a 2:1 majority, that the cost calculation method prescribed by US tax law Section 1.482-7(d) was inconsistent with the arm's-length standard and the fair dealing principle established by Section 1.482-1. However, because Section 1.482-7(d) is more specific than Section 1.482-1(b)(1), Section 1.482-7(d) took precedence [2]. On January 13, 2010, the decision was reversed in response to significant opposition and pressure. Stephen Reinhardt and Raymond Fisher were instrumental in the decision of the Ninth Circuit regarding the inconsistency between the cost calculation method and the arm's length principle. The outcome of this case is widely regarded as a direct assault on international taxation norms and a challenge to the principle of equitable treatment [3].

This paper will analyze and examine the implications of the Xilinx case for international tax law, tax authorities, practitioners, and MNCs, as well as its effect on the ongoing debate between the arm's-length principle and global formulary apportionment [4]. In light of the fact that this case represents one of the most significant transfer pricing decisions in recent decades, it is essential to understand its potential long-term implications on international taxation.

2. Background Analysis for MNCs' Transfer Pricing

2.1. Explanation and Definition of Transfer Pricing

Transfer pricing refers to the practice of unduly regulating prices within a corporate group in order to maximize group benefits [5]. Transfer pricing is most prevalent in transactions between MNCs and related parties. The determination of transfer pricing typically varies when a multinational corporation operates in countries with variable tax rates compared to situations in which there are no disparities in tax rates. As for the function, it can generate significant cash flow disparities despite minimal differences in tax rates.

Transfer pricing is frequently used by MNCs as a strategic instrument to transfer profits between related entities, reduce actual taxes, and maximize global after-tax profits. Profit shifting can be accomplished through accounting modifications as opposed to modifying production factors, thereby reducing transaction costs. In the context of economic globalization, MNCs' use of transfer pricing to circumvent taxes has become widespread.

2.2. Purpose of Transfer Pricing

Transfer pricing is utilized by MNCs for a variety of purposes. This paper investigates the specific objectives of transfer pricing in the context of MNCs, analyzing its implications and significance for corporate strategy, financial management, and taxation.

2.2.1 Financial and tax management

Transfer pricing is frequently utilised by MNCs to transfer profits to affiliated companies with lower tax rates or to reallocate profits from profitable entities to loss-making entities. This strategy reduces the group's overall tax liability, freeing up additional capital for investment and expansion opportunities.

2.2.2 Capital and risk management

MNCs can transmit funds between regions and circumvent foreign exchange controls by selling products to subsidiaries at a premium or by purchasing products from subsidiaries at a discount. This permits them to circumvent regulatory restrictions and obtain access to emergency funds. Moreover, MNCs can mitigate or avoid economic and political risks by transferring capital from high-risk subsidiaries using methods such as advance payments, thereby shielding the organization from adverse conditions that could impair operations and financial performance.

2.2.3 Strategy and Competitive Advantage

By providing their subsidiaries with inexpensive raw materials, components, technology, or labour, MNCs can strengthen their subsidiaries' competitive advantage. This improves the profitability and competitiveness of the subsidiaries, elevating them to a market-leading position. In addition, transfer pricing can be used to execute integrated (horizontal or vertical) or advantage (cost or technology) strategies that are aligned with an MNC's competitive requirements, allowing businesses to strengthen their market position and achieve sustainable growth.

2.3. Risks Related to Transfer Pricing

2.3.1 Disclosure risk

Many nations require MNCs to prepare documentation on their transfer pricing measures, including contemporaneous records, and to disclose or report these measures in accordance with applicable legal requirements. The extent and quality of the provided documentation can impact the scope of transfer pricing investigations by tax authorities. Failure to provide transfer pricing documentation in a timely manner may result in adjustments and penalties.

2.3.2 Audition risk

Due to the continuous development of transfer pricing legislation in various countries and the implementation of transfer pricing investigations and audits by tax authorities, MNCs run the risk of being audited at any time. According to the 2005-2006 Global Transfer Pricing Survey conducted by Ernst & Young, transfer pricing audit activity levels increased in 2005, with 65 percent of parent companies and 59 percent of subsidiaries having been subject to transfer pricing investigations since 2001. As a consequence of these investigations, 44% of primary companies and 33% of subsidiaries made adjustments [6].

2.3.3 Adjustment and penalty risk

If tax authorities determine that a multinational corporation's transfer pricing practices do not adhere to the applicable principles, they have the authority to demand adjustments. These adjustments can precipitate a series of consequences. Firstly, they may give rise to double taxation, wherein profits attributed to an overseas affiliate are subjected to taxation once more in another country. Secondly, they may prompt modifications to the original financial plans of the group and its affiliates, as adjustments engender the redistribution of profits among affiliates situated in diverse countries. Lastly, they may intensify the pressure on the company, as the investigation process entails collaboration among multiple departments and personnel across different countries and necessitates a reassessment of the company's financial statements.

In recent years, numerous nations have enacted legal measures to penalize excessive or malevolent transfer pricing practices, while also providing exemptions, reduced penalties, or heightened penalties based on the circumstances. By recognizing and mitigating these risks, MNCs can more effectively navigate the complex regulatory environment surrounding transfer pricing and ensure compliance with global tax regulations [7].

3. American Methods of Solving Transfer Pricing Problems

3.1. The United States' Efforts to Prevent Transfer Pricing

The United States has enacted a number of legislative measures to combat tax evasion by multinational taxpayers since the 1960s. When the Internal Revenue Service (IRS) discovered minimal profits in the accounts of a large number of Japanese subsidiaries in the United States in the early 1990s, transfer pricing issues drew considerable attention [8]. Section 482 of the Internal Revenue Code was enacted in 1994 to provide the IRS with legal protection, allowing it to administer cases involving foreign and domestic corporations that use transfer pricing to evade taxes.

The US tax code combats tax evasion by MNCs primarily through the advance pricing agreement (APA) system and Section 482. By transferring transfer pricing adjustments from a retrospective to a pre-approval procedure, the APA system, established in 1991, marked a significant milestone in the evolution of the US transfer pricing tax system. Despite some flaws, the APA system is widely regarded as an effective method for addressing transfer pricing issues, and its promotion in the United States has increased.

In addition, the United States uses the "arm's-length principle" to determine if transfer pricing is reasonable. Countries around the world have broadly adopted this principle. This principle is utilized by tax authorities to compare the transfer pricing of MNCs to the standard price established in comparable transactions between independent purchasers and sellers. If transfer pricing exceeds the standard established by the arm's-length principle, tax authorities may conduct a transfer pricing audit to alter and reallocate the company's profits, deductions, and other income items. The adjusted quantity is then used to ascertain the taxpayer's actual taxable income, and taxes and penalties are due accordingly.

The impact of U.S. legal measures on transfer pricing has resulted in a worldwide trend toward increased regulation and transparency in international transactions. This shift in emphasis is intended to prevent MNCs from using transfer pricing mechanisms to unjustly reduce their tax obligations. As

more nations adopt and implement transfer pricing regulations, it becomes increasingly crucial for cross-border businesses to be aware of the legal requirements and adhere to the appropriate pricing methodologies.

As the global economy continues to evolve and become more interdependent, transfer pricing issues will likely continue to be a crucial aspect of international tax policy. Globally, policymakers must continue to develop and refine transfer pricing regulations in order to ensure equity and prevent tax evasion. Harmonizing tax laws and regulations and creating a cohesive international framework that effectively addresses transfer pricing concerns will require international cooperation.

The efforts of the United States in instituting legal measures to combat tax evasion and transfer pricing manipulation have had a significant impact on global tax policy. MNCs must remain vigilant in their compliance with these regulations in order to avoid potential tax penalties and reputational harm as a result of the increasing trend of countries adopting similar regulations. The continued development of transfer pricing regulations will be crucial for fostering an equitable and transparent global tax environment, promoting international cooperation, and ensuring that MNCs pay their appropriate share of taxes in the jurisdictions in which they operate.

3.2. The Qualities of the U.S. Fiscal audits

The United States places a significant emphasis on tax audits, particularly with regard to MNCs' transfer pricing activities. Prioritization, auditor professionalism, targeted audit plans, a variety of auditing methods, efficiency, and strong judicial safeguards were the defining characteristics of U.S. tax audits. Tax audits are given a high priority, as exemplified by the substantial resources allocated to this area by U.S. tax authorities. This dedication to transfer pricing scrutiny reflects the elevated status of audit institutions within the United States tax system [9].

In the United States, auditors must be professionally certified and adhere to a hierarchical structure. They are separated into domestic and international auditors, with both divisions cooperating on cross-border tax matters. The tax authorities provide auditors with ongoing specialized training to ensure that their knowledge is current. Even though tax collection is not planned, tax audits in the United States follow a targeted and organized methodology. Regional tax bureaus are typically responsible for overseeing audits conducted under the direction of a central office. Typically, audit selection focuses on investors with high incomes, no income tax withholding, special tax avoidance behaviors, and tax returns with numerous, potentially unreasonable deductions.

In the United States, numerous auditing techniques are utilized, including office audits, correspondence audits, on-site audits, and group audits of significant taxpayers. For cases involving transfer pricing, the headquarters is in charge, with international auditors conducting the examination and domestic departments concluding the cases.

The U.S. tax judicial system is robust and provides tax authorities with the necessary enforcement authority. The penalties for tax evasion are severe, and those who falsify documents face criminal prosecution. Tax audits are bolstered by the fact that federal tax bureaus are staffed with criminal investigators who can bear firearms and present arrest warrants.

In recent years, U.S. tax audit departments have recovered roughly $50 billion per year in taxes evaded. The comprehensive approach to tax audits, characterized by prioritization, professionalism, targeted planning, diverse methods, efficiency, and judicial safeguards, assures the effectiveness of tax audits in addressing MNCs' transfer pricing activities.

4. Recommendations for Improving the Regulation System

Enhancing International Tax Supervision and Adjustment Mechanisms

In light of the need to protect national fiscal revenue and maintain reasonable profits for exporting businesses, nations must strengthen their international taxation oversight and transfer pricing adjustment mechanisms. The following measures should be taken to achieve these objectives:

Initially, a comprehensive tax investigation should be conducted based on the general principles of transfer pricing, with a particular emphasis on identifying companies suspected of significant tax evasion. Improving related party reporting and administration of contemporaneous documentation is crucial. Information pertaining to affiliated enterprises that pertains to the exports of MNCs particularly OFDI and FDI enterprises should be scrutinized, and contemporaneous documentation management should be strengthened, necessitating the disclosure of detailed information pertaining to affiliated enterprises.

Besides, there should be a reasonable application of general transfer pricing adjustment methods, implementing tax and foreign exchange management. In export practices, the transactional net margin technique and the profit share method are commonly used. In addition, the management procedures for advance pricing arrangements should be optimized in order to standardize the determination and scope of transfer pricing between exporting nations and their counterparts in the export destination nation. On the other hand, domestic tax and foreign exchange examinations should be strengthened, thereby constraining the regular mechanisms and timelines of domestic and foreign capital flow and boosting the degree and intensity of vertical tax supervision.

Countries' laws and regulations can play a significant role in strengthening international tax supervision and preventing multinational tax evasion through these measures.

4.1. Developing International Tax Cooperation and Management Expertise

To effectively address the transfer pricing issues of MNCs, nations must concentrate on two crucial aspects: enhancing international tax cooperation and cultivating pertinent professional talent. The achievement of these objectives can be aided by a comprehensive strategy integrating numerous specific measures.

Initially, nations should participate actively in international coordination organizations and engage in extensive collaboration with other nations. This collaborative approach enables countries to acquire affiliated enterprise information of MNCs, establish data information networks, and learn from the successes of other nations. A comprehensive international network contributes to the closure of regulatory breaches and the development of a more transparent global tax environment.

In order to cultivate professional talent in transfer pricing tax planning for international trade practices, a robust partnership between governments, universities, and foreign trade companies is essential. Investments by the government in education can facilitate the selection and development of well-rounded students in higher education institutions. In turn, businesses can provide employment opportunities and internships for aspiring professionals, fostering their hands-on experience. Collaboration between universities and businesses, such as inviting industry experts to give guest lectures and developing diverse training and learning programs, contributes to the development of a workforce that is well-equipped to manage the complexities of transfer pricing.

4.2. Fostering Innovation and Tax Support

To maintain a balance of export tax revenue interests and foster sustainable growth, MNCs from a variety of nations must increase their emphasis on innovation and receive increased tax support. A number of specific measures can be implemented to attain these objectives, thereby fostering innovation and long-term competitiveness.

Before engaging in foreign investments, MNCs should first reevaluate their input compositions. Companies can optimize their operational models and adapt to swiftly changing market conditions by innovating their methods and seizing control of export initiatives. Companies can establish corporate pricing standards for export procurement and sales prices by employing new systems and standards to supplant traditional large-scale production, which ultimately results in more effective business practices and enhanced global market competitiveness.

Second, MNCs must prioritize the introduction of cutting-edge technology and intellectual property while concurrently increasing their export technology innovation. This requires accumulating knowledge of key technologies and processes, which speeds up the development of

independent manufacturing and production capabilities. By fostering innovation, businesses can reduce their reliance on imports from affiliated companies, enabling them to better navigate global trade disruptions and uncertainties.

Governments play a crucial role in fostering innovation by instituting multinational-specific tax incentive policies. These policies should incentivize firms to increase R&D spending on export products, thereby enhancing the innovation efficacy of exports. Special tax incentives, such as higher-level tax deductions and export tax rebates, should be offered to small and medium-sized businesses in order to level the playing field and encourage innovation across the entire business landscape.

Lastly, it is crucial that governments consider regional disparities when designing technological innovation support and incentives. Governments can promote a more equitable distribution of resources and opportunities by increasing assistance to businesses in regions with inferior innovation capabilities. This strategy promotes the expansion of a more diverse and innovative business ecosystem, to the advantage of all participants in the global economy [10].

5. Conclusion

Transfer pricing poses significant challenges to MNCs operating in an increasingly globalized economy. This paper has highlighted the legal measures implemented by the United States to combat tax evasion and transfer pricing manipulation and the key attributes of its tax audit system. The study has also provided recommendations to strengthen the international legal framework surrounding transfer pricing, emphasizing the importance of enhancing international tax supervision, cooperation, and expertise in transfer pricing management. Furthermore, fostering innovation and providing tax assistance to global MNCs is crucial for balancing export tax revenue interests and promoting sustainable growth. To avoid potential tax penalties and reputational harm, MNCs must remain vigilant in their compliance with international tax regulations. The ongoing development of transfer pricing regulations and international cooperation will play a crucial role in establishing a more equitable and transparent global tax environment, ultimately contributing to a more equitable distribution of tax revenues and fostering global economic growth.

References

[1] Lu Junyao, Sun Jiangming. Cross-border Enterprise Export Transfer Pricing Issues and Responses. Foreign Investment in China, 2022, No.518(23): 92-95.Fangfang. Research on power load forecasting based on Improved BP neural network. Harbin Institute of Technology, 2011.

[2] Lorraine Eden. Taxing Multinationals. University of Toronto Press Inc. (UT Press), 1998.

[3] Fundamentals of International Transfer Pricing in Law and Economics. Springer Nature, 2012.

[4] John D Keyser, Erica Neuman. A Different Kind of Cola War: Coca-Cola versus the IRS. Issues in Accounting Education, 2022.

[5] Stephen L. Curtis. Transfer Pricing for Corporate Treasury in the Multinational Enterprise. Journal of Applied Corporate Finance, 2008.

[6] Na Li. The Debate between Arms Length Principle and Global Formulary Apportionment in Transfer Pricing. Modern Finance and Economics (Journal of Tianjin University of Finance and Economics), 2011, 31(08): 108-114.

[7] Cao Xiaoxue. Discussion on Risk Management of Cross-border Transfer Pricing. Contemporary Economic Research, 2009, No.162(02): 57-60.

[8] Ernest Young. Transfer Pricing Surveys 2006. A global leader in professional services.

[9] Li Bo. Comparison and Enlightenment of Transfer Pricing Control for Multinational Corporations in the United States and Japan. Contemporary Economic Research, 2006.3.

[10] Wang Yanhong. U.S. Prevention of Transfer Pricing for Multinational Corporations and Its Enlightenment. Modern Finance and Economics - Journal of Tianjin University of Finance and Economics, 2005(04): 72-75.