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**A COMPARATIVE EMPIRICAL STUDY OF INTERNATIONAL
TRANSFER PRICING PRACTICES AND AUDITS IN NEW
ZEALAND, AUSTRALIA AND CHINA**

A thesis
submitted in partial fulfilment
of the requirements for the degree of
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by Jian Li

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the requirements for the Degree of Doctor of Philosophy

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by Jian Li

Transfer pricing is the price used for internal sales of goods and services between profit centres within the same firm (Anthony and Govindarajan, 1998). The issue of transfer pricing has long been a source of frequent managerial concern and frustration (Rushinek and Rushinek, 1988). Compared with domestic business, pricing considerations for multinationals involved in international business are far more complicated. Multinational Enterprises (MNEs) are exposed to a greater variety of environmental disturbances than domestic firms. The constantly changing international environment can have a significant impact on multinational transfer pricing practices (Tang, 1982, Ghosh and Crain, 1993).

The objectives of this study are four-fold. First, it investigates the similarities and differences in international transfer pricing (ITP) practices by MNEs in New Zealand, Australia, and China. Second, it ascertains whether an ITP tax audit is an important concern of MNEs in formulating their ITP policies. Third, it identifies the characteristics of MNEs that make them more vulnerable to ITP tax audits. Fourth, it examines the ITP monitoring system in China.

Data were gathered through a questionnaire survey of 300 New Zealand subsidiaries, 250 Australian subsidiaries and 500 Chinese subsidiaries. The overall usable response rate was 20 percent. Four Chinese tax authorities were interviewed. Non-parametric statistical analysis was carried out using data collected through the questionnaire survey.

The research presents comprehensive statistical evidence on the ITP practices of the developing and developed economies in this study. Survey results revealed statistically significant differences between the ITP methods used by Chinese companies and their New Zealand and

Australian counterparts. Statistically significant differences were also found between the two sets of companies regarding the degree of emphasis placed on environmental factors that affected their ITP policies.

Tax authority transfer pricing auditing was an important concern in ITP decisions for New Zealand and Australian companies. In contrast, it was relatively unimportant for Chinese firms. This is, perhaps, because New Zealand and Australian tax authorities are more aggressive than their Chinese counterparts in administering and enforcing their transfer pricing rules.

A number of corporate attributes were associated with the potential risk of tax audits. Three corporate attributes, i.e., nationality, size and financing, are significant and positively related to ITP tax auditing – the dependent variable – both directly and interactively. This survey also found that the New Zealand Inland Revenue Department (IRD) and the Australian Tax Office (ATO) tended to audit large-sized multinationals; in contrast, the Chinese tax authorities focused their tax audit efforts on relatively small-sized firms. As the audits of large firms require sophisticated techniques, the Chinese tax authorities claimed that they lacked sufficient staff resources and experience to tackle the ITP issues raised by large MNEs. In this study, seven factors were identified as constraining the Chinese ITP monitoring system.

This study has significant implications for ITP theory and practices. It provides a useful insight into ITP practices and audits across New Zealand, Australia and China, providing MNEs and other businesses, which already operate or intend to operate between these three markets, with guidance in complying with the transfer pricing regulations of the three Asia-Pacific national economic regimes involved.

Key words: International transfer pricing methods; environmental factors; tax audits; New Zealand; Australia; China

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LIST OF ABBREVIATIONS

APA	Advance Pricing Agreement
ATO	Australian Taxation Office
FDI	Foreign Direct Investment
FIE	Foreign Investment Enterprise
IRD	Inland Revenue Department
ITP	International Transfer Pricing
MNE	Multinational Enterprise
OECD	Organisation for Economic Cooperation and Development
SAT	State Administration of Taxation
STB	State Tax Bureau(x)
VAT	Value-Added Tax
WTO	World Trade Organisation

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Part A

General Background to the Study

Chapter 1

Introduction to the Study

1.1 Introduction

The emergence of multinational enterprises (MNEs) has been one of the most significant global economic phenomena of recent decades (Leitch and Barrett, 1992; Ernst and Young, 1999). MNEs tend to integrate their operations globally, rather than within the boundaries of individual countries (Lin, 2001).

As a result, they transfer large quantities of goods and services among operating subsidiaries in different countries. International transfer pricing (ITP) is the pricing process they use for transferring goods and services between related companies located in different countries (Borkowski, 1997b, Chan and Chow, 1998, Oyelere, Emmanuel and Forker, 1999). The pricing system for such transfers across borders within corporate networks, especially those between foreign affiliates and the parent company itself, creates considerable managerial and tax problems owing to its direct effects on the profits of both parties and the revenue of host and home countries (Bartelsman, 2000).

Because of their widespread international operations, MNEs are exposed to a greater variety of environmental factors than domestic enterprises. These environmental factors differ substantially from country to country. The way they are perceived is likely to have a great impact on multinational transfer pricing policies (Al-Eryani et al., 1990, Borkowski, 1997b).

A number of environmental variables affecting multinational transfer pricing have been identified in previous studies (Tang and Chan, 1979, Tang, 1982, Yunker, 1983, Lecraw, 1985, Al-Eryani, Alam and Akhter, 1990, Tang, 1993, Borkowski, 1997a, 1997b, Chan and Chow, 1998, Oyelere et al., 1999). While the existing literature provides evidence that various environmental factors affect ITP decisions, the studies often have a single nation focus, or, in contrast, focus on two or more developed national jurisdictions. Limited studies have been completed on the ITP practices of MNEs that operate in developing countries as compared to those operating in developed countries (Al-Eryani et al., 1990). This study aims to investigate and contrast multinational transfer pricing practices and tax audits in a cross-national context – New Zealand in relation to Australia and China.

1.2 The Purposes of the Study

The specific objectives of this research are:

- 1) to investigate the similarities and differences in ITP practices by MNEs in New Zealand, Australia, and China;
- 2) to ascertain whether an ITP tax audit is an important concern of MNEs in formulating their ITP policies;
- 3) to identify the characteristics of MNEs that make them more vulnerable to ITP tax audits; and
- 4) to examine the ITP monitoring system in China.

The People's Republic of China is a timely subject for this study for several reasons. First, as the largest developing country in the world, China has become increasingly important in the international economic community since it implemented policies of economic reforms and adopted an open door trading policy in 1978 (Chan and Chow 1997a). China is a potentially enormous market. It is estimated that, measured by total gross domestic product, China is likely to become the second largest economy in the world by 2010. Over the past decade, the rapid economic growth in China has been accompanied by a large inflow of foreign direct investment (FDI) (Chan and Chow 1997a; Carnaut and Song, 2003).

China has long been the largest single recipient of FDI among the developing countries, and the second largest recipient of FDI in the world, during the period 1993 to 2001 (Chan and Chow 1997a, 1997b, 1998). With China's strong economic growth, the amount of FDI attracted to China jumped from US\$3.487 billion in 1990 to US\$52.74 billion in 2002. Since then, China has finally overtaken the U.S. as the world's largest recipient of FDI (Carnaut and Song, 2003). The cumulative total of FDI from 1979 to 2002 was US\$ 447.9 billion.

Table 1.1 shows this dramatic rate of increase of FDI over the period 1990-2002. The number of FDI projects increased from 7,273 in 1990 to 34,171 in 2002. The contractual value of FDI projects increased from US\$6.596 billion in 1990 to US\$82.768 billion in 2002. The realised value of all FDI projects increased from US\$3.487 billion in 1990 to US\$52.743 billion in 2002. Following China's entry into the world trade organisation (WTO) in 2001, FDI is likely to reach US\$100 billion per year (Carnaut and Song, 2003). The sheer magnitude of FDI has raised concerns among China's governmental authorities over how to deal with ITP issues.

Table 1.1
Foreign Direct Investment in China, 1990-2002

Year	Number of Projects	Contractual Value (US\$billion)	Realized Value (US\$billion)
1990	7,273	6.596	3.487
1991	12,978	11.977	4.366
1992	48,764	58.124	11.008
1993	83,437	111.436	27.515
1994	47,549	82.680	33.767
1995	37,011	91.282	37.521
1996	24,556	73.236	41.726
1997	21,001	51.003	45.257
1998	19,799	52.102	45.463
1999	16,918	41.223	40.319
2000	22,347	62.380	40.715
2001	26,140	69.195	46.878
2002	34,171	82.768	52.743

Source: Ministry of Commerce of the People's Republic of China's website.
The website address is <http://www.mofcom.gov.cn>.

Second, ITP is a very important issue, not only for MNEs, but also for the economies of most countries around the world, especially those of developing nations. Arpan (1972, p. 10) stated that “differences in perceived importance are a function of different cultural influences; and cultural differences lead to different international intracorporate pricing systems”. The business environments in developing countries are distinctly different from those in developed nations. Vaitos (1974) suggested that the systematic transfer of wealth away from developing countries by MNEs is due to a conjunction of motives with market opportunity and incentives based on the developing nations’ own policies. Chan and Chow (2001, p. 104) argued that “multinational companies’ operations in developing countries are subject to more economic, political and social risks and restrictions due to the peculiar business environments in these countries”.

Since market imperfections caused by government regulations or natural externalities in the transfer of knowledge and information are far more serious in developing countries, the temptations for MNEs to practise transfer pricing manoeuvres in developing countries should be stronger than in developed countries (Plasschaert, 1985). For this reason, governments of developing countries may be more vulnerable than those in developed countries to the transfer pricing manoeuvres of MNEs. The increasingly sophisticated and complex economic,

political and regulatory environment in developing countries enhances this trend (Brean, 1979; Rahman and Scapens, 1986). The number of MNEs operating in developing countries has increased significantly. Anecdotal evidence suggests that MNEs operating in developing countries have more income shifting opportunities by means of ITP manoeuvres. Given the increasing importance of China in the developing world, this study should add to our knowledge of ITP issues in developing nations.

Third, the Asia-Pacific region is home to a majority of the world's population. Within it, China is developing as one of the world's largest economies. Elsewhere in the region, New Zealand and Australia are two countries that have substantially expanded their trade with China and are set to develop it further. Currently, China is Australia's third and New Zealand's fourth largest trading partner. Free trade agreements are being negotiated between China and New Zealand on the one hand and between China and Australia on the other. New Zealand and Australia are likely to extend their international trade by establishing subsidiaries in the Chinese market, and vice versa. The conduct of companies in their dealings with taxation and the tax authorities will become an increasing matter of concern for managers who make the pricing decisions for their companies (Goldsmith, 2003; New Zealand and China to work towards free trade agreement, 2004). The examination and comparison of ITP practices in the three countries may have considerable practical implications for those in business in the region.

1.3 Statement of the problem

A critical issue for MNEs, both domestically and internationally, always exists over the prices they should fix for transferring, on the one hand, assets between their various divisions in their home countries and, on the other, the prices they should fix for transferring assets between their subsidiaries which are located in a number of foreign countries. The levels of pricing, and the control of those levels, are matters of constant concern and importance. For example, it might be desirable to transfer goods at cost price, but that could mean, either, a variable cost, the full cost or some other variation, such as standard cost. In contrast, the transfer price could also be set at market price, or some other form of negotiated market price.

Specifically, at the international level, additional considerations may obscure the ITP issue. Since intercompany transfers can be a significant portion of the transfers between an MNE and its various subsidiaries, the transfer prices an MNE chooses to adopt may have as their rationale the minimisation of taxation liabilities in the host country for the overall benefit of

the company, but also the attainment of other financial or commercial objectives.

At first sight, it might be supposed that commercial interests would dominate the attitudes of all trading companies over the issue and practice of ITP, irrespective of their type of business and the host countries in which they are located. However, given the high level of similarity between New Zealand and Australia, questions arise as to the level of comparability of ITP practices in the two countries, as compared to China¹. Hence, the following research questions were addressed in the study:

- 1) What are the primary ITP methods used by MNEs operating in China as compared to those operating in New Zealand and Australia?
- 2) Are the environmental factors affecting ITP practices in China different from those in New Zealand and Australia?

Many tax and non-tax factors influence an MNE's ITP policies. However, these factors could conflict with the objectives of the host governments². For this reason, tax authorities in many countries have improved their scrutiny of the ITP practices of MNEs. Therefore, ITP audits have significant tax implications for the MNEs involved (Ernst and Young, 1999, 2001). Predictably, an ITP tax audit should be an increasingly important variable in influencing multinational transfer pricing policies. Certain characteristics of MNEs are more likely to render them subject to ITP tax audits. Hence, the other research questions addressed in this study are:

- 3) Is tax authority ITP auditing an important factor influencing ITP policies of MNEs in New Zealand, Australia and China?
- 4) What corporate attributes are associated with ITP audits by tax authorities in China as compared to New Zealand and Australia?

The prior proposition that developing governments lack the technical expertise to challenge internal prices set by MNEs is conceptual rather than empirical, as it has not yet been subject to empirical analysis. As the largest developing country in the world, China provides an appropriate opportunity for investigating this issue. The remaining research questions addressed in the study are:

¹ The political, legal and economic systems and cultures in New Zealand and Australia are essentially similar but are different from those of China.

² While MNEs view ITP as an instrument for the effective management of their internal markets, host governments may view it as a serious tax avoidance issue, which could have an adverse effect on their economies. (Rugman and Eden, 1985, Nobes and Parker, 2000, Gresik, 2001).

- 5) What is the present extent of transfer pricing abuse in China?
- 6) How do the Chinese tax authorities administer a transfer pricing tax audit?
- 7) How adequate are the existing Chinese ITP control measures?
- 8) What factors constrain the ITP monitoring system in China?
- 9) How can the Chinese ITP monitoring system be improved?

1.4 Review of the Relevant Literature

1.4.1 ITP Methods

MNEs use a large variety of transfer pricing methods to deal with intercompany transfers crossing international boundaries. These methods may be classified into three major categories: market based, cost based and negotiated prices (Chan and Chow, 2001). Market based methods are based on the 'arm's length principle'. This principle establishes the transfer price of goods and services at the price that would have been obtained between independent enterprises in comparable transactions and circumstances (Evans, Taylor and Rolfe, 1999). Cost based methods are those derived mainly through cost information as opposed to using the market price of the goods transferred. Examples include the variable cost, the full cost or some other variation of cost, like, the standard cost (Evans et al, 1999). In some cases, the subsidiaries of a multinational group are free to negotiate transfer prices between themselves. Available information about costs and market prices may be entered into and used in these negotiations (Evans et al, 1999).

In a seminal article on transfer pricing, Hirshleifer (1956) developed an economic model to explain which transfer pricing methods should be used under given circumstances. Since then many accounting authors³ have espoused Hirshleifer's rule, that is, if the intermediate market is competitive, the transfer price should be the market price; but if the intermediate market is imperfectly competitive, then marginal pricing replaces market pricing (Hirshleifer, 1956).

Wu and Sharp (1979) investigated the dominant transfer pricing policies adopted by 61 firms based in the U.S. when the market price was unavailable. They reported that when a market price exists for an intermediate product, market pricing was the prevalent method, followed in descending order by negotiated pricing, full cost plus profit margin, adjusted market price, full cost, marginal cost, variable cost plus profit margin, and mathematical programming. In the absence of a market price, the top three transfer pricing methods used were full cost plus

³ See, for example, Wilson and Chua (1993, p. 294); Hansen and Mowen (1997, p. 497); Maher, Stickney and Weil (2000, p. 456); and Horngren, Foster and Datar (2000, p. 796).

profit margin, negotiation and full cost. Their finding reflects the approach encompassed in the economic model for explaining transfer pricing strategies.

A study by Borkowski (1990) found that most companies used the full cost method where market price did not exist. But the existence of a market price did not lead to the conclusion that the market pricing method would be used, as the accounting literature had indicated. This result suggested that MNEs did not choose ITP methods based on theoretical recommendations, or solely based on their organisational characteristics. Instead, it seems that MNEs chose ITP systems that were perceived as optimal for their own particular situations. In other words, multinational transfer pricing method choices depended on the operating environments in which they were involved (Borkowski, 1992, p. 35).

1.4.2 Environmental Factors Affecting ITP

Several empirical studies have analysed environmental factors that affect ITP policies. Tang (1982) investigated 20 environmental variables considered by British multinational companies in formulating their multinational transfer pricing policies. Of the 20 variables investigated, 'overall profit to the company' was the most important. The study also found that 'competitive position of subsidiaries' and 'maintaining adequate cash flows in foreign subsidiaries' were highly ranked by the respondents while 'differentials in income tax rates and income tax legislation' received low ratings.

Yunker (1983) investigated the empirical relationships within and among three dimensions of multinational policy. The three policy dimensions were performance evaluation, subsidiary autonomy and transfer pricing. Her results revealed significant interrelationships among the policy variables. MNEs that used transfer prices to achieve overall global profit placed less emphasis on the performance evaluation of divisional managers. She also found that overall market conditions and demand for the product, government regulations and restrictions, material and labour costs and the level of competition were the most important environmental factors affecting the transfer pricing method choice of those U.S. based MNEs.

Tang (1993) examined tax and management issues relating to U.S. transfer pricing practices in the 1990s. The results showed that many companies used at least one transfer pricing method. He found that companies used market-based transfer prices more often in the 1990s. Of the 12 variables, 'overall profit to the company' received the highest rating. Other relatively high ratings included 'income tax consideration', 'restrictions on repatriation of

profits or dividends', 'the competitive position of foreign subsidiaries' and 'rate of customs duties and customs legislation where the company has operations'. The three least influential variables were 'U.S. government requirements on FDI', 'risk of expropriation by foreign country' and 'rate of inflation in foreign countries'.

Oyelere et al (1999) investigated the relative importance of 17 environmental factors as ranked by two groups of foreign-controlled MNEs and indigenously-controlled ones. Data were collected by surveying 300 UK-based companies on *the Times 1000*. Half of the sample companies were foreign-controlled MNEs. These were then matched against 150 UK-controlled ones. Their results showed a high level of consistency between the two groups of companies on the rank ordering of all the 17 variables when taken as a whole. When the factors were layered into three distinct groups (income shifting, internal operations and economics related), however, the two groups of companies were found to only agree on the rank order of income shifting factors. They failed to agree on the ranks of internal operations and economic factors. On an individual factor level, significant differences were found in their ranking of five environmental factors consisting of 'performance evaluation', 'maintenance of cash flows', 'economic/market conditions', 'restrictions on repatriation of income' and 'subsidiary autonomy'.

Chan and Chow (1998) investigated ITP practices by foreign investors in China. The results showed that 'compliance with tax law and customs regulations' was the most important variable in transfer pricing decisions. Other variables considered important by MNEs were 'share of the Chinese market', 'a good relationship with the Chinese government', 'differentials in income tax rates', 'competitive position in China' and 'minimisation of disputes among partners over transfer pricing'. 'Foreign exchange control' and 'devaluation of Renminbi' were considered as moderately important, while 'restriction on payments of royalties' and 'interest and risk of expropriation and nationalisation' were considered unimportant.

From an MNE's perspective, ITP is a management instrument that exploits environmental differences between related countries. Given the economic, political and cultural differentials between nations, one dominant inducement in a host country may be trivial in another, suggesting that a more valid analysis of multinational transfer pricing practices should be conducted in cross-national settings.

A sizable and growing literature investigates and compares environmental factors affecting ITP practices in two or more countries. Tang and Chan (1979) investigated the environmental variables of ITP policies of Japanese and U.S. MNEs, and identified the environmental variables which discriminated between the Japanese and U.S. ITP practices. The results showed that overall profit was the most important consideration of ITP decisions for both the Japanese and U.S. companies. Other factors of joint importance to them were 'competitive position of foreign subsidiaries', 'restrictions on repatriation of profits', 'income taxes' and 'devaluation and revaluation of foreign currencies'. Five variables were identified as causing the discrimination between the two national groups. They were: 'the interests of local partners', 'devaluation and revaluation of foreign currencies', antidumping legislation', 'import restrictions imposed by foreign countries', and 'differentials in income tax rates and income tax legislation among countries'. Japanese corporations ranked the first three variables higher than the U.S. companies. The latter ranked the last two variables higher than Japanese firms.

Lecraw (1985) interviewed top managers of 153 subsidiaries of the 111 MNEs in six light manufacturing industries in five Southeast Asian countries – Thailand, Malaysia, Singapore, Indonesia and the Philippines. His results showed that MNEs used transfer prices to reduce customs duties and profit taxes, move funds across national boundaries and allocate them between subsidiaries, reduce country risk, and circumvent government price and capital-profit remittance controls.

Borkowski (1997a) compared organisational, environmental and financial factors influencing the transfer pricing choices of Japanese and U.S. MNEs. She found that Japanese and U.S. companies used different transfer pricing methods. The Japanese sample preferred noncost (primarily market and negotiated) methods. By contrast, the U.S. sample was divided between cost (47 percent) and noncost methods (53 percent). In her study, organisational variables included 'size', 'industry', and 'MNE home country', while environmental variables were 'corporate income tax rates', 'import duties', 'withholding tax rates', 'profit repatriation policies', 'currency fluctuations', and 'the form of the investment'.

Borkowski (1997b) extended her investigation of organisational, environmental and financial factors affecting the transfer pricing choices to Canadian and U.S. based MNEs. She found that Canadian MNEs preferred market methods, while U.S. MNEs preferred other methods. As for factors influencing method choice, her findings revealed that most organisational and

environmental variables did not seem to affect either country's choice, while prior audit experience was the only statistically significant environmental factor across both country and method choices. Financial variables were found to differ between the two countries but not by transfer pricing method.

While the existing literature provides evidence that various environmental factors affect transfer pricing decisions, studies have been focused on a single nation, or, for comparative purposes, across two or more developed national jurisdictions. Few studies provide evidence of ITP practices by MNEs that operate in developing countries (Lecraw, 1985; Chan and Chow, 1998). Fewer still have been completed to date on the ITP practices of MNEs that operate in developing countries, as compared with those operating in developed countries (Al-Eryani et al., 1990).

Chan and Chow (2001, p. 104) argued that "multinational companies' operations in developing countries are subject to more economic, political and social risks and restrictions due to the peculiar business environments in these countries". Given the fact that trade and investment relations among developed and developing countries have expanded rapidly in past decades due to globalisation, and, especially, that the economic, political characteristics and cultures in developing and developed countries are distinctly different, MNEs operating in developing countries may have different motives for their ITP behaviour (Chan and Chow, 1997a, 1998, 2001, 2004). Hence, any conclusions drawn from a single developed or developing national setting, while valid for that particular economy, provide a limited picture and perhaps a biased one for a more general understanding of ITP issues.

This study investigates and contrasts environmental factors of ITP policies and differences in pricing methods used by multinationals in two developed economies, New Zealand and Australia, on the one hand, and in China, the largest developing country in the world, on the other.

1.4.3 Tax Audits on ITP

In facing the growth of multinational business, national governments have become increasingly aware of the losses of tax revenues as a result of ITP abuses (OECD, 1995, Atkinson and Tyrrall, 1999, Ernst and Young, 1999, 2002). Consequently, a growing number of governments have devised measures to counter real or perceived ITP manoeuvres. The tendencies toward aggressive transfer pricing audits have been observed in the past. In many

industrial countries, notably Germany, Japan, the U.K. and the U.S., a comprehensive set of regulations have been put into force. It can be anticipated that multinational transfer pricing arrangements will be subject to stricter tax auditing by tax authorities over time (Ernst and Young, 1999). Predictably, an ITP tax audit should be an increasingly significant variable in influencing multinational transfer pricing policies. However, in the research of environmental factors affecting multinational transfer pricing, the variable of tax authority transfer pricing audit has remained largely ignored. Researchers have not recognised the impact of tax auditing as a main government countermeasure on multinational transfer pricing decisions. One exception is Borkowski (1997b) who found that the prior tax audit experience was the only statistically significant environmental factor affecting ITP. However, she did not specifically analyse the potential underlying reasons why tax authorities initiated a tax audit on ITP.

There is evidence that certain types of companies are more likely to manipulate transfer prices and therefore to be selected for ITP tax audits by tax authorities. Jacob (1996) suggested that multinationals with the greatest level of intercompany transfers had the most opportunities and the greatest incentive to shift income through transfer prices. Feres and Nancy (2000) argued that larger companies were more likely to shift income through transfer pricing. Jensen and Meckling (1976) found that larger firms encountered more governmental scrutiny. Atkinson and Tyrrall (1999) found that tax authorities tended to target those firms dealing in pharmaceuticals, electronics, or motor industry products. The subsidiaries of Japanese multinationals in the U.K. and the U.S. in particular, have been subject to a large number of transfer pricing investigations. Buckley and Hughes (2001) and Borkowski (2001) confirmed that Japan-owned subsidiaries were frequently audited by the host countries' tax authorities around the world.

While the above studies have provided evidence that certain types of companies are more likely to be selected for ITP tax audits, none of them has addressed the issue by using multivariate methodology. Because a considerable number of corporate attributes (predictor variables) may simultaneously relate to ITP audits, studies that rely on univariate analysis only (i.e., each individual study involving only one predictor variable), provide an inadequate basis for judging the relative importance among various predictor variables.

The work of Chan and Chow (1997b) is an exception. In a study of variables influencing ITP tax audit practices in China, Chan and Chow (1997b) found that tax audits on transfer pricing

were confined mainly to medium and small-sized foreign investments, lower-technology companies and the transfer of tangible goods, and tended to focus on certain nationalities and forms of foreign investment. Persistent losses, low profitability, and lack of local partners in joint venture management most often triggered tax audits. Chan and Chow used 81 cases of tax audits undertaken in 1992-1993 on transfer pricing to confirm their findings. While their conclusion was drawn from archival data and were valid for that particular period, their results, based on archival or less than systematic evidence, failed to reflect the changes in the attitudes of the Chinese tax authorities towards their tax issues since then.

Via a multivariate statistical analysis (i.e., the logistic regression analysis), this study investigates the relationships between corporate characteristics and the probability of being selected for transfer pricing audits by tax authorities, along with examining whether MNEs are concerned about the risk of an ITP tax audit in formulating their ITP policies.

The literature suggests that ITP is typically more detrimental to developing countries than to developed ones (Easson, 1991, Chan and Chow, 1997a, 1997b). Brean (1979), Lall (1979), and Plasschaert (1985) argued that developing countries were more vulnerable to transfer pricing manipulations both because of their limited knowledge of ITP matters and, even where tax authorities in developing countries had strong suspicions that transfer prices were being manipulated, their lack of information, expertise and staff to tackle the issue. Nonetheless, these assertions lack empirical support. This study examines tax authorities' expertise and ability to detect and prevent ITP abuse in the world's largest developing economy, namely China.

1.5 Scope of the Study

ITP is an interdisciplinary subject (Chan and Chow, 1998, p.140). To understand and effectively address the problems and issues on the subject, a multidisciplinary approach is required. This study takes a multidisciplinary approach to analysing the issues involved by an exploration of the neo-classical economics of FDI to interpret the origin of ITP, by investigating the use of various transfer pricing methods in developing and developed environments, by examining tax and legal implications in the use of various transfer pricing methods, and by comments on national legislation and tax auditing on restrictive transfer pricing practices. The remainder of the thesis is organised as follows.

Chapter 2 builds the regulatory framework for transfer pricing in New Zealand. This chapter reviews the New Zealand transfer pricing regulations and guidelines.

Chapter 3 builds the regulatory framework for transfer pricing in Australia. This chapter reviews the Australian transfer pricing regulations.

Chapter 4 builds the regulatory framework for transfer pricing in China. This chapter reviews the Chinese transfer pricing regulations.

Chapter 5 reviews the neo-classical economics of FDI, interprets the origin and the nature of ITP, and examines the economic impact of ITP manipulations on the economies of host countries.

Chapter 6 examines the theoretical and empirical studies on multinational transfer pricing method choices, with contingency theory literature seen as underpinning the divergence of theoretical and empirical studies on this subject. This chapter also describes various environmental factors and their possible impact on multinational transfer pricing decisions.

Chapter 7 develops hypotheses to test possible differences in the rankings of transfer pricing methods used, and environmental variables of ITP among the samples of MNEs operating in the three research settings. To investigate the corporate attributes associated with ITP audits in a multivariate setting, a logit model is also developed in this chapter.

Chapter 8 describes both the quantitative and qualitative approaches used in this study, discussing their corresponding strengths and weaknesses and, why and how they were employed. This chapter also states how the data were collected and analysed.

Chapter 9 describes some essential characteristics of the respondent firms. It also reports the findings from the survey on ITP methods used by the respondent firms in the three countries.

Chapter 10 first reports the findings on environmental factors of ITP in the three countries, and then provides a comparison of environmental factors affecting ITP policies of MNEs.

Chapter 11 describes ITP tax auditing practices in New Zealand, Australia and China, and reports on corporate attributes triggering the potential risk of ITP tax audits.

Chapter 12 chapter reports on the use of a qualitative approach to describe the Chinese ITP auditing system and illustrates its effectiveness in restricting multinational transfer pricing practices. It also presents questionnaire survey results generated from 37 respondent Chinese tax officials.

Chapter 13 presents conclusions drawn from the findings of this study, policy implications, research limitations, and suggestions for future research.

1.6 Summary

This chapter has presented an overview of this study. The next three chapters review the transfer pricing regulations and guidelines in the three countries.

Chapter 2

The Regulatory Framework for Transfer Pricing in New Zealand

2.1 Introduction

This chapter reviews the New Zealand transfer pricing regulations and guidelines. The main contents of the New Zealand transfer pricing regulations and guidelines include the definition of associated persons, the acceptable arm's length pricing methods, the burden of proof, documentation requirements, penalties, and advance pricing agreements (APAs).

2.2 Transfer Pricing Legislation in New Zealand

The development of the transfer pricing regulations and guidelines in New Zealand is relatively recent compared with those of its major trading partners. In 1915 and 1917, for example, the first transfer pricing legislation was established in the U.K. and the U.S., respectively. The Australian statutory rules on transfer pricing are contained within Division 13, Part III of the *Income Tax Assessment ACT* 1936 ('ITAA'), s. 136 of that ACT.

Before its international tax reform, the old rules – contained in the previous s GC 1 of the *Income Tax Act* 1994 – governing the transfer pricing practices of multinationals was infrequently used by the Commissioner of the Inland Revenue Department (IRD). This can be attributed to the difficulty associated with the application of that section. The increased operating losses of MNEs have drawn serious attention of the IRD to the fact that intercompany transfer pricing may be abused in New Zealand (Harrison and Glyn-Jones, 1999). In December 1995, the New Zealand government eventually overhauled the old rules and introduced new transfer pricing rules to deal with the issue of transfer pricing in the country (Coopers and Lybrand, 1997; Harrison and Glyn-Jones, 1999).

Following the release of two series of transfer pricing draft guidelines in October 1997 and January 2000, respectively, the IRD issued transfer pricing guidelines in a final form applied these rules in October 2000. The 2000 guidelines provide a general overview of the conceptual framework within which the transfer pricing rules operate, they discuss the level of documentation to be maintained by taxpayers to meet the requirement of the rules, and they address some specific transfer pricing issues involving the treatment of intangible property, provision and receipt of inter-group services, and cost contribution (New Zealand transfer

pricing guidelines, 2002).

The current New Zealand transfer pricing rules are contained in Sections GD 13, FB 2 and GC 1 of the *Income Tax Act* 1994. The rules are intended to prevent the New Zealand tax base being evaded by the blatant shifting of income out of the country without tax liability. The main transfer pricing rule – Section GD 13 – generally only applies to cross-border associated transactions between separate entities which have the potential effect of depleting the New Zealand tax base (Harrison and Glyn-Jones, 1999).

Section FB 2 stipulates the use of an arm's length basis to apportion income within a single legal entity such as an overseas head office and its New Zealand branch. In some circumstances, arrangements may occur where the parties are not technically associated. To ensure the regime is effective, a specific anti-avoidance provision is incorporated in Section GC 1 to deal with certain non-arm's length transactions that are entered into by a taxpayer, subject to GD 13, but have the purpose or effect of avoiding the application of GD 13 (Harrison and Glyn-Jones, 1999).

2.2.1 The Scope of the Current Transfer Pricing Regime

The New Zealand transfer pricing regime applies to income derived in the income year 1996/1997 and all subsequent years. The regime focuses on cross-border transactions between associated parties which may result in a loss of New Zealand tax revenue. The scope of the current regime under Section GD 13 includes the following:

- the supply or acquisition of goods, services, money, other intangible property, or anything else;
- the supplier and acquirer who are associated persons – essentially, any two companies with 50 percent or more common ownership;
- arrangements which are cross-border in character;
- arrangements on other terms other than arm's length basis; and
- arrangements with the potential to deplete the New Zealand tax base.

Arrangements which do not fall within the transfer pricing rule in Section GD 13 may be subject to the anti-avoidance provisions in Section GC 1 or the head office/branch structure provisions for a single legal entity in Section FB 2 (Harrison and Glyn-Jones, 1999; Clews and Howe, 2001).

2.2.2 The Main Features of the Transfer Pricing Regime

Associated Persons Section GD 13 applies only to transactions between associated persons. Associated persons are defined as companies with common ownership of 50 percent or more. Common examples of associated persons include the following:

- New Zealand parent companies and their overseas subsidiaries;
- foreign shareholders – both individuals and companies – of New Zealand companies, where the shareholders own more than 50 percent of the shares;
- New Zealand companies and overseas sister subsidiaries; and
- New Zealand resident settlers of foreign trusts.

Acceptable Methods Following the methods contained in the OECD Transfer Pricing Guidelines, Section GD 13 (7) prescribes five different methods as an acceptable range from which the taxpayer can make his choice for calculating the arm's length transfer price (Clews and Howe, 2001). These pricing methods can be categorised as either transaction based or profit based methods, where the transaction based methods consist of the comparable uncontrolled price method, the resale price method, and the cost plus method, while the profit methods consist of the profit split method and the comparable profits methods (Clews and Howe, 2001).

The New Zealand legislation does not impose a hierarchy of preference for the acceptable transfer pricing methods. However, in the selection of a pricing method, a taxpayer must select the method that provides the most reliable measure of an arm's length amount. This provides multinationals with opportunities for selecting methods more appropriate for their circumstances. In practice, the availability of comparable data often determines which method can be used. Given the small size of the New Zealand market, reliable comparable data are difficult to locate in the New Zealand market. The IRD, therefore, allows overseas data in foreign markets, such as the U.S. and Australia, to be used in the taxpayer's transfer pricing analysis (Harrison and Glyn-Jones, 1999; Clews and Howe, 2001).

Burden of Proof Section GD 13 (9) prescribes that the onus is on the taxpayer to determine an arm's length amount. In this regard, the regime is consistent with the transfer pricing rules of other tax jurisdictions. However, unlike the regulations of its major trading partners, which explicitly require taxpayers to prepare and maintain transfer pricing documentation to support the method and calculations used to set transfer prices, the IRD puts the onus on the Commissioner to show that the transfer price used by the taxpayer is not of an arm's length

consideration. Thus, the burden of proof lies with the Commissioner. If the Commissioner chooses to dispute the price determined by the taxpayer is at arm's length, the Commissioner must be able to prove that either:

- another price provides a more reliable measure of an arm's length amount; or
- the taxpayer is not co-operating with the Commissioner in the administration of the regime (Rolfe, 1997; Harrison and Glyn-Jones, 1999; Clews and Howe, 2001).

Documentation and Penalties Section GD 13 requires taxpayers to determine their transfer prices in accordance with the arm's length principle. As a practical matter, it would be necessary for taxpayers to prepare and retain sufficient documentation to show:

- how their transfer prices have been determined; and
- why these prices are considered to be consistent with the arm's length principle.

Documentation requirements include a functional analysis of the parties, which describes the functions performed, assets used and risks assumed by the business in its transaction with related parties, and justification for selecting the pricing methods actually chosen.

The transfer pricing regime does not have any special penalty provisions. Rather, it is subject to the general penalty provisions applicable to income tax issues. With regard to a taxpayer's transfer pricing arrangements, the taxpayer is likely to be required to demonstrate that the most reliable method has been selected and applied in an appropriate manner. A taxpayer that fails to document transfer pricing arrangements appropriately may incur a minimum penalty of 20 percent under Section 141A of the Tax Administration Act 1994 for not exercising "reasonable care". In addition, depending on the size and sophistication of a taxpayer, the absence of documentation in the determination of an arm's length amount makes the taxpayer vulnerable to a 40 percent penalty under Section 141C, on the basis that the taxpayer has been "grossly careless". Since these penalties are non-deductible for income tax to the taxpayer, they represent a significant potential cost. To avoid such a penalty, the taxpayer must maintain a sufficient level of supporting documentation to meet the requirements of the transfer pricing regime (Rolfe, 1997; Rich and Harrison, 1997).

Advance Pricing Agreements An APA is a binding legal agreement between the taxpayers and the tax authority. The APA programme provides an important mechanism for allowing taxpayers to be certain that their transfer pricing policies and procedures meet the requirements of the arm's length standard. The New Zealand regime has issued binding APAs

dealing with the application of the arm's length standard to intercompany transfer prices⁴. An APA is issued as either a private binding ruling by the Commissioner under Section 91E of the Tax Administration Act 1994, or under the Mutual Agreement article of the applicable double taxation agreement (Rolfe, 1997).

2.3 Summary

The basic principle underlying the New Zealand transfer pricing regime is that the arm's length standard should be adopted as the overriding benchmark for determining transfer prices between related parties. That is, the transfer price adopted by the related parties must be compared with the price adopted by independent parties operating on the open market. Section GD 13 applies to cross-border associated transactions between separate entities. Section GD 13 (7) prescribes two types of methods. They are transaction based methods (comparable uncontrolled price, resale price, and cost plus) and profit based methods (profit split and comparable profits). Transaction based methods compare prices or gross margins whereas profit based methods compare net profits.

⁴ In 2001, the IRD and the ATO reached an agreement over APA for the purpose of eliminating taxpayers' risk of double taxation and providing tax certainty for international transactions between New Zealand and Australia (Ferrers, 2001). In the same year, Australia's largest gaming machine company – the Aristocrat International Pty Ltd – simultaneously signed the first bilateral APA between New Zealand and Australia on the pricing of its dealings with its New Zealand subsidiary (i.e., Aristocrat Technologies NZ Ltd).

Chapter 3

The Regulatory Framework for Transfer Pricing in Australia

3.1 Introduction

This chapter reviews the Australian transfer pricing regulations. These regulations provide guidance with respect to acceptable methods, documentation requirements, potential penalties for taxpayers who do not comply with transfer pricing requirements in their international dealings with related parties, relief from double taxation, and APAs.

3.2 Transfer Pricing Legislation in Australia

Transfer pricing regulations in Australia follows U.S. legislation, i.e., the Section 482 regulations and the Section 6662 transfer pricing penalty regulations of the U.S. Internal Revenue Code. In addition, they fully endorse the OECD definition of acceptable transfer pricing methods.

Compared to its New Zealand counterpart, the Australian Taxation Office (ATO) has established a comprehensive structure for dealing with related party transfer pricing issues. The Australian statutory rules on transfer pricing are contained in Section 136 of Division 13, in Part III of the *Income Tax Assessment ACT* 1936 (ITAA). The ATO has also issued various taxation rulings concerning transfer pricing. They include Rulings TR 92/11, TR 94/14 (Transfer Pricing); TR 95/23 (APA); TR 97/20 (Methods); TR 98/11 (Documentation); TR 98/16 (Penalties); TR 99/1 (Services); TR 99/8 (Adjustments); TR 2000/16; TR 2001/11; TR 2002/5; TR 2002/2 and TR 2004/1. The main features of the Australian transfer pricing regime are presented as follows:

Relationship Tests The test level of common ownership required is not specified by the ATO. This is a significant difference between the Australian and the New Zealand transfer pricing legislation. The New Zealand legislation specifies that the relationship test of associated parties is the existence of ownership of 50 percent or more. In contrast, the Australian relationship test is based on determining whether the consideration in any transaction between two parties is of arm's length in nature. Therefore, dealings between seemingly unrelated parties in the view of the New Zealand IRD may be caught out by Australian rules. As such, Australian taxpayers are under a burden to confirm that the involved price is arm's length in nature (Campos 1996; Rolfe, 1997).

Acceptable Methods The ATO permits the use of the traditional transaction based methods, such as, on the one hand, the comparable uncontrolled price method, the resale price method, the cost plus method and, on the other hand, profit based methods, such as the profit split method and the transactional net margin method. These are consistent with the OECD Guidelines on transfer pricing methods. However, the Australian regulations do not prescribe any hierarchy or order of preference for applying the various methods. The ATO expects taxpayers to use the method that is ‘most appropriate’ or ‘best suited’ to their facts and circumstances. That is, where there is an insufficiency of data, or the existing methods cannot be used, the ATO allows taxpayers to use ‘novel’ or ‘hybrid’ methods, provided these methods can produce a comparable result. Hybrid methods are those methods that may be necessary in cases in which the application of more than one method is needed to increase the reliability of the taxpayer’s results (Campos 1996; Rolfe, 1997).

Burden of Proof The ATO imposes the burden of proof upon the taxpayers. The taxpayers are required to demonstrate that their pricing practices equate with the norm of arm’s length pricing. To reduce the risks of disputes with the Australian Commissioner, multinational firms must prepare and retain sufficient documentation as evidence that their transactions with affiliates satisfy the arm’s length standards (Campos 1996; Rolfe, 1997).

Contemporaneous Documentation The Australian regime requires taxpayers to prepare and maintain documentation to demonstrate that the amounts charged in related party transactions are consistent with the arm’s length standard. In addition to the ordinary documentation requirements, such as regular books and records and contractual agreements, the ATO also requires taxpayers to create and retain contemporaneous documentation which details the pricing methods adopted and indicates why a particular method is most appropriate in determining an arm’s length price. The contemporaneous documentation requirements are a substantial administrative and operational burden for multinationals in relation to the justification and documentation of international transactions. These requirements contribute to more detailed and tighter rules in the Australian jurisdiction (Campos, 1996; Rolfe, 1997).

The ATO has placed great emphasis upon the value of contemporaneous documentation in demonstrating that two related companies are, in fact, dealing at arm’s length. The documentation can be used to justify the use of a method to price cross-border transfers and thus prevents the Australian Commissioner from using his or her power to deem an amount to

be arm's length in nature. For a multinational subsidiary operating in Australia, if it wishes to avoid disputes with the ATO on intercompany charges, and if it wishes to avoid double taxation of income, contemporaneous documentation is imperative.

Penalties Both the Australian and New Zealand transfer pricing rules emphasise that their tax authorities need to be able to collect a fair share of tax with respect to international transfers. Consequently, the two tax jurisdictions restrict the application of their transfer pricing penalty regimes to transactions that have the effect of depleting their tax base (Campos, 1996; Rolfe, 1997).

In comparing the two transfer pricing penalty regimes, however, it appears that Australia has adopted a more rigorous approach. In Australia, a non-deductible penalty of 25 percent of the tax shortfall plus deductible interest will be payable where there is no dominant tax avoidance purpose. In the situation where profit shifting involves a dominant tax avoidance purpose, the relevant penalties will be 50 percent of the tax shortfall. If certain culpable behaviour has occurred, this penalty may be as high as 90 percent. If, however, the taxpayer has a reasonably arguable position as, for example, when the taxpayer's transfer pricing policy is well documented, then the penalty will be reduced to 10 percent of the tax shortfall.

Advance Pricing Agreements In June 1995, the ATO released a taxation ruling (TR95/23) containing guidelines on the APA process. Taxation Ruling 95/23 set out the factors that will be considered by the ATO in deciding whether to accept an application for an APA, including whether the taxpayer is seeking a bilateral APA and whether the other country involved is a tax treaty partner (Rolfe, 1997). APAs may be unilateral or bilateral – such as involving tax authorities from foreign countries. There is a strong preference with the tax authorities for bilateral over unilateral APAs in the case of transactions involving entities in countries which have double tax agreements with Australia. The commissioner will generally not consider applications for bilateral APAs with non-tax treaty countries (Campos 1996; Rolfe, 1997).

There is a formal application process for an APA in Australia. To initiate the process, a taxpayer must apply to the ATO for a pre-lodgement meeting to discuss the requirements of the proposed APA. Where an APA is considered appropriate, the taxpayer will then be required to lodge a formal application providing details of the following:

- the proposed methods;
- the documentation supporting the chosen methods;

- the terms and conditions which govern the APA; and
- the duration of the APA (Rolfe, 1997).

3.3 Summary

The central purpose underlying Australian transfer pricing legislation is to ensure that the Australian tax base is not eroded by international profit-shifting arrangements. The ATO permits the use of the traditional transaction methods (comparable uncontrolled price, resale price, cost plus) and transactional profit methods (profit split and transactional net margin). Traditional transaction methods are preferable to transactional profit based methods. Where there is adequate comparable data, the preferred traditional approach is the comparable uncontrolled price method.

Chapter 4

The Regulatory Framework for Transfer Pricing in China

4.1 Introduction

This chapter reviews the Chinese transfer pricing regulations. They include the definition of associated enterprises, the transfer pricing methods used, the burden of proof, the obligatory documentation, and APAs.

4.2 Transfer Pricing Legislation in China

China is a late-comer to the transfer pricing arena. In 1979 China started a policy of economic intercourse with the rest of the world. In the early years of this policy, transfer pricing was not a significant concern to the Chinese government because its energies were mainly focused on attracting FDIs and also because China lacked an institutional framework to deal with the issues involved in the country.

Since then, however, China's enormous market potential and cheap labour costs, along with a series of preferential tax policies for foreign investors, have combined to encourage large numbers of foreign investment enterprises (FIEs) to embark on investment opportunities in China. The wide range of related party transactions typically engaged in by FIEs with overseas affiliated companies, along with the fact that more than half of the FIEs reported an operating loss in the 1980s have, in turn combined to imply that the potential for transfer pricing manipulations in China have been immense.

As a result, since the late 1980s the Chinese government has noted the phenomenon and has taken steps to combat tax avoidance through the use of transfer pricing abuses by FIEs in China. In November 1990, the State Administration of Taxation (SAT) issued a set of provisional rules regarding the administration of taxation on transactions between FIEs and their associated enterprises. These rules set forth general guidelines on the transfer prices of these transactions and provided the basis for the subsequent legislation.

The Chinese transfer pricing legislation was first introduced in 1991 by the National People's Congress under the Income Tax Law for FIEs. The transfer pricing legislation – Article 13 of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (Tax Law) – adopts the arm's length principle, which stipulates that the prices charged or paid in business dealings between the establishments of

FIEs within China and their associated enterprises⁵ should be the same as the prices charged or paid in comparable uncontrolled transactions between independent, unrelated enterprises. Under Article 13 of the Tax Law, if the transactions are not carried out at arm's length and, thus, result in a reduction of taxable income, the tax authorities have the right to make reasonable adjustments (Chan and Chow, 1997a; Huang and Yu, 1997).

Article 13 of the Tax Law is further supplemented by Articles 52 to 58 of the Detailed Implementing Rules of the Tax Law (DRR). The Tax Law has been in force since 1 July 1991, and the Implementing Rules (DRR) since 30 June 1991 (Huang and Yu, 1997).

On April 23 1998, the SAT issued comprehensive transfer pricing regulations entitled Tax Administrative Rules and Procedures for Transactions between Related Parties (SAT Circular No. 59). This Circular contains 52 articles aimed at setting criteria for selecting tax examination targets, standardising transfer pricing examination procedures, and strengthening internal co-ordination amongst the local tax bureaux and the SAT (Guo, 2000).

The regulations explicitly indicated that, in addition to providing an attractive investment environment for foreign investors, the Chinese government also intends to ensure its fair share of tax revenue from MNEs undertaking business in the country (Guo, 2000).

Unlike other countries' transfer pricing regulations which focus on corporate income tax, the Chinese transfer pricing regulations might be applicable not only to income tax, but also to other taxes, such as VAT, consumption tax and business tax. Additionally, as a result of China's tax-sharing system, not only cross-border transactions but also domestic transactions conducted between associated enterprises are targets for transfer pricing examination – although it appears that the Chinese transfer pricing audits have focused mainly on cross-border transactions (Rolfe, 1997; Guo, 2000).

Associated Enterprises As with transfer pricing rules in other jurisdictions, the Chinese transfer pricing rules only apply to transactions that are conducted between or among related parties or controlled parties. A foreign enterprise and another company, enterprise or organisation will be considered as associated in the following circumstances:

- where an enterprise directly or indirectly owns 25 percent or more of another enterprise;
- where two enterprises are directly or indirectly owned by a third enterprise with 25 percent or more capital interest;

⁵ An associated enterprise is defined in Article 52 of the DRR as an association based on direct or indirect ownership or control in respect of capital, business operation, purchase or sales, direct or indirect ownership or control by a common third party and any other association with mutual benefits.

- where an enterprise borrows more than 50 percent of its loans from another enterprise, or where an enterprise guarantees 10 percent or more of another enterprise's loans;
- where one of the managing directors or half or more of the board of directors or the executive managers of an enterprise is/are appointed by another enterprise;
- where an enterprise's production can only be operated on the provision of proprietary technology owned by another enterprise;
- where the provision of raw materials, parts, and semi-finished goods used by an enterprise in production are supplied or controlled by another enterprise;
- where the sales of the commodities of an enterprise are controlled by another enterprise; and
- where the production, trading activities and profits of an enterprise are effectively controlled by another enterprise having mutual benefits, such as the existence of family relationships.

Transfer Pricing Methods Used As with the approaches to transfer pricing by both the OECD and the U.S, the Chinese transfer pricing regulations endorse and support the arm's length principle as the best approach to address transfer pricing issues. According to the rules, tangible assets must be priced based on a transaction basis, using one of three methods as follows:

- the comparable uncontrolled price method;
- the resale price method; or
- the cost plus method.

Owing to the lack of reliable public data in China, the tax authorities probably also consider other methods to price transactions as being appropriate. They are profit based methods, such as the comparable profit method, profit split method, transactional net margin method and deemed profit method. It should be noted that the circumstances under which these methods could be applied were not addressed in the regulations (Guo, 2000).

As for transactions involving intercompany provisions of services, loans and the transfer of other assets, no particular methods are stipulated in determining their arm's length results. Arm's-length prices under such circumstances are broadly referred to as any payments or receipts that a third party would agree to for the same kind of transaction (Guo, 2000).

Burden of Proof In China, the burden of proof regarding the arm's length price in related party transactions rests with the taxpayers. The tax authorities are not required to prove that the taxpayer intended to avoid Chinese tax. When the tax authorities suspect that an FIE's income has been reduced as a result of non-arm's length pricing, the tax authorities will require the FIE to provide relevant information regarding transfer pricing (Rolfe, 1997; Guo, 2000).

Documentation Unlike the practice in Australia, the U.S. and many other industrial countries, the Chinese transfer pricing regulations do not require contemporaneous documentation. However, in a transfer pricing audit, the Chinese tax authorities have the right to require that the taxpayer provides information to support its transfer pricing (Article 18 of SAT Circular No. 59, April 1998). The taxpayer assumes the burden of proof and provides the documentation to support its intercompany pricing policies (Article 24 of SAT Circular No. 59, April 1998). The information that would then be requested includes the following:

- detailed third-party transaction information for such variables as tangible property transactions, intangible property transactions, loans, provision of services and rent;
- components of price determination, such as transaction volumes, locations, form or product, trade marks, and terms of payment; and
- other relevant information associated with determining prices and charges.

The following information might also be required for intercompany tangible property transactions.

- functions performed by all related parties;
- whether the sales of goods and selling prices will be affected by seasonal variations;
- any intangible property involved; and
- pricing methods used.

Advance Pricing Agreements APAs are common in OECD countries and have also, in practice, been informally adopted in China. As indicated in Circular 59, APAs are acceptable avenues of negotiation with the tax authorities. To date, Circular 59 has not provided a prescription on the detailed procedures for an APA application and what kind of information is required for this exercise.

The FIE must provide relevant information and fill out the application form for using the advanced pricing method. After a review of the information and documents, the tax authority may sign an APA with the enterprise and then supervise its implementation.

Under the current Chinese transfer pricing regulations, taxpayers can negotiate APAs with provincial tax authorities, and no approval from the SAT is required. The fact that the provincial tax authorities are more likely to be familiar with the taxpayer's operations, and are also responsible for tax collection and audit, can accelerate the negotiation process, and facilitate the implementation of the APA (Guo, 2000).

4.3 Summary

The Chinese transfer pricing legislation adopts the arm's length principle and introduces similar methods commonly used in OECD countries for determining appropriate transfer prices. It acknowledges the need for taxpayer documentation of all related party relationships and the arm's length character of its transfer pricing. These signify the Chinese government's attempt to structure its transfer pricing rules in line with that of the OECD nations in order to harmonise its approach with international practices for its participation in world trade.

Part B

Theoretical Framework

Chapter 5

Theories of Foreign Direct Investment and International Transfer Pricing

5.1 Introduction

The theories of the MNEs and FDI have been advanced over several decades. The literature include contributions by a number of economists, including Coase (1937), Vernon (1971), Buckley and Casson (1976), Hymer (1976), Dunning (1980), Kindleberger (1984), Dunning and Rugman (1985), Corley (1992) and Caves (1996). Nowadays, the world economy has become significantly globalised and MNEs contribute a substantial portion of the world trade. MNEs have distinctive features that set them apart from their domestic counterparts. MNEs consider the global economy as a single marketplace. They integrate their production and trade on a global scale, rather than within individual countries, and internalise trade and investment within a multinational system. Compared with domestic companies, MNEs have additional management problems. The noticeable issue is international taxation and its pervasive influence on MNEs operations. ITP is one of the most important international tax issues facing MNEs (Ernst and Young, 1999).

With the development of the global economy and the increasing worldwide reach of MNEs, ITP has become a central concern for managers of MNEs (Cunningham, 1978; Itagaki, 1985). This chapter reviews the neo-classical economics literature on FDI, interprets the origin and nature of ITP. Linkages among market imperfections, FDI and ITP are also explored.

5.2 Multinational Enterprises and Theories of Foreign Direct Investment

The world economy has been significantly globalised since the end of World War II. As a result, a large percentage of the world's economic products is generated by international business activity, mostly undertaken by MNEs (Nobes and Parker, 2000). An MNE is an organisation that engages in production or service activities in two or more countries (Cunningham, 1978; Leitch and Barrett, 1992). As part of the increased globalisation of companies, MNEs have significantly expanded their international operations. MNEs engage in international operations mainly through FDI (Dunning and Rugman, 1985). In contrast with exporting and importing, where a stake is taken in an overseas business without operational control, FDI requires the establishment of a subsidiary or branch by a company from one country in the territory of another country, at which point the investing company becomes a parent company (Easson, 1991). FDI can take one of three forms:

- the establishment of a new enterprise in an overseas country – either as a branch or as a subsidiary;
- the expansion of an existing overseas branch or subsidiary; and
- the acquisition of an overseas business enterprise or its assets (Buckley, 1992).

The theories of MNEs and FDI provide a conceptual framework for explaining the reasons why MNEs exist and what leads to their foreign investment decisions. Economists have developed the field around the following three key questions:

- Why do firms move abroad as direct investors?
- How can direct-investing overseas firms compete successfully with local firms in the host country, given the disadvantage of operating in an unfamiliar foreign territory? and
- Why do firms choose to enter a foreign country via FDI instead of exporting or licensing? (Hymer, 1976; Root, 1978; Buckley, 1992).

Hymer (1976) established his theory of imperfect competition and monopoly advantages to explain the reason for MNEs. In his dissertation on “The international operations of national firms: A study of direct foreign investment”, Hymer argued that a perfectly competitive market is only possible in theory. In the real world, the market is imperfect. Because of their unfamiliarity with local market conditions, MNEs engaging in international production are at a disadvantage compared to local firms. In order to compete successfully with local firms in the host environment, MNEs must be able to exploit certain specific advantages not possessed by their local competitors. Market imperfections, created by the existence of some monopolistic or oligopolistic advantages for MNEs, offer them compensating advantages exceeding the disadvantages of being in a host country (Hymer, 1976; Buckley, 1992).

Market imperfections offer MNEs competitive advantages over indigenous firms, and these advantages must be held monopolistically. In other words, these advantages cannot be purchased by their local competitors. Otherwise, their specific advantages may be duplicated over time. To survive in foreign markets, MNEs install effective barriers to competitive entry by internalising markets across national boundaries (Hymer, 1976; Buckley and Casson, 1979; Corley, 1992).

Hymer’s theory is based upon the concept of structural market failure and, therefore, is restricted to the structural aspect of market imperfections. The elements of structural market

imperfections include scale economies, knowledge advantages, distribution networks, product diversification, credit advantages (Dunning and Rugman, 1985).

Dunning and Rugman (1985) noted that Hymer (1976) had ignored the distinction between structural (endogenous) and transaction-cost (cognitive or exogenous) market imperfections and, hence, had overlooked the work of Coase (1937) who emphasised the transaction-cost side of market imperfections and the importance of internal markets. Coase's (1937) theory originally applied to multiplant indigenous firms. He suggested that because the external market mechanism inflicts higher transaction costs in areas such as defining and accepting contractual obligations, fixing contract prices, and taxes to be paid on market transactions, a firm may organise these activities internally, namely, in response to the transaction costs, the firm may create an integrated internal market.

Buckley and Casson (1976) developed this into an explanation for MNE activities. They stressed the importance of market imperfections in intermediate product markets, particularly those of patented technical knowledge and human capital, and further concluded that such imperfections provide an incentive for an MNE to internalise resource markets.

Perhaps the most influential work on the subject of multinational international production is Dunning's (1980) eclectic paradigm. This paradigm is an attempt to synthesise the essential features of the MNEs and FDI theories. Dunning's 'eclectic theory of international production' has three dimensions, namely:

1. Ownership specific advantages (competitive advantages): These advantages explain the 'why' of international production. An MNE possesses ownership advantages that may be held temporarily or permanently, but are held exclusively. They are also called 'monopoly advantages'. For example, securing a monopoly of intangible assets or economies of scale provides an organisation a competitive edge over the indigenous firms in the foreign market.
2. Location specific advantages (configuration advantages): These advantages explain the 'where' of international production. They consist of factors specific to a particular place. Therefore, the home or host country, rather than the MNEs, contributes to these advantages. Location advantages include, but are not limited to, sources of materials, market structure, provisions of infrastructure (for example, commercial, legal, educational, transport and communication), economic systems and government policies.

3. Internalisation specific advantages (coordinating advantages): These advantages explain the 'how' of international production. MNEs operating in the host countries inevitably face market imperfections caused by government regulations or natural externalities in the transfer of tangibles or intangibles (for example, technical know-how and information). The main advantage of an MNE is its ability to use its internal markets within the same firm to overcome market imperfections in the host environment (Dunning, 1980; Dunning and Rugman, 1985; Buckley, 1992).

To summarise, Dunning's (1980) eclectic paradigm sets out a generalised framework for explaining the level and pattern of international business activity of MNEs. Changes in the configuration of the ownership, location and internalisation advantages account for the rise, persistence or decline of MNEs' overseas production. These advantages contribute significantly to market imperfections in the host environment of MNEs, and determine the propensity for them to engage in international production (Leitch and Barnett, 1992; Nobes and Parker, 2000).

5.2.1 Market Imperfections and Foreign Direct Investment

Dunning's eclectic paradigm emphasises exogenous market imperfections, which are classic reasons for the internalisation of markets by MNEs and the motives for FDI. An MNE entering foreign markets has a choice of three approaches, namely, exporting, FDI or licensing. As international business increases, FDI is favoured more by MNEs. Why does an MNE choose to enter a foreign country via FDI instead of exporting or licensing? Market imperfections explain the need for FDI. In a perfectly competitive market, a firm can buy or sell goods and services at market prices, and foreign markets can be serviced by exports or licensing. Nevertheless, perfect competition is not common in practice. Rather, markets are imperfect. Imperfect markets often inflict high transaction costs on transfers of goods and services. In response to market imperfections in foreign countries, an MNE internalises its trade transactions by using a hierarchical structure to control its international production, thereby minimising transaction costs. Internalisation takes the form of FDI when there are barriers to trade which preclude exporting, or risk dissipating firm-specific advantages of the MNE (for example, technological knowledge, management skills or market know-how) which prevents licensing. It can be concluded that FDI occurs as a response to both natural and unnatural market imperfections (Dunning and Rugman, 1985; Benvignati, 1985; Rugman and Eden, 1985; Rugman, 1985b; Leitch and Barrett, 1992). In short, FDI is determined by the

need to internalise a firm-specific advantage to overcome market imperfections which, as a response, has greatly increased the volume of international trade.

5.2.2 The Types and Magnitude of Intercompany Transactions

The activities of MNEs have an important impact on international trade. Currently, a substantial part of international trade consists of high volumes of intercompany sales, or commercial transactions between parent companies and their foreign affiliates. These transactions may take various forms, i.e., transfers of goods and services, transfers or uses of intangible property, the use of tangible property, intercompany financing and licensing. The internal charges for these related party transactions may also take a variety of forms, such as management fees, service charges, royalties, licensing fees, franchise, rents, and interest (Tang, 1993).

The WTO has estimated that intercompany transactions among MNEs now account for about one-third of total world trade (Rust and Graham, 2000). This amount of intercompany transactions has important tax implications for both the MNEs themselves and the agencies of governments of the countries in which they operate. Since a large proportion of international trade consists of transfers between related business entities located in different tax jurisdictions, a small change in the transfer prices adopted for such intercompany trade could have a huge potential for saving substantial tax payments for the MNEs involved but could also deny tax revenues to the governments concerned. Consequently, tax authorities in many countries have intensified their surveillance and investigation of multinational transfer pricing practices to counter actual or suspected ITP manoeuvres. Hence, a major challenge facing MNEs today lies in the effective management of international transfer prices – an activity that has been, and continues to be, of central managerial concern for them (Dunning and Rugman, 1985; Rugman, 1985b; Sun, 1999; Borkowski, 2001).

5.3 International Transfer Pricing: Organisational Perspective

The use of transfer pricing can occur both domestically as well as internationally. It is needed when a company structures itself into profit-making units, which are able to make independent decisions, and can sell their products or services to each other within the company. From a domestic company's point of view, transfer pricing is the price used for internal sales of goods and services transferred from one profit centre to another within the same firm. In this regard, transfer pricing is at the heart of inter-profit centre relations. The prices adopted for the transfer of goods or services between such related parts of the same

firm may be fixed at sharply different levels from that which would apply to the same transactions between unrelated parties (Eccles, 1985; Rugman and Eden, 1985; Anthony and Govindarajan, 1998). At the domestic level, transfer prices are designed to accomplish the following objectives:

- to provide each part with the relevant information required for determining the optimum trade-off between company costs and revenues;
- to promote goal congruence;
- to preserve divisional autonomy;
- to enhance managerial motivation; and
- to help in the evaluation of the performance of various profit centres (Anthony and Govindarajan, 1998; Garrison and Noreen, 2000).

If a company located wholly within a single national boundary, albeit in the form of numerous independent units, grows to the point of being able to contemplate the establishment of overseas units, the firm becomes, by definition, an MNE. The intercompany pricing processes which then take place between its constituent parts across national borders within the MNE group are critically different from those previously and exclusively conducted within a single national boundary. Compared with intracompany pricing practices for domestic firms, ITP is thus of great significance for MNEs. They are faced with an “economic environment...much more complex and perplexing than that for domestic transfers...” (Wu and Sharp, 1979, p. 83) and, therefore, “setting an international transfer price is more complex than domestic pricing” (Borkowski, 1992, pp. 33-34). At the international level, the objectives and motivations associated with transfer pricing revolve around issues of taxation and custom duties. Within the host country MNEs focus on minimising tax liability, reducing tariffs on imports and exports, avoiding restrictions on the repatriation of profits, minimising foreign exchange risks, enhancing the competitive position of subsidiaries in international markets and improving the relations between subsidiaries and foreign host governments (Cunningham, 1978; Garrison and Noreen, 2000).

Dunning’s (1980) theory stresses market imperfections and internalisation. His theory underlies the analysis of MNE transfer pricing motivations and behaviour. Since internal transfers of intermediate products take place within some multinational organisational contexts, a basic understanding of the nature of ITP can be gleaned from the analysis of the varied organisational structures of MNEs.

The core reason for the existence of an organisation can be identified in its vision and mission statement, and can be defined, more specifically, by its corporate goals and objectives. Corporate goals and objectives can be directly and indirectly linked to different corporate strategies and, in turn, to different organisational structures (Ward, 1992; Anthony and Govindarajan, 1998). Since organisations exist in different shapes and sizes, their organisational structures can be categorised in different ways. The traditional organisational alternatives are functional, divisional, and matrix forms. In a multinational context, corporate structures can be grouped into three categories: vertically integrated businesses, horizontally integrated businesses and conglomerates (Ward, 1992; Rugman, 1985b; Anthony and Govindarajan, 1998). Each of these organisational structures may be considered in association with its specific issues for multinational intercompany transfer pricing as follows.

5.3.1 Vertically Integrated Businesses

This is a common industrial structure for MNEs. In terms of Porter's (1980, 1985) strategic management concept of vertical integration, vertically integrated businesses tend to operate with a relatively undifferentiated product. This business strategy can be used as a competitive weapon against non-integrated firms. The vertical integration form enables an organisation to take advantage of economies of scale, and enables it to use an internal market to minimise its transaction costs (Dunning and Rugman, 1985).

For reasons of size, most of a vertically integrated company is broken down into a variety of geographic and functional divisional units located in different countries. The divisions often trade with each other within the integrated group, and each division is given responsibility for a specified set of activities in recognition of its superior information regarding resource use and labour effectiveness compared with central management. To measure financial performances effectively at the division level, the group must set transfer prices for those goods and services exchanged between any two divisions or between the divisions and their parent company (Ward, 1992; Anthony and Govindarajan, 1998). This regime is established in the case of the oil industry, which is normally a single focus industry, operating as a vertically integrated business.

Aliber (1970, cited in Rugman, 1985a, p. 176) has presented the rationale for vertical integration structure for oil companies on an international scale:

Efficiencies may be realised by co-ordinating activities that occur in several different countries within the firm. Thus, an international oil company co-ordinates the production, transport, refining, and the distribution of petroleum at lower costs than individual firms at each stage might be able to by using the market. The economies of vertical integration involve reduction in transactions costs, the costs of search, and the costs of holding inventories (pp. 19-20).

As illustrated above, there are four levels of vertical integration for the oil company – extraction, transportation, refining and distribution. The upstream and downstream operations of the group are run separately by the four divisions. The corporate office coordinates and integrates their competitive strategies. Their performances are evaluated by a variety of financial indicators, such as profits and return on investment. This divisional structure within the vertically integrated firm enables divisional managers to focus attention on their own divisions.

For intercompany trade between the divisions, internal transfer prices are used by the upstream division to attach a price to products transferred to the downstream division, located in a different country. Thus, the crude oil to be processed by the division in the refining stage is supplied by the upstream transportation division. Because divisional managers are held responsible for both revenues and costs in their own profit centres, and are often evaluated and rewarded on the basis of divisional profits, they take considerable interest in the price they pay or receive because this intercompany price plays a major part in showing a profit or a loss for their divisions (Eccles, 1985; Ward, 1992; Iqbal, Melcher and Elmallab, 1997; Hansen and Mowen, 2000). As an example, in the case of the oil company, when the upstream division sells a product to the downstream division, it would try to receive the highest possible price from the downstream division that will raise its operating income, and vice versa. To ensure objectivity, these prices are normally set at externally established and quoted spot market prices, or are negotiated between the managers of the two divisions. Otherwise, disputes and controversy between divisional managers over transfer prices may occur, with possible damaging effects on employee morale (Rugman, 1985b; Rugman and Eden, 1985; Ward, 1992).

5.3.2 Horizontally Integrated Businesses

An alternative structure to vertical integration for industrial MNEs is horizontal integration. Horizontal integration involves two or more subsidiaries located across national boundaries.

These subsidiaries operate in the same line of business and are controlled by the same parent company, headquartered in the home country. Like vertical integration, a horizontally integrated MNE has a transactional advantage in using a hierarchical administrative structure to control the allocation and distribution of resources and goods within the MNE group (Rugman, 1985b).

Horizontal integration is common in many industries. An example of the horizontally integrated form of MNEs is in the pharmaceutical industry. The industry, characterised by high technology applications and expensive research, engages in horizontal integration to protect its technical know-how. A viable multinational drug company must engage in research and development to remain competitive with new products. High research and development costs contribute to the high costs of innovative drugs (Wündisch, 2003).

An alternative way to recover the costs would be to place a patent on the products. This gives the firm exclusive property rights over the manufacture and distribution of the products in the domain of the patent. However, in host nations where patents are not recognised, or when the firm fears that licensing or joint ventures can lead to the dissipation of its firm-specific advantage, the MNE will not risk collaborating with local firms if they are not certain that their intellectual property will be safe. Instead, the parent company has an incentive to keep the proprietary knowledge within the firm, rather than patent its products. This can be accomplished by creating an internal market through organising a horizontally integrated structure. Internal prices are set for the transfer of innovative pharmaceutical products from one subsidiary to another within the same horizontally integrated business. Another reason to set an internal price is that it is relatively difficult to establish the proper market price for intangibles involving research and development costs and intellectual property (Rugman, 1985b; Anthony and Govindarajan, 1998; Horngren, Foster and Datar, 1999).

5.3.3 Conglomerates

Distinct from the vertical integration and horizontal integration business structures is the conglomerate structure. This structure usually results from growth, which characterises many large MNEs. A conglomerate is the result of an action by an enterprise to acquire any number of distinct industries or types of business operations that are not organically related to one another as far as production and the market place are concerned. Each business is controlled from its parent company but operates as a relatively autonomous subsidiary. The connection between the subsidiaries is purely financial. A single conglomerate firm may operate in such

diverse businesses as wiring instruments, helicopters, chainsaws, air-craft engine components, forklifts, machine tools, specialty fasteners, and gas turbine engines (Rugman, 1985a; Ward, 1992; Anthony and Govindarajan, 1998).

The organisational form of conglomerate is partly justified by the generation and use of economies of scale that are mostly gained through shared common services by the individual subsidiaries. These services include such assets as information technology, research and development, market research, and financial departments (Ward, 1992; Anthony and Govindarajan, 1998). The efficiency of these services is centrally controlled at the group level. However, the subsidiary managers can control the amount of services they receive. As these subsidiaries are autonomous businesses, they may be tempted to seek maximise their own benefits to the detriment of the MNE as a whole. For instance, if a subsidiary pays less than it should be charged, it may be motivated to use more of the service, in self-interest, than it should. This behaviour could then be disadvantageous to the company as a whole. In another instance, if a subsidiary is required to pay more than it should be charged, it might avoid using certain services that are worthwhile from the point of view of management. To achieve goal congruence and effectively evaluate their financial performances, senior management must devise an appropriate method of charging each subsidiary for its usage of such shared services. This is normally achieved by creating an ITP system to ensure the efficient allocation of resources within the MNE group (Plasschaert, 1979; Ward, 1992; Anthony and Govindarajan, 1998).

For trade transactions or non-trade payment flows between affiliates of an MNE group, an appropriate ITP policy can be established to fit the organisation's structure and industry character. From an organisation's perspective, the objectives of transfer prices are designed to provide reasonable measures of subsidiary economic performance, to motivate subsidiary managers and to promote goal congruence. These objectives focus on the behavioural effects of the pricing of an organisation's internal transfers as is the case for domestic and international transfer prices (Plasschaert, 1979; Ward, 1992).

On the other hand, at the international level, additional factors must be taken into account by MNEs. Compared with domestic firms, composed of a number of divisions that trade with each other within a single nation state, foreign affiliates of an MNE are usually further removed geographically from the central headquarters. Subsidiaries may face very different economic conditions, political forces and contrasting cultures from those of their home

countries. ITP policies of the MNE are, therefore, far more affected by differing foreign environmental factors than by organisational variables such as size and internal structure. Among various areas related to multinational ITP objectives and motivations in the host countries, income tax tends to attract the greatest attention (Plasschaert, 1979; Hansen and Mowen, 2000). The following discussions focus on the examination of the nature of ITP with a tax perspective, regardless of the underlying organisational structure.

5.4 International Transfer Pricing: Tax Management Perspective

Multinational transfer pricing is a highly contentious international tax issue. From the point of view of taxation, ITP can be defined as the pricing process of goods and services transferred between related companies of a multinational system across different tax jurisdictions. The amount of taxes paid in each jurisdiction is, therefore, subject to the internal price that is assigned to the intermediate goods involved (Eden, 1985; Gresik, 2001). There are charges levied by the parent company for specific services rendered to its subsidiaries. Since corporate income tax rates vary across countries, and the foreign subsidiaries are theoretically subject to control by the parent company, the parent company may have considerable discretion in setting its transfer prices when one subsidiary – or the parent company itself – transfers an asset or provides a service to another subsidiary, and vice versa, as a means for manipulating tax liabilities. This process is modelled in Figure 5.1.

In this simplified ITP model, the parent company in the home country has two Subsidiaries A and B, located, respectively, in the host countries α and β . Subsidiary A sells its product to Subsidiary B. The corporate tax rate in host country α is 20 percent, but 33 percent in the host country β . It follows, for example, that Subsidiary A can produce an intermediate product to be sold to Subsidiary B, the latter processing the intermediate goods into a final product for sale in its local market. The products transferred have an open market price. The parent company sets an ITP policy based on a chosen currency.

In this case, with all other factors being equal, the parent company would like to allow its Subsidiary A in the low tax country α to sell its products to its related Subsidiary B in the high tax country β at a high price – one that exceeds the market selling price – ignoring constraints imposed by tax laws in the host country. Higher products prices would transfer profits from Subsidiary B to Subsidiary A. The resultant loss in Subsidiary B's high tax jurisdiction country β is more than offset by the profits of Subsidiary A in a low tax

jurisdiction country α . The overall effect is that the MNE as a whole can minimise its total tax payments by shifting its profits to the lower tax jurisdiction country α .

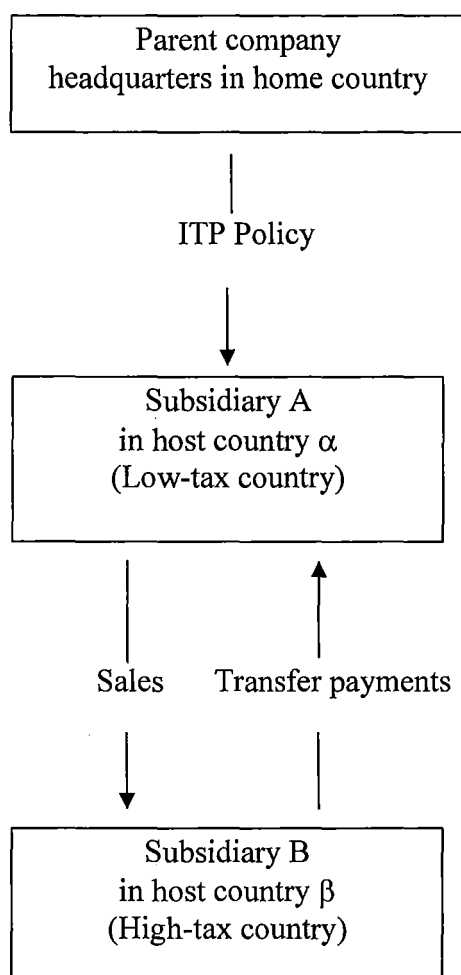


Figure 5.1 Simplified International Transfer Pricing Model

In addition to tax rate differences among nations affecting ITP decisions, and the resulting income shifting, the extent and magnitude of cross-border profit shifting through ITP also depends on which tax system – either the exemption system or the credit system – governments in home countries use to avoid double taxation.

The gains from profit shifts are largest if the MNE resides in a home country that uses the exemption system. Once the firm has been taxed abroad, foreign income is exempted from home-country taxation. Examples of countries that use the exemption system include Canada, France and the Netherlands. Japan, the U.K. and the U.S. are among those countries that use the credit system, which provides a tax credit for corporate taxes already paid abroad, and

defers home tax payments until income is repatriated from the source country – the host country – to the resident country – the home country. Under the credit system, the gains from profit shifting primarily arise from deferring the timing of profit repatriations from foreign subsidiaries to a residence country with a higher tax rate (Bartelsman, 2000).

5.4.1 Prior Empirical Evidence on Tax-Motivated International Transfer Pricing Practices of Multinational Enterprises

As there are huge potential tax saving opportunities arising from the use of appropriate ITP strategies, considerable evidence have been accumulated concerning the tax-motivated ITP strategies adopted by MNEs. Studies have examined whether tax rates affect taxable income reported by MNEs operating in different foreign locations. Substantial attention has been given to income shifting activities by firms with tax haven affiliates. Tax havens are often defined as locations with the following four attributes: low corporate tax rates; legislation that supports banking and business secrecy; advanced communications facilities; and self-promotion as an offshore financial centre (Hines and Rice, 1994). Consistent research results show that reported incomes of foreign affiliates of MNEs are significantly higher in countries with low corporate income tax rates than those in countries with high tax rates.

Grubert and Mutti (1991) examined the relationship between profit margins and tax rates to see whether profits were being shifted from high-tax countries to low-tax countries. They examined profit/equity and profit/sales ratios of affiliates of U.S. companies in 33 foreign countries. Their results revealed that before-tax profitability is negatively correlated with local tax rates, and that high taxes reduce the reported after-tax profitability of local operations. The fact that tax rates are a significant determinant of reported profits may, indirectly, be evidence of international tax avoidance activities by the MNEs.

Hines and Rice (1994) examined the ability of U.S. multinationals to shift their reported profits and real business activities between high-tax foreign countries and foreign tax havens. By analysing the 1982 aggregated reported profits of U.S. firms in different tax locations, they found that reported profit rates were sensitive to local tax rates. A one percentage point increase in tax rate reduced reported profits by three percent in their data. This elasticity may have been partly the consequence of profit shifting incentives.

Grubert and Slemrod (1998) investigated the impact of taxation in the context of U.S. corporate investments in Puerto Rico, a foreign tax haven favoured by many U.S.

multinationals. Their results showed that income shifting advantages were the predominant reason for U.S. investments in Puerto Rico. This finding is an echo of the prevalent allegation that a significant role of tax havens is to facilitate international tax avoidance.

The above studies focused on multinationals of U.S. origin. They provide evidence that U.S. multinationals shift profit out of high-tax countries into the U.S., and from the U.S. to low-tax countries or tax havens. Profit shifting can take place in two ways. One way to shift profits is through the capital structure of MNEs. For example, a multinational can use debt to finance foreign affiliates in high-tax countries and use equity to finance subsidiaries in low-tax countries. Another way is by the manipulation of transfer prices for cross-border intercompany deliveries of goods and services (Bartelsman, 2000). The second type of profit shifting activity – ITP – is the subject of this thesis.

Most MNEs are headquartered in the wealthy, industrialised nations such as Germany, France, Japan, the U.K. and the U.S. These countries have enacted sophisticated ITP regulations and have expertise to deal with the issues generated by this practice.

In contrast, developing countries are often host countries. ITP is likely to be more detrimental to developing countries (typically the source countries) than to developed countries (typically the residence countries). It is generally easier to expropriate the profits that would accrue to the subsidiary than the parent company. This is simply because developed countries usually have, and can afford, more sophisticated administrative structures that are able to identify ITP abuses, whereas developing countries lack institutional and administrative structures to analyse complex ITP situations, and are, therefore, more vulnerable to ITP manipulations. Conceivably, the threat to fiscal sovereignty through multinational transfer pricing manoeuvres is more prominent and imminent for developing countries than for developed economies (Easson, 1991; Chan and Chow, 1997a, 1997b).

5.4.2 The Adverse Effects of International Transfer Pricing Manipulations on the Economies of Host Nations

With regard to ITP issues, both MNEs and host countries frequently have their own conflicting interests and philosophies. Typically, companies may regard their strategies for tax avoidance as a conventionally acceptable position to adopt, while host countries may regard such action as culpable tax evasion. ITP manipulation is more likely to be a more serious problem in developing countries (and especially the least developed countries) where the

governments do not have the capacity or resources to identify the profit-shifting effects of ITP practices. Another possible motive is that MNEs, as a risk-averse strategy, may consider it preferable to remit their profits out of a developing country to a developed country where the parent company domiciles.

Recently, the number of MNEs operating in developing countries has significantly increased. Anecdotal evidence suggests that MNEs operating in developing countries have considerable income shifting opportunities through ITP. One explanation for this is the lack of institutional and administrative structures in these countries to deal with the situation. Another important explanation is that some developing countries are so eager to attract FDI that they have little interest in ITP controls (Rahman and Scapens, 1986, Chan and Chow, 1997a, 1997 b, 1998).

Some studies have provided empirical evidence as to the extent of income shifting out of developing countries through ITP manipulation. These studies reveal significant overpricing of imports or underpricing of exports by MNEs in certain industries. Lall (1973) used data from the Colombian Planning Office and the Import Control Board to investigate the extent of ITP abuses in Colombia. The results showed that, compared with world market prices, MNEs in Colombia overpriced their imports by about 33 percent to over 300 percent in the pharmaceutical sector, and from 24 percent to 81 percent in the rubber and electrical industries. It could be suggested from the findings that the Colombian tax base had been eroded as a result of profit shifting by MNEs. Natke (1985) used data on imports collected from 141 manufacturing firms – both domestic and multinational – operating in Brazil during 1979. These data were used to test the hypothesis that import prices paid by MNEs would be higher than those of Brazilian firms for the same products because of ITP behaviour. The findings revealed that, overall, all sampled MNEs paid higher prices than Brazilian firms, with the degree of overpricing ranging from a high of 39 percent in the full sample (127 products) to 21 percent in the narrow sample (26 products). The import prices of MNEs exhibited even greater variability. These results may be caused by multinational transfer pricing behaviour. Rahman and Scapens (1986) investigated the ITP practices of MNEs in Bangladesh. They compared the reported profits of the MNEs with those of their local counterparts. The results showed that MNEs were less profitable than local enterprises, a finding that was inconsistent with the relative market power of MNEs in Bangladesh. The authors concluded that ITP manipulation accounted for the low profitability of MNEs in the country. In order to get specific evidence, they further investigated the import prices of 10 pharmaceutical items. They found that the overpricing of imports by MNEs from affiliates

varied by 78 percent to 600 percent in the pharmaceutical industry and could be cited as evidence of income shifting activities by MNEs in the country. Chan and Chow (1997a) examined the business environment in China and used import and export data to test the hypothesis that MNEs in China overpriced their imports and underpriced their exports to shift profits out of the country. Outward profit shifting was detected in certain industrial sectors, such as the manufacture of audio/video equipment, garments, and plastics raw materials and products. Both the overpricing of imports and the underpricing of exports were detected in these three industries. This implies that MNEs shifted profits out of these businesses in China.

While ITP may maximise profits or minimise operational risks for MNEs, its abusive nature has far-reaching implications for the economies of countries where MNEs operate. The conceivable costs of ITP manipulations to the host countries can, therefore, be summarised as follows:

1. Tax losses. Through ITP manipulation, the host governments receive reduced revenue from taxes imposed on corporate income, import duties, and withholding taxes (Lin et al., 1993).
2. Difficulty in auditing and evaluating firms. ITP manipulations can distort a company's operating and financial results. To evaluate and audit the financial reports, the local government must attempt to identify and adjust for the effects of ITP. This can be very inefficient and costly especially in developing economies that are poorly equipped for this task (Lin et al., 1993).
3. Monopolised market. The ITP mechanism can be used by an MNE to protect its monopoly position as a supplier. It is often the case that a foreign subsidiary needs some components or parts from the parent company. The parent company could, therefore, use the ITP mechanism to keep its monopoly position as a supplier. For example, when there is no competition, the parent supplier can overprice, but as soon as competition appears, it can underprice the product or service (Lin et al., 1993).

5.5 Summary

According to the neo-classical economics of 'perfect competition' or 'imperfect competition', in a frictionless world of perfect competition, the internal price within an MNE group will be equated with the market price, and transaction costs will never occur in this market condition. Therefore, the use of internal pricing mechanisms should be redundant. Unfortunately, perfect competition is not commonly seen in practice. The extent to which the environment in which the transfers occur is imperfect may inflict high transaction costs on intercorporate transfers of

goods and services. In response to market imperfections in the host countries, MNEs may create internal markets through ITP to overcome transaction costs (Dunning and Rugman, 1985; Benvignati, 1985; Rugman and Eden, 1985; Leitch and Barrett, 1992).

With the speed in globalisation of economic activities and the internalisation of the greater part of world trade, more MNEs are engaging in transfers of larger monetary amounts with affiliates located in a number of countries. Such transfers also take place between the affiliates themselves. The prices at which goods, services or other assets are transferred determine the profits of MNEs and, therefore, the tax base of the countries involved. Tax underpayments caused by the movement of profits out of a country can result in shortfalls in government revenue and in foreign exchange reserves. Developing countries “have long relied on corporate income taxes as a principal means of revenue. These taxes account for up to a third of revenue in some developing countries” (Cohen, 1995, p. 11). Therefore, the nature of ITP can have significant tax implications in developing economies. ITP methods can directly affect the amount of profit reported in a country by an MNE, which in turn affects the tax revenues of that country (Bartelsman, 2000).

Chapter 6

Contingency Theory and International Transfer Pricing

6.1 Introduction

MNEs use a large variety of pricing methods to deal with intercompany transfers crossing international boundaries. The methods actually used in practice, however, may be very different from the theoretically based recommendations in the accounting literature. Contingency theory may offer an explanation of a firm's choice of transfer pricing methods in practice. The contingency theory approach presumes that firms are likely to choose the ITP systems that are perceived as optimal for their particular situation. In other words, each company selects a method that offers a best fit for its needs and circumstances (Borkowski, 1980, 1990).

6.2 Theoretical Frameworks of Alternative Transfer Prices

In the transfer pricing literature, three different theoretical research frameworks have been developed to explain multinational transfer pricing strategies: economic models, mathematical programming, and behavioural approaches, respectively.

6.2.1 Economic Model

The economic model includes market and marginal (incremental) pricing. In the economic model, if the intermediate market is competitive, the transfer price should be the market price; but if the intermediate market is imperfectly competitive – as it always is in the real world – then marginal pricing replaces market pricing (Hirshleifer, 1956). These methods, however, are open to criticism in that they ignore factors such as uncertainty and risk aversion by managers (Kanodia, 1979). Critics of these economic methods also cite their defects as ignoring both the divergence of preferences among division managers and information asymmetries. The latter occurs when upper management does not possess all the information available to lower management. A consequence of this is that upper management cannot choose an optimal ITP method for the firm as a whole (Borkowski, 1990).

6.2.2 The Mathematical Programming Model

The mathematical programming model equates transfer price to the opportunity cost of the intermediate product. It deals with multiple divisions and multiple products, and allows for the inclusion of realistic production constraints. In the study of the mathematical programming model, both linear and non-linear approaches are developed (Al-Eryani et al,

1990). Critics of this method cite its defects as including the underlying assumption of certainty, the neglect of managerial motivation and its complexity in implementation (Kanodia, 1979, Ismail, 1982, Borkowski, 1990).

6.2.3 The Behavioural Model

Both the economic and mathematical programming models place high importance on production efficiency, cost minimisation and profit maximisation. Although these economic analyses have provided useful insights, both models fail to take into account the human dimensions in transfer pricing decisions. To correct this deficiency, the behavioural model has been developed to incorporate the human dimension in ITP (Al-Eryani et al, 1990).

Rather than relying on market forces or cost structures for determining transfer prices, the behavioural model recommends the use of negotiated transfer pricing for achieving organisational goals. Waston and Baumler (1975, cited in Al-Eryani et al, 1990, p.411) argued that successful firms resolve interdepartmental conflicts through negotiated transfer prices. Acklesberg and Yukl (1979, cited in Al-Eryani et al, 1990, p.411) suggested that negotiated transfer prices could result in better relations and co-operation among divisions of an MNE. Cited defects of this method have included the necessity for a higher claim on management time, a possible increase in division conflict, and evaluations based more on a manager's negotiation ability and handling of the process and less on his or her ability to control economic factors (Kaplan, 1982, Borkowski, 1990).

In contrast to these three alternative transfer pricing models, many firms are in favour of cost-based methods in practice, although the cost-based methods do not have as much theoretical support as the three listed above.

6.3 Findings of Initial Survey of Transfer Pricing Methods Used

Three pricing models have been developed to explain the theoretical merits of various pricing methods in the literature. Empirical research on ITP has found a substantial difference between the actual methods used in practice and the theoretical models discussed above. Empirical studies of ITP methods concentrate on three major categories: market-based, cost-based and negotiated prices (Chan and Chow, 2001).

Arpan (1972) investigated non-U.S. systems of transfer pricing by comparing their attitudes and experiences with those of their U.S. counterparts. The study found that the nationality of the parent company affected the transfer pricing system used by MNEs and the importance given to the various factors in selecting transfer pricing systems. For example, American, French, British and Japanese companies preferred cost-based transfer pricing systems, but Canadians, Italians and Scandinavians preferred market-based transfer pricing systems. This study also revealed a substantial correlation between a firm's size and its transfer pricing system orientation: the larger the parent company, the more likely it is to use a cost-oriented transfer pricing system.

Tang (1979) reported on transfer pricing methods employed in the U.S. and Japan. Of the 133 firms surveyed in the U.S., 56 percent used cost-based methods – rather than market, negotiated, mathematical programming or other noncost-based methods – as their dominant transfer pricing mechanisms. A relationship between firm size and transfer pricing method chosen was not found.

Price Waterhouse (1984) surveyed the largest 148 of the Fortune 500 companies. Of the 74 respondent firms, 51 companies (69 percent) used transfer pricing, with 16 (31 percent) using full cost methods and 22 (44 percent) using cost plus methods, adopted either alone or in conjunction with a market based technique. Larger firms tended to use what Price Waterhouse termed 'value added transfer pricing'.

Benvignati (1985) used the Federal Trade Commission's (FTC) data for 466 manufacturing firms in the U.S., organising the sample into 3,186 'lines of business', of which 674 reported undertaking foreign transfers. Benvignati investigated whether or not transfer pricing methods were associated with firm and, or industry characteristics. Her study found that a firm's features were more likely to influence internal pricing decisions than that of the type of industry. Of the firm's characteristic variables investigated, advertising intensity, volume of foreign transfers, and the number of different countries where firms operated, were found to be strongly associated with non-market pricing, while larger MNEs and those with a large number of foreign subsidiaries tended toward market-based methods.

Al-Eryani et al (1990) surveyed controllers, treasurers, financial vice presidents and vice presidents for international operations from 791 *Fortune 500* and *Fortune Second 500* firms. They found that legal constraints and firm size were significantly associated with the use of market-based transfer pricing strategies of US MNEs. The study also found that large firms preferred market-based transfer pricing whilst there was no relationship between performance evaluation and market-based pricing. As for transfer pricing methods used, the research showed that the United States-based companies favoured cost-plus and market-based pricing that were the methods allowable under Section 482 of the U.S. Internal Revenue Code.

Academic research has tended to focus on the pricing methods used from a managerial or motivational point of view. Surveys for academic purposes are directed at uncovering whether market-based, cost-based or negotiated prices are in operation (Atkinson and Tyrrall, 1999). In contrast to academic research, Ernst and Young in their global survey of activity on transfer pricing, interviewed MNEs in 22 countries on the use of legally oriented transfer pricing as arm's length pricing methods⁶. The survey results show that cost plus and comparable uncontrolled price dominate the legally oriented pricing methods used by firms for all types of transaction.

Comparable uncontrolled pricing method uses the market price for transferred goods and services and is often thought of as the 'best pricing method' (Atkinson and Tyrrall, 1999, p.216). In practice, however, it can be extremely difficult to account for all the material differences in terms that are present between intergroup and third party transactions (Radebaugh and Gray, 1997, Atkinson and Tyrrall, 1999).

The cost plus method involves the costs of manufacturing the product plus a normal profit margin that would accrue from the sales of similar products. The cost plus method is generally simpler to administer and understand. Furthermore, the data are more readily available. The disadvantages are that the system does not create incentives for manufacturing companies to reduce costs and that, accordingly, it often reduces the profit margin for the final selling firm (Arpan, 1972, Radebaugh and Gray, 1997).

⁶ An arm's length price is the price that an unrelated party would have paid under the same circumstances for similar products/services (details see Atkinson and Tyrral, 1999, pp. 53).

The resale price method is used to determine the transfer price that a controlled sales and marketing company, as a distributor, should pay for goods which it sells on to unrelated parties. The resale price method works best when the distributor does little to add value to the product other than normal sales, marketing and distribution activities. Hence, there is less concern with the comparability of products than in comparable uncontrolled pricing method. The method is probably most useful where it is applied to marketing operations (OECD, 1995, Atkinson and Tyrrall, 1999).

The profit split method is based upon the economic notion of joint venture or partnership relationship. It divides profits between associated companies according to the relative economic value of each firm's contribution to that transaction. The profit split method depends on profit comparisons rather than price or transaction comparisons and functional analysis (OECD, 1995, Atkinson and Tyrrall, 1999).

Some studies examined the relationship between corporate size and industry on the one hand, and transfer price methods used on the other. However, their findings were inconsistent and differed regarding the strength of relationship between them. For example, Benvignati (1985), Borkowski (1990), and Al-Eryani et al (1990) found that larger firms tended to use market-based transfer prices, but Arpan (1972) found that larger companies tended to use cost-oriented transfer pricing system. Tang (1979) and Price Waterhouse (1984) found that there was no significant relationship between the size of American companies and the orientation of their transfer prices. However, Tang (1979) did find that larger Japanese firms tended to use noncost-oriented transfer prices.

The findings of previous empirical studies suggest that MNEs do not choose ITP methods based on theoretical recommendations, or solely based on their organisational characteristics. Instead, it seems that MNEs choose ITP systems that are perceived as optimal for their own particular situations (Borkowski, 1990). The contingency theory literature provides possible explanations for the divergence of actual methods, in practice, from the theoretically recommended methods in the accounting literature. Contingency theory approach may also help to explain some inconsistencies in the previous studies.

6.4 The Contingency Theory

Contingency theory originated from Lewin's (1935, cited in Borkowski, 1980, p. 48) field theory. As an alternative to Gestalt psychology which emphasises personality, motivation and social psychology, field theory stresses on perception, that is, it analyses people's behaviour in terms of the field at the time behaviour occurred, with the field defined as the total environment which exists for a person at that particular moment. The recognition of varying perceptions due to multiple fields led to the development of contingency theory.

Based on the premise that "there is no universally appropriate accounting system that applies equally to all organisations in all circumstances" (Otley 1980, p. 413), contingency theory stresses that "management styles and organisational structures are situation specific for organisational effectiveness, and that no one universal set of management principles exists. Hence, different environments for a task situation necessitate different management practices" (Schweikart, 1986, p. 541 cited in Borkowski, 1992, p. 35). Otley (1980, p. 413) further concluded that "a contingency theory must identify specific aspects of an accounting system which are associated with certain defined circumstances and demonstrate an appropriate matching". In the management accounting literature, the contingency theory approach has been used in three ways: (1) prior to collecting data, a hypothesis is formulated to assess the impact of contingent factors; (2) after the research has been undertaken, contingency theory is used to explain the inconsistent or sometimes contradictory results of empirical research, and (3) as part of a theoretical formulation (Otley, 1980).

Eccles (1985, p. 297) argued that "existing theory about transfer pricing (bears) no relationship to the empirical phenomenon" because the theory addresses only specific variables rather than the transfer pricing environment as a whole (Borkowski, 1990). Section 6.2 and 6.3 examined theoretically recommended transfer pricing methods and actual methods used in practice. This indicates that firms seem to arbitrarily choose transfer pricing methods, despite the guidance provided in the accounting literature. To date, there is no prevailing model which explains how these methods are chosen. Also, no "best method" exists that can satisfy the needs of all MNEs.

The features of the main pricing methods are presented as follows:

Cost-based methods have the advantage that they are simple to use, being based on readily available data. They are easy to justify to tax authorities and are easily routinised – features which make cost basis a commonly used method. However, a cost basis may not encourage

the units which transfer assets to control their costs as actively as they might, thereby imposing their inefficiency on the company to which the transfer of assets is made. For example, if the transfer price markup is to be 10 percent of cost where the total cost is 100 then the subsidiary will pay 110. If subsequently the total cost rose to 120, the subsidiary would have to pay 132. A subsidiary which, for whatever reason, is tied to dependency on continued transactions with the transferring company, is at the mercy of the latter's capability and, or willingness to manage its costs. In other words, there is no incentive for the transferring firm to reduce expenditure. Inefficiencies are passed from one company to the next. This is then an inequitable method for the transfer of goods between related companies (Radebaugh and Gray, 1997, Evans et al., 1999).

A market-based transfer pricing system is generally regarded as the most authentic method in transfer pricing. By using market prices, the firms concerned are acting almost as though they were independent companies. It is easier to defend a company's transfer pricing policy and practice on this basis to foreign governments and tax authorities for its reliability as opposed to various forms of arbitrary pricing, which inevitably raise the suspicions and possible investigations of host country authorities (Radebaugh and Gray, 1997, Evans et al., 1999).

However, a market-based system is not always possible. An arm's length market price can be established only if identical goods and services are traded among unrelated entities. One subsidiary may be the only outlet for the sale of goods of a multinational group, there being no buyers outside the multinational company itself. In such a situation, negotiated market/cost pricing between the selling and buying companies might be more appropriate (Radebaugh and Gray, 1997).

The results of previous research indicate a void in existing transfer pricing theory and thus suggest that a contingency theory approach may be appropriate in explaining the differences between management's perceived optimal transfer pricing method and the theoretically prescribed method. To date, the major contingent factors identified by research as affecting the structure of an organisation's management accounting system are (1) the effect of technology; (2) the effect of organisation structure; and (3) the effect of environment (Otley, 1980). According to contingency theory, managers are exposed to stimuli and information from the external environment and from the internal firm/organisation, defined as a field. If managers perceive and interpret their fields differently, then approach to decision making, such as choosing an ITP method, will differ. In other words, managers choose ITP methods

for their companies based on their attention to, and interpretation of, environmental and organisational factors. A variable which one manager perceives as important and uses in the decision-making process to choose a transfer pricing method may be considered unimportant by another (Borkowski, 1992). In order to effectively analyse management behaviour in a particular situation, the variables of potential importance in choosing a transfer price in a firm, therefore, must be identified, and the perception of their importance assessed. These variables will be classified according to two major constructs: external environmental factors and internal organisational factors (Borkowski, 1980, 1990).

6.5 Factors Affecting International Transfer Pricing

Evidence suggests that obtaining a tax advantage is not the primary reason for ITP abuses in some host countries, especially when these particular host countries are developing nations (Chan and Chow, 1997a). Non-tax factors probably play an equally important role. These non-tax factors, along with tax considerations themselves, are generally grouped together as environmental variables in the transfer pricing literature.

Subsidiaries of an MNE family are geographically distant and operate in different jurisdictions and cultural environments. Their overseas operations are subject to the laws and regulations of the host countries. Apart from international tax differentials, many other environmental factors, both natural and government generated, need to be considered in dealing with problems of ITP in the multinational environment (Leitch and Barrett, 1992).

If the assumption is made that a parent company sells an intermediate product to its foreign subsidiaries, an ITP manoeuvre can take place in its simplest form by overpricing (also called overinvoicing or overcharging) or underpricing (also called underinvoicing or undercharging). The environmental factors likely to influence the parent company's pricing behaviour may include, but are not limited to, the following:

6.5.1 Differences in Income Tax Rates

The disparity in tax rates across countries creates an incentive for the members of an MNE to try to minimise tax liability in the home or host countries, but, in turn, to maximise joint profits within the MNE as a whole. For an MNE, this effect can be accomplished by artificially shifting taxable income from affiliates incorporated in high-tax jurisdictions to subsidiaries in low-tax jurisdictions to reduce total worldwide tax payments (Grubert and Mutti, 1991, Ghosh and Crain, 1993, Anthony and Govindarajan, 1998).

6.5.2 Rates of Customs Duties

In industrialised nations, import and export duties serve as protective devices rather than distributive objectives. By contrast, governments of some developing countries still regard import duties as a major source of revenue, and as such are substantially higher than those in developed countries. Tariffs can be reduced by making transfers at an arbitrarily low price. If goods are transferred at low prices, the resulting tariffs they attract will be lower. In this case, there must be some inducement for the parent company to underprice goods by using ITP means to gain fiscal savings at the expense of the host government⁷ (Lecraw, 1985, Belkaoui, 1991, Lin et al., 1993, Chan and Chow, 1997a, Anthony and Govindarajan, 1998).

6.5.3 Currency Fluctuation and Inflation

A country with balance of payments problems may decide to devalue its national currency. Currency devaluation often results in an inflationary environment. The devaluation could substantially reduce corporate profits of foreign subsidiaries if they did not take measures to hedge against the devaluation. Furthermore, inflation in a host country weakens the purchasing power of any return on investment. By setting a high transfer price on goods imported into the host country, the parent company may transfer funds out of this uncertain environment (Plasschaert, 1985, Lin et al., 1993).

6.5.4 Comply with Tax Law and Regulations

Complying with tax law and government regulations play a significant role in formulating multinational transfer prices. A number of legal-related variables such as compliance with tax and custom regulations, anti-dumping and antitrust legislation and financial reporting rules of the host countries are important factors in multinational transfer pricing decisions. Such governmental counter-measures may constrain ITP manipulation behaviour of MNEs and, therefore, force MNEs to use market prices for internal dealings (Wu and Sharp, 1979, Al-Eryani et al., 1990).

6.5.5 Restrictions on Repatriation of Income

Limits imposed on the remittance of profits create a strong inducement for an MNE to use the ITP mechanism. In some less developed countries, notably those that have balance of payment problems, governments introduce a number of regulations or policies to restrict

⁷ Low import duties are often associated with high income tax rates. The savings resulting from underinvoicing for customs purposes may be more than offset by higher income tax liabilities because income taxes are, typically, a larger imposition than tariffs (Plasschaert, 1979).

profit and capital repatriations. When foreign subsidiaries face the difficulties of profit remittance to their home countries, they could plan to circumvent such constraints through the use of ITP. In this case, the parent company artificially raises its transfer prices to the foreign subsidiary to avoid the restrictions on the remittances. In addition, ITP could be used to minimise withholding tax on dividends. By artificially setting high prices for transferred-in goods, cash is funnelled to the parent in the form of the sales price. This leaves less profit in the subsidiary's country, reducing the need to transfer funds to the parent through dividends (Plasschaert, 1985, Belkaoui, 1991, Lin et al., 1993).

6.5.6 Competitive Position of Subsidiary

MNEs enter foreign markets through establishing subsidiaries or branches. Frequently, ITP is used as an instrument to facilitate the penetration of an overseas subsidiary into foreign markets, or to support an infant subsidiary abroad in its competition with local firms. In these cases, the parent company may temporarily underprice to provide support to its subsidiaries in another country where they want to increase market share (Plasschaert, 1979, Belkaoui, 1991).

6.5.7 Overall Profit to MNE

The maximisation of global profit is a major objective for many MNEs. This objective can be partly facilitated through the shifting of income from higher to lower tax jurisdictions to minimise total tax liabilities and thereby maximise after-tax profits. However, while aiming to achieve this objective, MNEs also have to deal with other competing, and sometimes, directly conflicting factors such as governmental regulations, currency fluctuations, foreign exchange control and risks (Wu and Sharp, 1979, Chan and Chow, 1997). Their ability to balance these competing factors in their choice of ITP method is crucial and is likely to determine the level of overall profits that the MNEs is able to achieve.

6.5.8 Import Restrictions

When goods are transferred by a parent company to a subsidiary in a foreign country, the host government may impose anti-dumping charges on a multinational company, to protect its home industries against the dumping of excess production. Dumping is recognised as taking place when goods are sold at a lower price for export than for domestic consumption in the exporting country under comparable conditions of sale. In this case the parent company may overprice to escape charges of anti-dumping practices (Belkaoui, 1991).

6.5.9 Foreign Currency Exchange Controls

In some developing nations, foreign exchange is stringently controlled by governments, local currencies being only semi-convertible. In this situation, an MNE would face problems in converting profits into its own currency. Moreover, when the local currency unit is devalued, exchange losses may rise. MNEs usually view exchange uncertainties as their most pervasive risk in foreign environments. In most cases, they tend to hedge this risk through changes in the timing of the payments, that is, by leading (anticipatory moves) or lagging (delaying techniques). For example, a buyer company may pay a selling company before the due date (leading) and thereby anticipate a fall in the currency of the buyer's country. In this way, an exchange loss may be averted. ITP practices can enhance the exchange-risk-avoiding strategies of leading or lagging. An MNE faced with exchange rate risks can use a higher transfer price to move funds out of countries with weak currencies into countries with strong ones. In this particular case, the perceived exchange loss risk may induce the parent company to transfer profits out of the host country through overpricing (Plasschaert, 1985, Lin et al., 1993).

6.5.10 Good Relations with Host Government

The practice of shifting profits out of host countries by MNEs has attracted considerable attention from governments. Concerned about the potential adverse effects on their economies, tax authorities of host countries have adopted an increasingly aggressive attitude towards the audit of multinational transfer pricing practices, and have placed some economic restrictions on their operations. These actions can impose intense pressures upon MNEs. If disputes with local tax officials arise, they can be costly to foreign subsidiaries. MNEs have realised the importance of maintaining positive relations with host governments. In justifying their ITP methods, some subsidiaries are even willing to sacrifice some profits by ITP in order to satisfy the host governments. Their end purpose is to forestall any government action that may have potential detrimental effects (Plasschaert, 1979).

6.5.11 Pricing Controls of Host Government

In some industries, host governments control prices in relation to the costs and profits of foreign companies, requiring that all price increases be approved by government agencies in advance. High import prices can reduce profits and increase costs, thereby justifying increased prices. In this case, the parent company may allow its subsidiaries to record a low profit by overpricing in order to resist the introduction of price controls (Lecraw, 1985).

6.5.12 Existence of Local Partner

MNEs sometimes conduct business in foreign environments through joint ventures for political, legal or cultural reasons. For example, some host governments in developing countries require that a local firm must be a partner in the business venture of a foreign-based company. MNEs themselves may use the strategy of local presence for bridging cultural gaps and fostering local cultural understanding. In most arrangements of this type, both sides – foreign investors (subsidiaries) and local partners in joint ventures – share the profits, costs and management. This means that a foreign investor has only a part profit share, the rest being distributed to the local partner who has legal rights to a fair share of the profit of the business. To restrict the profits accruing to the partner, and in return, to increase its own interest and benefit, the parent company has a high motivation to shift profits out of the joint venture by ITP (Lecraw, 1985, Lin et al., 1993, Iqbal et al., 1997).

6.5.13 Performance Evaluation

Corporate policies regarding ITP for tax purposes may be in conflict with the performance evaluation of subsidiary managers. For example, arbitrarily shifting profits from a foreign subsidiary through ITP while enhancing overall corporate profitability may affect the measured profitability of that subsidiary and, in turn, distort the performance of the subsidiary's managers. Performance is frequently evaluated on the basis of net income and return on investment. To resolve this conflict, MNEs often separate managerial performance from that of the subsidiary's performance. Another alternative is to set a 'fair' transfer price – an intercompany price that managers can perceive as equity in performance evaluation, based on an externally established market price (Yunker, 1983, Hansen and Mowen, 2000).

6.5.14 Political and Social Pressure

Political and social pressures as determinants appear to be related to some of the aforementioned factors. For example, volatile fluctuations in the value of currencies, high inflation rates, foreign exchange controls, and restrictions on remittances increase financial risks and uncertainty. A lack of political stability increases the political risk for foreign subsidiaries. In some developing countries the threat of expropriation and nationalisation is often a concern for MNEs. All these factors impose political and social pressures on business operations. Consequently, MNEs tend to transfer profits out of the host country to avoid these risks (Plasschaert, 1985, Belkaoui, 1991, Lin et al., 1993). In some countries, labour unions exercise a significant influence. They may impose pressures on subsidiaries to raise wages for local workers in response to high operating earnings of the foreign firms. In order to nullify

claims for higher wages by local labour unions, the parent company may overprice to reduce the profits of its subsidiaries (Belkaoui, 1991). In conclusion, a host country that tries to control or limit the activities of MNEs may be considered an undesirable place for retaining high profits with safety in the long-term. The multinational subsidiaries may use ITP mechanism to send profits abroad (Lall, 1973).

6.5.15 Royalty Restrictions

MNEs are organisations which have one or more subsidiaries operating in foreign markets. Internal prices are often set for the transfer of intangibles – such as research and development costs and intellectual property – from the foreign subsidiaries to their parent companies. Many host governments have imposed some restrictions on the amount of royalty or management fees the local subsidiaries can pay to their parent companies abroad. To avoid governmental royalty restrictions and, in turn, to facilitate the local subsidiary to remit more profits overseas, the parent company may set a high transfer price on goods sold to the subsidiary (Robbins and Stobaugh, 1973).

6.5.16 Maintenance of Cash Flows

An MNE may prefer to accumulate its funds to address the business' current financial needs, to ensure there is sufficient cash reserves to meet financial commitment and thus ensure financial stability. ITP could then be employed as a means of shifting funds into a subsidiary at that location. For example, a local manager may feel pressured to maintain adequate cash flows in the subsidiary. ITP manipulation may be caused by the cash flow requirements of the company (Anthony and Govindarajan, 1998).

Table 6.1 provides a summary of the analysis of the 16 environmental factors as governing multinational transfer pricing decisions. This list of environmental factors is not exhaustive. The concepts of environmental factors (also called variables, determinants), transfer pricing motivations, and transfer pricing objectives are often used interchangeably in the ITP literature (Chan and Chow, 1997a).

The foregoing analysis of the multinational transfer pricing motives adopts the deductive line of reasoning, that is, a parent company would have the incentive to shift profits out of the host country through the overpricing of its exports, if one or more particular condition applies, when all other factors remained the same. These conditions include when:

- the effective tax rate in the host country is higher than in the home country;

- the exchange rates of the two currencies fluctuate frequently;
- the host government imposes restrictions on foreign investors who are repatriating their share of profits to their home country;
- the political and social situation is uncertain in the host country.

An MNE would take advantage of market imperfections by using ITP as expressed in the words of one American MNE manager:

If I cannot get my dividends out, and my royalty rate is fixed, and I want to remit more money, then I do this by an uplift [sic] of my transfer prices on commodities (Robbins and Stobaugh, 1973, p. 91)

At first glance, the foregoing explanation is straightforward and intuitively obvious. And yet the deductive line in assessing multinational transfer pricing practice is debatable in the real world. Actual conditions are seldom as clear-cut as that shown in Table 6.1. ITP objectives are interactive. One motivation may conflict with other inducements during the formulation of multinational transfer pricing policies. Therefore, it is difficult to manipulate transfer prices to achieve all corporate objectives simultaneously. For instance, while overpriced exports reduce the taxes on profits in the importing country (the host country), it may enhance the burden of import duties of the foreign subsidiary. Another dilemma is that arbitrarily taking out profits from the foreign subsidiary for purely tax avoidance purpose may have a distorting effect on subsidiary performance evaluation (Plasschaert, 1979). The pros and cons of any particular level of transfer prices must, therefore, be considered.

The general theoretical analysis of environmental factors affecting ITP is bound to be controversial in actual practice. MNEs are exposed to a wide variety of environmental conditions that affect their international operations. As the environment in the host country of an MNE remains in a state of flux, the transfer pricing objectives and policies must also change to adapt to changing environments in foreign countries, since the changing environments may affect management's perception of the relative importance of various factors of transfer pricing decisions in a foreign country over time (Cunningham, 1978, Tang, 1993, Lin et al., 1993, Borkowski, 1996b, Oyelere et al., 1999). Empirical evidence concerning the number of factors considered in transfer pricing decisions and the relative importance of various factors in national settings are, therefore, of practical significance.

Table 6.1
Environmental Factors and Their Possible Effect on ITP Decisions

Assumption: The parent company sells to the foreign subsidiary

Environmental Factors	Scenarios	Action Taken by Parent Company
Differences in income rates	Host country tax is lower	Underpricing
	Host country tax is higher	Overpricing
Rates of customs duties	High import duties in host country	Underpricing
Currency fluctuation and inflation	Devaluation of the foreign currency	Overpricing
Comply with tax law and regulations		Fair Pricing
Restrictions on repatriation of income		Overpricing
competitive position of subsidiary		Underpricing
Overall profit to MNE	Host country tax is lower	Underpricing
	Host country tax is higher	Overpricing
Import restrictions		Overpricing
Foreign exchange controls		Overpricing
Good relations with host government		Underpricing
Pricing controls of host government		Overpricing
Existence of a local partner		Overpricing
Performance evaluation		Fair Pricing
Political and social pressures		Overpricing
Royalty restrictions		Overpricing
Maintenance of cash flows		Underpricing

Source: Adapted from Plasschaert, 1985, p. 265, Chan and Chow, 1997a, p. 1278.

6.6 Summary

Previous studies have provided some insight into ITP practices. Some studies have reported on ITP methods according to distinct categories such as full cost, variable cost, market, and negotiated, while others have grouped negotiated and market prices together as market-based methods. The finding of Ernst and Young (2001) was that the cost plus and the comparable uncontrolled price dominated the use of arm's length pricing methods by firms for all types of transaction. Although economic theory suggests that the marginal cost pricing and mathematical programming are the most appropriate policies for many ITP situations, they are rarely used in practice (Tang, 1993).

A joint study by the Business international Corporation and Ernst and Young (1991, cited in Borkowski, 1996b) found that "transfer pricing is a complex function of the regulatory environment, organisational structure, corporate strategy, industry type, precedent, and a host of other political and economic factors". This broad view of the transfer pricing issue confirms contingency theory that transfer prices are chosen by MNEs based on the factors that confront their operations rather than on economic or accounting theory (Borkowski, 1980, 1990). Contingency theory posits that MNEs will choose the optimal transfer price for a given situation. In other words, multinational transfer pricing method choices depend on the operating environments they involved (Borkowski, 1992, p. 35).

Part C

Research Design and Measurement

Chapter 7

The Development and Formulation of Testable Hypotheses

7.1 Introduction

This chapter develops hypotheses to test possible differences in the rankings of transfer pricing methods used, and influential environmental variables bearing on ITP among the samples of MNEs operating in the three research settings. To investigate the corporate attributes associated with ITP audits in a multivariate setting, a logit model is also developed in this chapter.

7.2 Hypotheses Development and Formulation

In this study, Dunning's (1980) theory of market imperfections and contingency theory are merged to provide a framework. Dunning's (1980) theory explains why MNEs establish cross-border subsidiaries through FDI. According to Dunning's theory of market imperfections and internalisation, MNEs take a number of considerations into account when determining the degree of their FDI and international operations. These considerations generally include ownership advantages, location advantages and internalisation advantages. MNEs can exploit market imperfections to achieve ownership, location and internalisation advantages. Furthermore, MNEs can manage transfer prices according to perspectives on how best to use various market imperfections. In the ITP literature, the elements of market imperfections are referred to as environmental factors.

MNEs use a large variety of pricing methods to deal with intercompany transfers across international boundaries. Some methods – such as marginal cost, opportunity cost, and mathematical programming models – are theoretically effective but are rarely used in practice (Tang, 1993). The contingency theory approach presumes that firms choose the ITP systems that are perceived as optimal for their particular situation. In other words, each company selects a transfer pricing method that offers the best fit for its needs and circumstances (Borkowski, 1980; 1990). The contingency theory approach offers a theoretical foundation on which to analyse multinational transfer pricing behaviour.

According to contingency theory, “management styles and organisational structures are situation specific for organisational effectiveness and...no one set of universal management principles exists. Hence, different environments for a task situation necessitate different management practices” (Schweikart, 1986, p. 541 cited in Borkowski, 1992, p. 35).

Theoretically, transfer pricing methods used and factors affecting the choice of a transfer pricing method in developing economies should be determined separately from those in developed economies.

New Zealand and Australia, in developing their economies initially from a position heavily influenced by their British colonial history, have adopted the norms and practices of a European and, particularly, British nature. In many respects, these two nations tend to have similar features, which are different from Chinese culture and practices. Both New Zealand and Australia have enacted a free market system. Under this system, intellectual property rights are protected by laws, foreign currency is fully convertible, and the political situation has a relatively predictable, if not certain, quality about it in these two countries, compared to China.

Given the recognised similarities in the New Zealand and Australian political, economic, legal, and cultural systems, and their apparent differences from those of China, they might be expected to determine the level of similarities and variations between MNEs located in these three countries. It is therefore conjectured that multinational transfer pricing practices in New Zealand and Australia should be similar as multinationals in these two countries take similar environmental factors into consideration, differing however from those of their Chinese counterparts. To verify the validity of this conjecture, eight hypotheses are formulated to investigate possible differences in the rankings of ITP methods used and the ratings of environmental factors affecting ITP in the three countries. For research convenience and consistency, all hypotheses are stated in the null form.

Hypothesis 0a:

There are no differences in ITP methods used by multinationals in New Zealand, Australia and China

Hypothesis 0b:

There are no differences in ITP methods used by multinationals in New Zealand and Australia

Hypothesis 0c:

There are no differences in ITP methods used by multinationals in New Zealand and China

Hypothesis 0d:

There are no differences in ITP methods used by multinationals in Australia and China

Hypothesis 0e:

There are no differences in the ratings of environmental factors affecting ITP by multinationals in New Zealand, Australia and China

Hypothesis 0f:

There are no differences in the ratings of environmental factors affecting ITP by multinationals in New Zealand and Australia

Hypothesis 0g:

There are no differences in the ratings of environmental factors affecting ITP by multinationals in New Zealand and China

Hypothesis 0h:

There are no differences in the ratings of environmental factors affecting ITP by multinationals in Australia and China

Previous studies have suggested that certain types of MNEs are more likely to manipulate transfer prices and therefore to be selected for transfer pricing audits by tax authorities. The characteristics of companies include industry (Atkinson and Tyrrall, 1999), nationality (Buckley and Hughes, 2001, Borkowski, 2001), size (Jensen and Meckling, 1976, Chan and Chow, 1997b, Feresca and Nancy, 2000), volume of interfirm transactions (Jacob, 1996), and the types of interfirm transactions (Chan and Chow, 1997b). This study, therefore, was based on the expectation that particular attributes of a company are likely to be associated with ITP audits by the tax authorities.

These corporate attributes were expected to include:

1. The industry of the company. In this study, the industries of companies were re-categorised into two groups. Manufacturing firms formed one category and the remaining companies were combined into another category. The study hypothesised that manufacturing companies are more likely to be audited by tax authorities for their transfer pricing transactions.

2. The nationality of the company. In this study, the nationalities of companies were re-categorised into two groups. The Japanese and Hong Kong-based firms formed one category and the remaining companies the other. Borkowski (2001), and Buckley and Hughes (2001) suggest that Japanese multinationals manipulate transfer pricing to avoid tax in the host countries and, therefore, were frequently audited by these countries' tax authorities. Given Hong Kong's generous tax system and low income tax rate, Hong Kong-based firms may have the incentive to try to minimise tax liability by artificially shifting profits from abroad to Hong Kong through transfer pricing mechanisms. As such, they would be more likely to be audited by tax authorities. Hence, the study hypothesised that Japanese-Hong Kong sourced companies are more likely to be audited by tax authorities for transfer pricing transactions.
3. The size of the company. In this study, the firm's size is measured in terms of total sales/total revenue. The study hypothesised that the large companies are more likely to be audited by tax authorities for transfer pricing transactions.
4. The annual volume of intercompany transactions. In this study, the annual volume of intercompany transactions is measured as the percentage value of intercompany transactions out of total company transactions. The study hypothesised that companies with greater volumes of intercompany transactions are more likely to be audited by tax authorities for transfer pricing transactions.
5. The types of intercompany transactions. In this study, the types of intercompany transactions include the payments arising from the transfer of tangible goods, intangibles, financing and services. The study hypothesised that companies with certain types of intercompany transactions are more likely to be audited by tax authorities for transfer pricing transactions.

Hypothesis 0i is formulated for testing as follows:

Hypothesis 0i:

There is no relationship between ITP tax audits and MNEs' characteristics such as industry, nationality, company size, and the volume and types of intercompany transactions

7.3 Regression Model and Measurement of Variables

To test Hypothesis 0i in a multivariate setting, a logit model is developed as follows:

$$\begin{aligned} \text{ITP AUDIT} = & \beta_0 + \beta_1 \text{INDUSTRY} + \beta_2 \text{NATIONALITY} + \beta_3 \text{SIZE} + \beta_4 \text{VOLUME} + \\ & \beta_5 \text{TANGIBLE} + \beta_6 \text{INTANGIBLE} + \beta_7 \text{FINANCING} + \beta_8 \text{SERVICE} \\ & + \beta_9 \text{HOST} + \varepsilon \end{aligned}$$

Where:

ITP AUDIT = ITP tax audit. The dependent variable assumes the value of 1 if the company has been subjected to an ITP audit and 0 if the company has not been subjected to an ITP audit yet;

INDUSTRY = Industry type. Where a value of 1 is assigned if it is in manufacturing and 0 if it is in another industry;

NATIONALITY = Nationality of companies. Where a value of 1 is assigned if it is Japan or Hong Kong and 0 if it is other countries;

SIZE = Company size. Where a value of 1 is assigned if total sales are less than \$20 m, 2 if \$20 m to \$100 m, 3 if \$101 m to \$200 m, 4 if \$201 m to \$500 m, 5 if \$501 m to \$800 m, and 6 if more than \$800 m;

VOLUME = Volume of intercompany transfers. Where a value of 1 is assigned if the volume of intercompany transfers as a proportion of total company transfers is less than 5%, 2 if 5% to 20%, 3 if 21% to 50%, 4 if 51% to 70%, 5 if 71% to 85%, and 6 if more than 85%;

TANGIBLE = The transfer of tangible goods. Where a value of 1 is assigned if transfer of tangible goods never happened, 2 if rarely, 3 if often, and 4 if always;

INTANGIBLE = The transfer of intangibles. Where a value of 1 is assigned if transfer of intangibles never happened, 2 if rarely, 3 if often, and 4 if always;

- FINANCING = The transfer of financing. Where a value of 1 is assigned if transfer of intangibles never happened, 2 if rarely, 3 if often, and 4 if always;
- SERVICE = The transfer of services. Where a value of 1 is assigned if transfer of intangibles never happened, 2 if rarely, 3 if often, and 4 if always;
- HOST = Control variable for host country. Where a value of 1 is assigned if it is China and 0 if New Zealand or Australia.

As the dependent variable in the equation is binomial, the equation is estimated using logistic regression. To identify which corporate attributes are being associated with ITP tax audits in the multivariate setting, the analysis was conducted in two ways. First, data from the three countries were summed up and were, subsequently, used as input to the initial logit model. To control for the potential effects due to the host countries (New Zealand and Australia and China), a HOST variable is incorporated in the statistical analysis as a control variable. Second, data from each country were used, respectively, as input to a reduced logit model (i.e., ignoring the control variable – HOST) to identify corporate attributes associated with tax audits in each individual country.

7.4 Summary

To investigate possible differences in the rankings of transfer pricing methods used, and environmental variables of ITP among the samples of MNEs operating in the three research settings, this research has developed eight hypotheses. The literature suggests that a number of variables may lead to the potential risk of tax audits. A logit model is built with the ninth hypothesis developed which will be tested for support.

Chapter 8

Data Collection and Sampling Methods

8.1 Introduction

The results of this study are presented in this thesis using three approaches:

1. the results of a questionnaire mailed to subsidiaries of MNEs that operate in New Zealand, Australia and China;
2. the findings of interviews with four Chinese tax authorities; and
3. survey results from canvassed 38 Chinese tax authorities.

This chapter describes both the quantitative and qualitative approaches used in this study, discussing their corresponding strengths and weaknesses and, why and how they were employed. This chapter also states how the data were collected and analysed.

8.2 Study Design

In contemplating how to collect the data required for a study of ITP involving New Zealand, Australia and China, a variety of possibilities were considered. The great distances, the disparate languages and the costs that are characteristic of such an undertaking created potential difficulties and affected the eventual choice of research methods from the panoply of methods potentially available. These consist of various instruments such as self-administered questionnaire surveys, personal or telephone interviews, field studies and analysis of archival information. There is no one best data collection approach. Each has its strengths and weaknesses but must be subjected to a consideration of its suitability as a method of data collection, depending on the research objectives and the physical factors involved (Czaja and Blair, 1996).

The primary information about company characteristics, environmental variables and ITP methods used by companies were obtained by means of a questionnaire. Chapter 6 has examined the various environmental variables that are theoretically likely to determine the transfer pricing behaviour of MNEs. Based on previous research and an analysis of business environments in the three countries, seventeen environmental variables were selected in designing the data collection questionnaire.

As part of the development of a questionnaire that would prove effective for the purposes of the research, a review of existing literature on the subject of ITP was first carried out, with particular attention being paid to various management and tax issues relating to MNEs, such

as issues concerning the administration of an ITP system, ITP method choices, and environmental variables affecting ITP.

Another information source for the research was archival data. This included finding transfer pricing regulations, guidelines or policies issued by government agencies in the three countries.

The primary data were gathered by two methods – direct from the subsidiary companies of multinationals in the three countries by questionnaire, from personal contact and in-depth interviews with Chinese tax officials.

8.2.1 The Questionnaire Survey

8.2.1.1 Choice of Research Instrument and Approach

The choice of an appropriate research method (i.e., self-administered questionnaire survey, personal or telephone interviews, field studies and analysis of archival information) depends on three conditions: (1) the type of the research questions; (2) the control an investigator has over actual behaviour events; and (3) the focus on contemporary as opposed to historical phenomena (Yin, 1992, p.1). One major objective of this study is to investigate environmental differences and their impact on multinational transfer pricing decisions in the three countries. To provide an explanation regarding environmental factors influencing a transfer pricing method choice, a number of alternative research strategies and techniques had been carefully considered before a questionnaire survey approach was chosen.

Certain approaches, such as archival and analytic research, were dismissed because they are inappropriate to the research objective of explaining multinational transfer pricing choice, which focuses on contemporary phenomena. While a case study via personal interviews would provide in-depth details on the environmental variables, conclusions drawn from case study findings of a limited number of firms, would not allow for the extension of any findings to other firms not participating in the study. Hence, a case study approach is likely to lack external validity on its own. Given the multi-location nature of this study, field studies were also considered inappropriate from a cost and practicality perspectives. Generalising findings beyond participating firms is always a major problem when case and field studies approaches are used for studies of this nature (Yin, 1992; Cooper and Schindler, 1998).

Drury (1997, p. 103) states that “surveys [of management accounting practice] provided a useful overview of current practices.” Compared with other approaches, the obvious advantages of the mailing questionnaire survey include:

1. it is the least expensive of the survey methods;
2. they have been successful in the collection of data about sensitive topic;
3. they encourage respondents to consult records rather than to answer from memory; and
4. a mail survey is more likely to include the population of interest. Depending on the nature of the survey instrument, data from mail surveys can be used for statistical analysis, and results from sample findings can be generalised to a population (Czaja and Blair, 1996).

Given these distinct advantages of the mailing survey approach, the reason for adopting the survey instrument (questionnaire) as the primary strategy to obtain data in this particular research can be explained as follows:

First, mailing can enable the researcher to contact the financial controllers (i.e., the respondents) of each organisation who might otherwise be inaccessible in other ways. Second, foreign subsidiaries are geographically dispersed in the three research settings – New Zealand, Australia and China. Compared with other ways such as personal interviews, questionnaire surveys enable the sampling of a large population at lower cost. Third, this research required, in part, the “views, judgements or appraisals of other persons with respect to a research problem” (Buckley and Casson, 1976, p. 23). Since opinion research has the ability to “capture people’s impressions about themselves, their environments, and their response to changing conditions” (Buckley and Casson, 1976, p. 23), the self-administered survey was highly appropriate to this research. Finally, data collected by a questionnaire survey can be analysed using rigorous statistical techniques to draw inferences on the extent of environmental factors affecting transfer pricing (Tang, 1993).

Notwithstanding these obvious advantages, a survey instrument (questionnaire) does have limitations. The disadvantages of the questionnaire survey instrument are:

1. Low response rate. Response bias is potentially greater in mail surveys than with other methods because respondents can more easily ignore mail questionnaires than a polite, but persistent, interviewer. Response bias occurs when one subgroup is more or less likely to cooperate than another. (Czaja and Blair, 1996).
2. No assurance that questions were understood. A mail questionnaire must be

completely self-explanatory because the investigator is not present and cannot assist the respondent if something is confusing or complex. For this reason, the questionnaire cannot be very long, nor can it look complex or difficult to complete (Czaja and Blair, 1996).

3. No assurance that the addressee was the respondent (Czaja and Blair, 1996).

The typical disadvantage of the low response rate, along with the potential of response bias inherent in mail survey were carefully considered by the researcher and were addressed through various well-established techniques, including postage-paid self-addressed return envelopes, a short questionnaire, follow-up reminders, and non-response bias tests.

8.2.1.2 Justifying the Selection of the Respondent Companies for Questionnaire Survey

This is concerned with the impact of environmental factors according to a company's geographic area of operation, not the location of the firm's headquarters or home country. This approach to a study of ITP is based on the notion that MNEs generally adapt their foreign operations to local cultural environments rather than the firm's home country environment. Hence, the target research units of study for this thesis are foreign-owned subsidiaries operating in New Zealand, Australia and China.

Previous studies of ITP practices have predominantly focused on the headquarters – the parent companies of MNEs. The rationale for their selection is based upon the notion that managers of the subsidiaries do not have freedom to take independent decision, and as a consequence, corporate policies, in general, and transfer pricing policies, in particular, are frequently set by the headquarters of the parent companies located in the home countries. Hence, the reasoning has prevailed that data about corporate transfer pricing practices should be taken directly from the headquarters of the parent unit (Yunker, 1983; Hansen and Mowen, 2000). However, it can be argued that corporate headquarters may not have all the facts about their foreign subsidiaries and that the information which they do have may be inaccurate, while managers of their subsidiaries may have different or more realistic perspectives of what business operations are intended to achieve and how they might be affected by the environmental factors prevailing in a host country (Arpan, 1972).

As their overseas operations expand, large MNEs often become highly decentralised. A highly decentralised structure forces decision-making down to the local managers on the basis that they have more accurate information than their parent companies about the external

environments relevant to the local daily operations and management of their companies (Chan and Chow, 1998). For example, phillips, the global electronics company with its headquarters in the Netherlands, delegates marketing and pricing decisions for its television business in the Indian and Singaporean markets to its local managers (Horngren et al., 1999). Members of senior management are obliged to use divisional reports to make policy decisions. In the establishment of corporate policies, such as transfer pricing policies, a parent company often relies heavily on the information that is, typically, supplied, and periodically reported, by the subsidiary firms that are located in the local markets of their host countries.

Most importantly, an effective host country corporate policy should provide for timely responses to local economic conditions and changes in the political climate. Foreign managers of subsidiaries have keener perceptions and specialised knowledge of local environments than higher-level management. They are more familiar with the local political, economic and, cultural environment (Hansen and Mowen, 2000). In conclusion, while investigations carried out on the headquarters of parent units in their home countries are valid in reflecting the impact of home country environmental variables on ITP policies, they fail to address the foreign host country environmental aspects of ITP, which should be registered by the subsidiaries located in overseas countries. Therefore, the study focuses on subsidiaries located in three host countries in the Asia-Pacific region – New Zealand, Australia and China.

8.2.2 Developing the Questionnaire

The questionnaire was divided into three sections as follows:

- 1) Section one: General information on the company and its related party transactions.
- 2) Section two: ITP methods used.
- 3) Section three: Environmental variables affecting ITP.

The contents of sections two and three took account of and adopted or adapted items from previous studies, such as Al-Eryani et al. (1990), Tang (1993), Borkowski (1997a, 1997b) and Chan and Chow (1998). The survey used closed structured questions in most cases. A five-point Likert-like scale was used by the responding firms to rate the importance of each environmental variable. Copies of the questionnaires are presented in Appendices.

Section one of the questionnaire was designed to collect general information on the company and related party transactions – its type of industry, nationality, size, and the volume, nature and frequency of intercompany international transfers, ITP auditing, and company status regarding APAs⁸. These are detailed as follows:

Industry Classification The first question in the survey sought to establish the industry type of the respondent companies. The analysis later in this study will examine whether certain types of industry are more prone to investigation by host country tax authorities than others. The industry classes were based on the Australian and New Zealand Standard Industrial Classification (ANZSIC) codes with minor modification. There were initially 10 categories corresponding to the ANZSIC codes, with the respondents fitting into eight of the categories. The industry information of Chinese firms was obtained from archival sources.

Nationality of Companies The second question sought to establish the nationality of the respondent companies. The analysis later in this study will examine whether certain companies are investigated more thoroughly by the host country tax authorities, on account of the nationality of their foreign parent companies, than others. For the New Zealand sample, information about nationality of companies was collected by asking where their ultimate parent companies were located. The same information was obtained from archival sources in the cases of the Australian and Chinese firms.

Company Size The third question asked about the size of the respondent companies. The analysis in later chapters will examine whether larger companies tend to be subject to more attention by the tax authorities of host countries than smaller companies. The firm's size is measured in terms of total sales/total revenue. Information on the size of Australian and Chinese companies was obtained from archival data.

Types of Transaction The fourth question addressed the nature and frequency of intercompany international transfers, which generally can involve up to four types of transaction. These are the payments arising from the transfer of tangible goods, intangibles, financing and services.

⁸ An APA is a negotiated agreement between tax authorities and the taxpayer. It establishes a transfer pricing method to be applied to the allocation of income among associated units of an enterprise in advance of a transaction. One way for an MNE to reduce exposure to transfer pricing investigations is to establish an APA with tax authorities.

The respondents were asked to rank the frequency of the four types of intercompany transfers of their companies on a Likert-like scale, assessed as being either 'always', 'often', 'sometimes', 'rarely', or 'never'. The analysis in a later chapter will examine whether certain types of intercompany transfers will attract more attention by the tax authorities in host countries than others.

The Volume of Intercompany Transactions The fifth question asked the respondents to estimate the percentage value of intercompany transfers - the transfers of tangible goods, intangibles, financing and services involved in either New Zealand, Australia or China, as the case might be – out of total sales transactions for the entire company in 2002 (i.e., a company's worldwide transactions together with related or unrelated parties). The analysis in a later chapter will examine whether companies with greater volumes of intercompany transactions will be subject to greater attention by host country tax authorities than those with low volumes.

International Transfer Pricing Tax Auditing The sixth question asked whether or not the respondent firms have been the subject of an ITP audit since 1998. The data gathered for this variable will be used to examine the relationship between a firm's tax auditing status and its type of industry, country of origin, and the volume, nature and frequency of intercompany transfers.

Advance Pricing Agreements The seventh question therefore asked the respondents to indicate their status regarding APAs with local tax authorities. The data obtained for this variable will be used to examine the extent of use of APAs by MNEs in the three countries.

International Transfer Pricing Methods Used Section two of the questionnaire dealt with ITP methods used by the respondent firms. This section contained two questions, numbers eight and nine. Question eight asked for the actual ITP methods used by the respondents from the point of view of managerial preference, while question nine related to the use of the legally oriented transfer pricing methods.

Environmental Variables of International Transfer Pricing Section three of the questionnaire contained the final question which focused on the 17 environmental variables that could be held to influence the ITP method choices of MNEs. Most of the environmental variables listed in the questionnaire were identified and selected from extant literature, as

reviewed in chapter 6. A few modifications to the wording of some of the variables were made as follows:

1. This research differentiated from previous studies by focusing on ITP practices of foreign subsidiaries in three Asia-Pacific countries. The maximisation of global profit of a multinational group is the major objective of MNEs. This objective may conflict with that of the corporate profit of the subsidiary and performance evaluation of subsidiary managers. The initial variable – ‘overall profit to MNE’ – indicated in chapter 6, was therefore replaced by two variables, ‘overall profit to multinational group’ and ‘corporate profit of the subsidiary’, in this study.
2. At the time of the research, the price level in the three Asia-Pacific countries was stable, and their inflation was low. For this reason, the initial variable – ‘currency fluctuation and inflation’ - indicated in chapter 6, was not regarded as a major issue in transfer pricing in the research setting and, therefore, this variable was ignored in this study.
3. The variable – ‘tax authority transfer pricing audits’ which previously had not been used, except by Borkowski (1997a, 1997b, 2001), was included in the questionnaire to test whether or not tax auditing is an important factor affecting multinational transfer pricing decisions. The 17 environmental variables used are shown, with their origins, in Table 8.1.

The development of the questionnaire consisted of drafting, pretesting and pilot testing it. In its draft form, containing previously identified ITP methods and environmental variables, it was checked by a manager and a Chinese member of staff of a New Zealand Company with long experience in both New Zealand and Chinese markets⁹. Contacts were also made with one tax consultant of the Institute of Chartered Accountants of New Zealand, two staff members of an international firm of consultant accountants located in the U.S. and New Zealand, and two staff members of international professional services firms located in New Zealand and the U.K. Their comments and suggestions were incorporated into a revised questionnaire for a pilot test. Finally, the survey was approved both the Lincoln University Human Ethics Committee and the thesis supervisors prior to distribution.

⁹ I wish to thank Dr. Alan Paisey for helping me to gain access to the site.

Table 8.1**Environmental Variables Used in the Questionnaire and Their Sources**

Variables	Reference
VAR 01 Differences in income tax rates	Tang and Chan (1979), Tang (1982), Al-Eryani et al. (1990), Tang (1993), Borkowski (1997a), Chan and Chow (1998)
VAR 02 Rates of customs duties	Tang (1981), Tang (1982), Rushinek and Rushinek (1988), Tang (1993), Chan and Chow (1998)
VAR 03 Tax authority transfer pricing audits	Borkowski (1997a, 1997b, 2001)
VAR 04 Comply with tax law and regulations	Wu and Sharp (1979), Rushinek and Rushinek (1988), Al-Eryani et al (1990), Chan and Chow (1998)
VAR 05 Restrictions on repatriation of income	Tang and Chan (1979), Al-Eryani et al (1990), Tang (1993), Borkowski (1997a), Chan and Chow (1998), Oyelere et al (1999)
VAR 06 Competitive position of the subsidiary	Tang and Chan (1979), Tang (1981), Tang (1982), Tang (1993), Chan and Chow (1998)
VAR 07 Overall profit to multinational group	Tang and Chan (1979), Wu and Sharp (1979), Tang (1982), Yunker (1983), Al-Eryani et al (1990), Tang (1993)
VAR 08 Corporate profit of the subsidiary	Oyelere et al (1999)
VAR 09 Import restrictions	Tang and Chan (1979), Tang (1982), Rushinek and Rushinek (1988)
VAR 10 Foreign currency exchange controls	Al-Eryani et al (1990), Chan and Chow (1998)
VAR 11 Good relations with host government	Tang (1982), Rushinek and Rushinek (1988), Chan and Chow (1998)
VAR 12 Price controls of host government	Al-Eryani et al (1990), Chan and Chow (1998)
VAR 13 Existence of local partner	Tang and Chan (1979), Tang (1982), Rushinek and Rushinek (1988), Chan and Chow (1998)
VAR 14 Performance evaluation	Tang and Chan (1979), Tang (1982), Yunker (1983), Rushinek and Rushinek (1988), Chan and Chow (1998), Oyelere et al (1999)
VAR 15 Political and social pressure	Al-Eryani et al (1990), Chan and Chow (1998)
VAR 16 Royalty restrictions	Tang (1982), Rushinek and Rushinek (1988), Chan and Chow (1998)
VAR 17 Maintenance of cashflows	Tang (1982), Oyelere et al (1999)

The questionnaire was pilot tested in late 2002 by 30 financial controllers of subsidiaries located in New Zealand and Australia, and 70 financial controllers of subsidiaries located in China. Based upon their responses, some modifications were made to the original questionnaire.

International research frequently requires translation of survey instruments into a foreign language to ensure that recipients get an accurate understanding of the contents. To ensure that the final contents and the terminology of the questionnaire were appropriate for the Chinese context, it was important to invite a Chinese financial controller to evaluate the newly revised questionnaire. Contact for this purpose was made with such a person in a multinational company in Beijing. The controller made some constructive additional suggestions to improve the questionnaire's applicability in China. Both the questionnaire and the letter of request to be used in China were checked by this financial controller in the Chinese language. Although the Chinese version of the questionnaire was essentially identical to that used in New Zealand and Australia, some non-substantive variations were necessary to eliminate cultural, institutional, and language differences.

8.3 Sample Selection Method

The sampling frame for the research of ITP in Chinese companies was the list of the foreign-controlled subsidiaries in China as contained in the publication *Foreign Investment Companies Operating in China* (GuangDong World Publishing, 2001) – a directory listing 22,000 MNEs located in China, together with another directory entitled *The World Top 500 Multinational Companies Operating in China* (People's Publisher of ShangDong, 2003). In addition to the sample assembled from these two directories, additional 50 firms were randomly selected from a network of 1,000 multinationals located in Beijing, as listed by a consultancy firm in that city. The final Chinese sample, therefore, contained 500 companies¹⁰.

¹⁰ In recognition of China's entrenched cultural disposition for secrecy and reluctance to communicate information about a firm's activities to outsiders, it was anticipated at the start of the research that eliciting any responses from Chinese respondents would be difficult when compared with the approaches made to Australian and New Zealand firms. Hence, it was necessary to despatch an inordinate number of questionnaires in the hope of receiving enough returns to fulfil the research objectives.

For the survey of New Zealand and Australian practices, a total of 300 New Zealand and 250 Australian subsidiaries of foreign multinationals were randomly drawn from *Dun and Bradstreet's Business Who's Who* (2001, 2002, and 2003). To ensure the accuracy of the addresses of the intended respondents, the data from the directories were carefully cross checked on the Internet database. The website addresses used were: <http://www.yellowpages.co.nz> and <http://www.yellowpages.com.au> for New Zealand and Australian respondents, respectively.

8.4 Data Collection

8.4.1 Administration of the Surveys

A number of limitations are associated with survey-based research. They include sample bias, position bias, and respondent subjectivity. Nonetheless, one major weakness of a survey study is possible nonresponse error (Cooper and Schindler, 1998). To improve mail response, Cooper and Schindler (1998) suggested the following ten concurrent techniques, a variation of which was used in this research: (1) reduce questionnaire length; (2) survey sponsorship; (3) return envelopes; (4) postage; (5) personalisation; (6) cover letters; (7) anonymity; (8) size, reproduction and colour; (9) incentives; and (10) deadline dates.

Cooper and Schindler (1998, p. 306) state that “short questionnaires should obtain higher response rates than longer questionnaires”. This survey questionnaire was designed to a short questionnaire while still enabling all relevant information to be collected. Cooper and Schindler (1998) also suggest that an “official” or “respected” sponsorship increases response rates. In the enclosed cover letter of the questionnaire survey, the present investigation made reference to the Institute of Chartered Accountants of New Zealand (ICANZ) that provided scholarship for this research.

Cooper and Schindler (1998) note that the inclusion of a stamped, return envelope encourages response. In this survey, self-addressed postage-paid envelopes were provided.

Personalisation of the mailing has no distinct advantage in terms of improved response rates (Cooper and Schindler, 1998). Since the names of individuals were not available, the surveys were addressed, commonly, to the financial controller in each company, who is most likely to be directly involved with ITP policy and administration (Borkowski, 1990).

Although “the influence of the cover letter on response rates has received almost no

experimental attention”, Cooper and Schindler (1998, p. 306) believe that “it is the most logical vehicle for persuading individuals to respond”. The surveys had a covering letter, which stressed the importance of the study, the confidentiality of the responses provided by each company, the support of the ICANZ, and when to return the questionnaire. Copies of the cover letters are shown in the Appendices.

Experimental evidence shows that the promise of anonymity, questionnaire size, method of reproduction and colour have no significant effect on response rates (Cooper and Schindler, 1998). The survey design allowed the completed questionnaire to be anonymously returned to the present investigator from New Zealand respondents - even the present investigator could not know who completed a particular questionnaire. Confidentiality was promised to the Chinese and Australian respondents while an ID number was fixed on the returned envelopes of these companies for the purpose of collecting archival data on each respondent firm.

Cooper and Schindler (1998, p. 306) believe that “a monetary incentive sent with the questionnaire is very effective in increasing response rates”. Surveys of professionals might need to include a larger amount (Rodeghier, 1996). Given the limitation of the research budget and the position of the potential respondents (i.e., financial controllers), the surveys did not offer any monetary incentives, rather, a nonmonetary incentive – providing a copy of the summary results from the survey (if requested) – was offered (Rodeghier, 1996).

Cooper and Schindler (1998) note that deadline dates do not increase response rates, but they do serve to accelerate the rate of questionnaire return (Cooper and Schindler, 1998). In view of this, deadline dates were provided at every stage of the survey process.

Cooper and Schindler (1998) also stress the importance of follow-ups to improve response rates. Two follow-ups were made to New Zealand and Australian respondents, while for the Chinese respondents a third follow-up was considered necessary.

8.4.2 Questionnaire Distribution and Response Rates

The final version of the questionnaire was sent by post with its explanatory letter, addressed to the financial controllers of 300 subsidiaries operating in New Zealand, 250 subsidiaries operating in Australia and 500 subsidiaries operating in China. The sample was reduced to 274 New Zealand firms, 216 Australian firms and 435 Chinese firms, respectively, by the 125 envelopes that were returned unopened as a result of incorrect addresses or changes of

personal employment without forwarding addresses. To secure a viable number of returns, it was necessary to send two follow-up letters to New Zealand and Australian companies and three to Chinese firms. The last two follow-ups to Chinese firms are combined into one in the analysis of these survey data as presented in Table 8.2, Panel A.

The first follow-up was sent three or four weeks after the initial mailout. It consisted of a short cover letter, a copy of the questionnaire, and a return stamped envelope. The response rates, which resulted from the first follow-up, are shown in Panel B of Table 8.2. The second follow-up was sent three weeks after the first follow-up. It included a copy of the questionnaire, a return stamped envelope, and a non-response sheet to be completed by the respondents if they do not intend to respond. The latter requested for the reasons why the recipients do not want to complete the questionnaire. As a result of the second follow-up, additional completed questionnaires were received. The response rates from the second follow-up are shown in Panel C of Table 8.2.

The overall response rates for the survey are shown in Panel D of Table 8.2. The overall response rates for the New Zealand and Australian respondents are 52.55 percent and 41.20 percent, respectively. These response rates are reasonably good, considering the highly sensitive nature of the information requested in the survey. The overall response rates for Chinese companies (20 percent) are relatively lower than those for New Zealand and Australian companies. The possible reason for the lower response rates from China may be explained as follows. First, in Chinese society, which has a culture of conservatism and secrecy over matters concerning the holding, retention and disclosure of information, people are afraid to disclose corporate data to third parties. Western society has grown used to surveys but Chinese people are far from being accustomed to such practices. Second, Chinese businesses are traditionally secretive about their finances. The topic of ITP is not only extremely sensitive but very secretive. The data on ITP are related to the commercial information of companies. Many Chinese companies may prohibit their employees from disclosing any sensitive information to an outside party. Third, the first mailing was sent out at the time that year-end financial reports were being prepared. It was close to the Chinese New Year festivities. Some Chinese financial controllers may have been too busy to reply. Fourth, and most importantly, the lower response rate of Chinese companies may have been significantly influenced by the recent investigations by Chinese tax authorities and customs houses into the ITP practices of MNEs. There has been a national campaign against tax evasion.

Table 8.2
Questionnaire Response Rates from the Mailings

Panel A: First Mailing	Survey mailed	Total responses	% of sample	Unusable responses¹¹	% of sample	Usable responses	% of sample	Non-response sheet
New Zealand	274	42	15.33	2	0.73	40	14.60	---
Australia	216	29	13.43	1	0.46	28	12.96	---
China	435	27	6.21	7	1.61	20	4.60	---
Subtotal	925	98	10.59	10	1.08	88	9.51	---
Panel B: Second Mailing								
New Zealand	274	23	8.39	2	0.73	21	7.67	---
Australia	216	23	10.65	1	0.46	22	10.19	---
China	435	22	5.06	5	1.15	17	3.91	---
Subtotal	925	68	7.35	8	0.86	60	6.49	
Panel C: Third Mailing								
New Zealand	274	77	28.10	0	0	14	5.11	63
Australia	216	37	17.13	0	0	10	4.63	27
China	435	38	8.74	0	0	10	2.30	28
Subtotal	925	152	16.43	0	0	34	3.68	118
Panel D: Overall Response Rates								
New Zealand	274	144	52.55	4	1.46	77	28.10	63
Australia	216	89	41.20	2	0.93	60	27.77	27
China	435	87	20.00	12	2.76	47	10.81	28
Total	925	320	34.59	18	1.95	184	19.89	118

¹¹ Either partially completed or not completed.

The SAT has tightened regulations seeking to prevent foreign investment enterprises (FIEs) from escaping taxes by passing liabilities between related business units. Shortly before this study was undertaken, the Chinese tax authorities and customs offices were investigating tax avoidance through multinational transfer pricing abuses and alleged dumping violations by intercompany underpricing transfers.

Though the response rate from China is lower than desired, the number of usable responses, however, is still large enough for an analysis of Chinese ITP practices. Moreover, when early respondents were compared to late respondents no significant differences were found between the early and late respondents.

Previous studies had experienced differing return rates for mailed questionnaire, which range from 14 percent to 56 percent. Yunker's (1993, p. 56) study had a low response rate of 14.5 percent (i.e., 52 firms responding from the sample of 358). She justified the low response rate by argues that "while a higher response rate would certainly have been desirable, the fact is that response rates below that achieved in this project are often observed in published research. Moreover, the sample size in absolute number is quite substantial... (and) is sufficiently large for purpose of statistical inference". Similar argument can be made for the current study.

All in all, the overall usable response rate for the three countries combined is 19.89 percent (28.10 percent of New Zealand respondents, 27.77 percent of Australian respondents, and 10.81 percent of Chinese respondents). The combined overall rate is not as would have been desirable yet it is comparable to prior studies. Divulging information on corporate internal pricing policies is an extremely sensitive issue that most companies will like to avoid, especially multinational firms, which is also compounded in the case of China due to cultural factors.

The sensitivity of internal pricing information has been heightened by national government agencies and the growing concerns and interests in the subject matter by groups inside and outside a firm, namely, stockholders, investors, competitors, local partners, and pressure groups. Corporate managers are not inclined to share information about their pricing policy with outsiders. It could not be expected, therefore, that firms would welcome and freely respond to an outsider's request of such information. However, a satisfactory number of respondents eventually cooperated with the present investigator because of the importance of

ITP, their expectation of the results of the research, and the pledge of confidentiality.

One hundred and twenty-four respondents to the survey declined to participate in the study. Majority of these respondents (52) said that they do not engage in international transfers or that the volume of their international transfers is insignificant. Other reasons cited for declining participation in the study include company policy (25), time constraint (22), and confidentiality issues (16).

8.4.3 Non-Response Bias

A *chi-square test* of homogeneity was carried out as a test for non-response bias on the rate of return data of the New Zealand, Australian and Chinese respondents. This test seeks to ascertain whether or not there are significant differences between early and later respondents in each country on the basis of type of industry and the ITP methods used. Early responses in each country were compared with late responses of the same country on those bases. Early respondents are those who responded to the first wave of questionnaire mail outs, while those who responded to the second and third waves of mail outs are proxies for late respondents (Wallace and Mellor, 1988). The results of the test are shown in Table 8.3.

Table 8.3
A *Chi-Square Test* on the Questionnaire Non-Response Rate

	New Zealand			Australia			China		
Basis	<i>Chi-square</i>	Df	Significance	<i>Chi-square</i>	Df	Significance	<i>Chi-square</i>	Df	Significance
Industry	5.686	7	0.577	7.586	7	0.371	4.293	3	0.232
Methods	0.251	1	0.616	0.361	1	0.545	1.349	1	0.246

Df: Degree of freedom.

The test results shown in Table 8.3 indicate that there were no significant differences between early and late respondents in each country. These results diminish the possibility of the presence of significant non-response bias.

8.5 The Qualitative Evidence

In this study, there are four research objectives. While a questionnaire survey was designed to address the first three objectives, an interview method was considered the appropriate technique to address the final research objective, that is, to investigate the ITP monitoring

system in China.

Previous literature argues that developing countries are more vulnerable to transfer pricing manipulations than developed countries. This could be due to the fact that developing countries generally lack institutional frameworks, information, expertise, and staff to tackle the ITP issue (Brean, 1979, Lall, 1979, Plasschaet, 1985, Rahman and Scapens, 1986). While the *a priori* proposition is, perhaps, self-evident, it is not necessarily true and even if available cannot be statistically tested. Hence, the use of a survey instrument (questionnaire) was considered inappropriate. China is a latecomer to the ITP arena. Compared to transfer pricing auditing systems of developed economies, it is considered rudimentary in China. The investigation of the ITP audit practices in China – the world's largest developing country – through interview the Chinese tax officials would provide enhanced evidence to support this proposition, or may lead to reconsideration and modification of this argument. This further justifies the selection of the interview approach. To obtain the data needed for this part of the research, in-depth personal interviews with officials of the four state tax authorities in China were undertaken. They took place in two contrasting city venues – one, a major coastal city, the other, a medium-sized inland provincial capital in a different part of China.

The first of these cities is a popular destination for foreign investment and has a municipal state tax authority with a sound tax auditing system to prevent its tax base being eroded. In the second city foreign investments are much less in evidence. The tax authorities in inland China, in general, and in this city, in particular, are relatively ineffective. These two cities may be considered as representing the developed and developing parts of China. Data about tax authority transfer pricing auditing from these two areas may be taken as representing the range of practices of ITP auditing in China.

8.5.1 Gaining Access to the Inland City State Tax Bureaux

When endeavouring to undertake personal interviews, one must obtaining commitment from the organisation to participate in the study over a period of time. Under the habitual practices of Chinese culture it is difficult for an outsider to be allowed to interview someone directly who holds any office in government. Furthermore, since the data on ITP auditing issues are related to the commercial information of companies, and tax officers are prohibited by law from disclosing any sensitive information obtained from audited companies to a third party.

But even if China has opened its doors to the outside world, most Chinese people – especially

government officers – remain sceptical regarding the intentions of foreigners, including overseas Chinese, who are collecting data from China. Zhu (1997) found that the most typical concern of Chinese respondents is that of disclosure of their views owing to past political purges when people had suffered as a result of revealing their views.

For the above reasons, it would normally be almost impossible to have direct access to any tax officer in China. This applies literally in the physical sense as well as at the interpersonal level. On one occasion an attempt was made to enter the inland city tax authority's building. The guard on duty denied entry, and remained adamant in spite of all the explanations put to him. To achieve the goal of obtaining personal interviews, it seemed that the only way was to find an intermediary to facilitate access to the Chinese tax authorities.

In the inland city, a tax officer of the city tax authority was contacted privately, in order to explain the nature and specific objectives of the academic research involved. Once these matters were understood, this officer agreed to a visit to her office by the researcher with a view to being able to speak with other officers who were working in the field of ITP auditing.

An introduction to the chief tax officer of the inland city tax authority followed. This officer supplied a general overview of the province's ITP auditing policy and practice. Another tax officer who was responsible for auditing ITP cases, provided detailed information about auditing practice and the current concerns the authorities had about it. In response to careful questioning, this officer answered such questions as to how effectively the inland city transfer pricing auditing system worked and how the inland city tax authority administered transfer pricing tax audits. Another tax officer could not be personally contacted but agreed to respond to a written version of the interview questionnaire – a contract that was duly fulfilled.

8.5.2 Gaining Access to the Major Coastal City State Tax Bureaux

In the major coastal city, the assistance of a person, who happened to know three tax officers at a district tax authority, was solicited. On being acquainted with the purpose of the research, the person invited the tax officers for the interview. The researcher started by introducing the purpose of the survey, authenticating his claims with proof of his status and commitment as a PhD student, and offering a description of his study areas. Then the researcher explained the nature of the academic research in detail and guaranteed the confidentiality of the information the interviewee would disclose. These efforts alleviated concerns about the potential misuse of survey data. Each interviewee answered questions one by one in terms of the unstructured

interview questions. When their answers raised a further question, the researcher asked the interviewees to clarify their answers more fully. The interview was carried out in a friendly manner and the researcher was careful not to influence the interviewees' responses by giving the researcher's own opinions or by prompting.

Richardson, Dohrenwend and Klein (1965) noted that the use of a tape recorder to record interviews could influence respondents' answers so, to hold these interviews in an unrestrained and open way, it was decided not to use tape recordings in China. It took one and a half hours to finish the interview with these three tax officers.

Another tax officer, as a specialist of many years experience in the ITP tax auditing field, was also interviewed. With an explanation of the purpose of the study and a guarantee that all the data supplied would only be used for research, the interviewee answered all the questions in detail about ITP auditing issues.

8.5.3 Collecting and Assessing the Evidence

The interviews were recorded in note form in Chinese and were later transcribed into English form to facilitate an analysis of the data. During this portion of the investigation, intensive inquiries were made into the following four main questions.

- 1) What is the present extent of transfer pricing abuse in China?
- 2) How do the Chinese tax authorities administer a transfer pricing tax audit?
- 7) How adequate are the existing Chinese ITP control measures?
- 8) What factors constrain the ITP monitoring system in China?
- 9) How can the Chinese ITP monitoring system be improved?

As a questionnaire survey or structured interview is narrow in scope and content, this part of the investigation was designed as semi-structured interviews that would enable complex information to be collected. All interviews were conducted in an informal way, so that advantage could be taken of new areas that were uncovered as the interviews progressed. A common concern about qualitative method is that they provide little basis for scientific generalisation (Yin, 1992, p.10). To overcome this flaw and to permit the generalisation of the main findings from these interviews, a survey was initiated, based on part of the findings from these interviews, together with items from an archival analysis. They were edited into a short semi-structured questionnaire and sent to 80 Chinese tax authorities covering most of the

provincial and main city jurisdictions in China, supported by a letter of explanation about the research, and with a promise of research findings feed-back.

Twenty-four questionnaires were returned after the first mailing. Four weeks later, a follow-up letter with a copy of the questionnaire were sent to non-respondents. This resulted in the return of another 14 completed questionnaires. Overall, thirty-eight usable questionnaires were obtained, representing a response rate of 48 percent.

A *t-test* was carried out to assess any possible non-response bias. Early responses were compared with late responses about their concerns over ITP abuses by MNEs through their related-party transactions. The results indicated that there were no significant differences between the two groups.

8.6 Data Analysis

Since the design of research includes both quantitative and qualitative data, procedures relevant for the analysis of both types of data are used. While the questionnaire survey data are subjected to rigorous statistical analysis, data gathered from answers in interviews to open-ended questions are edited and organised into interview reports.

8.6.1 Quantitative Analysis

All data have been coded and analysed using computer programs available in the Statistical Package for the Social Sciences (SPSS). A number of statistical methods were used to analyse the data collected through the questionnaire survey. They are briefly described as follows:

1. Ratios, means and standard deviations were calculated to describe the nature and characteristics of variables;
2. An R-type, varimax-rotated, common factor analysis was performed using programs available in the SPSS;
3. Given the categorical or ordinal nature of the data collected in this research, non-parametric statistics were used as the main test technique for the analyses. They include The *Chi-Square* and the *Spearman's Correlation Coefficient Tests*, the *Mann-Whitney U Test*, the *Kruskal-Wallis test*, and the *logistic regression analysis*.

8.6.2 Qualitative Analysis

The major source of the qualitative data was the face-to-face interviews with the Chinese tax authorities. They involved in-depth discussion on transfer pricing tax audit issues with

different respondents to gain a broad perspective on the issues from different points of view. Data analysis consisted of two phases: first, the interview data was summarised based on the research objectives and questions. The aim of this phase was to develop a summary report identifying key information directly relevant to the research questions. This process was assisted by using notes and memos, containing all relevant information. The second stage was to analyse the data to provide explanation using applicable and valid analytical techniques. The objective of this phase is to address the research questions. Maximum care was and is being taken to protect the identity of organisations used in these studies and in other constituent parts of the research.

8.7 Summary

A sound and effective research methodology is the bedrock of every successful research study. These need to be carefully designed, based on a theoretically well-grounded framework and practically tested for internal and external validity. In this study, the development of the questionnaire consisted of drafting, pretesting and pilot testing. Pretest and pilot tests produced a survey form that was more usable and reliable. Variables of the questionnaire were drawn from previous studies and, samples were randomly drawn from directories. Data from questionnaire were subjected to rigorous statistical analysis. A chi-square test was carried out as a test for non-response bias. Results indicated that there were no significant differences between the two groups, suggesting that there was no significant non-response bias. The objectives of the qualitative study are to describe the Chinese ITP auditing system and to illustrate its effectiveness in restricting ITP practices. The analysis has been limited to the research questions addressed within this study. Validity of the findings was insured by asking respondents to review a draft interview report to correct any misunderstanding or inconsistency.

Part D

Data Analysis and Interpretation

Chapter 9

Survey Results of International Transfer Pricing Methods

9.1 Introduction

This chapter presents the empirical results of the statistical analysis performed on the data of the study. Specifically, this chapter begins by presenting the data about these respondent companies, with suitable analyses of the data for its significance for the practice of ITP. This is followed by the findings from the survey on transfer pricing methods used by the respondent firms in the three countries.

9.2 Profile of the Respondent Firms

Table 9.1 presents the industry and sales/revenue classifications of the respondent companies in the three countries, listed in descending order by the proportions of New Zealand respondents. The size of the participating firms is classified according to their total sales/total revenue as of 2002. It can be seen, in Panel B of Table 9.1, that the distribution for sales of the respondent companies is unevenly divided among the six categories in all three countries.

9.2.1 Industrial Classification

As can be seen in Panel A of Table 9.1, a wide range of industries is represented in all three countries. In New Zealand, the largest industry of the respondent firms is Wholesale and retail trade (44.2 percent). In contrast, in Australia and China Manufacturing is the highest proportion of the respondent firms – 41.7 percent in Australia and 53.2 percent in China. Between 85.8 percent to 90 percent of the respondent firms, in total, in each of the three countries fall into three categories – Wholesale and retail trade, Manufacturing, and Services industries. The remaining five industries –Finance and Insurance, Mining, Transport and Storage, Construction, Agriculture, Forestry and Fishing – altogether account for barely 14.3 percent of the respondent firms in New Zealand, 10.1 percent of those in Australia and 10.7 percent of those in China.

9.2.2 Size of the Respondent Companies

It can be seen, in Panel B of Table 9.1 that New Zealand companies are, on average, smaller than the respondent firms in Australia and China. For example, about 93.6 percent of the New Zealand respondents had total sales of \$200 million or less. Of these, 46.8 percent of the firms reported total sales of under \$20 million. In contrast, 83.3 percent of Australian companies, of which 40 percent reported total revenue of under \$20 million, and 80.9 percent of Chinese

firms, of which 36.2 percent reported total revenue of under \$20 million, are in the same category.

The size of New Zealand firms in 2002 is measured in terms of total sales, whereas the size of Australian and Chinese companies is measured by total revenue from sales and other sources. This difference in approach to the measurements of company size need to be borne in mind with respect to the New Zealand firms.

Table 9.1
Industrial and Size Classification of Respondent Companies

	New Zealand		Australia		China	
Panel A: Industry Type	# of firms	%	# of firms	%	# of firms	%
Wholesale and retail trade	34	44.2	21	35	12	25.5
Manufacturing	20	26	25	41.7	25	53.2
Services	12	15.6	8	13.3	5	10.6
Finance and insurance	7	9.1	1	1.67	0	0
Mining	1	1.3	1	1.67	0	0
Transport and storage	1	1.3	0	0	0	0
Construction	1	1.3	3	5	3	6.4
Agriculture, forestry and fishing	1	1.3	1	1.67	2	4.3
Total	77	100*	60	100*	47	100*
Panel B: Total sales/total revenue						
Less than \$20m	36	46.8	24	40	17	36.2
\$20m to \$100m	24	31.2	21	35	13	27.7
\$101m to \$200m	12	15.6	5	8.3	8	17
\$201m to \$500m	2	2.6	4	6.7	3	6.4
\$501m to \$800m	1	1.3	1	1.7	5	10.6
More than \$800m	2	2.6	5	8.3	1	2.1
Total	77	100*	60	100*	47	100*

Note: * Percentage totals are rounded.

All values are stated in New Zealand dollars; the Australian and Chinese data were converted from the Australian dollar and the Chinese Yuan, respectively. Currency conversion rates used as at September 2003, New Zealand \$1=Australia \$0.8778 and Chinese Yuan 4.9478.

9.2.3 The Nationality of the Respondent Companies

The home countries of the respondent subsidiary companies are shown in Table 9.2. A wide range of nations are involved for all three countries. In the case of New Zealand, subsidiaries of the U.S., Australian and Japanese parent companies make up the largest group (71.5 percent). In Australia, subsidiaries of the U.S., Japanese and the U.K. parent companies make

up the largest group (66.6 percent), while in China, subsidiaries of Hong Kong, the U.S., Japanese and Taiwanese parent companies make up the largest group (61.7 percent).

The home countries of the respondent companies are the major trading partners of each of the three countries. Table 9.3 shows the nationalities of the Chinese respondent firms and the top fifteen sources of FDI in China. There is a consistency between the national distribution of the sources of FDI in China and the home country of the respondent companies. The sources of FDI in New Zealand and Australia are predominantly from OECD countries. All the New Zealand and Australian sample firms are owned by parent companies in these industrialised nations, except for one Australian subsidiary that is controlled by a Korean parent company.

Table 9.2
The Home Countries of the Respondent Subsidiary Companies

Home country	New Zealand		Australia		China	
	# of firms	%	# of firms	%	# of firms	%
USA	21	27.3	17	28.3	8	17
Australia	20	26.0	0	0	0	0
Japan	14	18.2	14	23.3	6	12.8
UK	6	7.8	9	15.0	2	4.3
Switzerland	4	5.2	1	1.67	0	0
Germany	3	3.9	6	10	1	2.1
Canada	2	2.6	1	1.7	0	0
France	2	2.6	2	3.3	3	6.4
Sweden	2	2.6	1	1.7	1	2.1
Finland	1	1.3	0	0	0	0
Denmark	1	1.3	1	1.7	0	0
Ireland	1	1.3	1	1.7	0	0
Netherlands	0	0	4	6.7	1	2.1
New Zealand	0	0	1	1.7	0	0
Belgium	0	0	1	1.7	0	0
Italy	0	0	0	0	1	2.1
Korea	0	0	1	1.7	3	6.4
Hong Kong	0	0	0	0	10	21.3
Taiwan	0	0	0	0	5	10.6
Virgin islands	0	0	0	0	1	2.1
Macao	0	0	0	0	1	2.1
Singapore	0	0	0	0	3	6.4
Thailand	0	0	0	0	1	2.1
Total	77	100*	60	100*	47	100*

Note: * Percentages may not add up to totals because of rounding.

9.2.4 Volume, Nature and Frequency of Intra-company International Transactions

To determine the importance of intercompany international transfers to the respondent companies, each respondent was asked to estimate the levels of their particular subsidiary's intercompany transfers that cross international boundaries, as a percentage of the company's total transfers – total company transfers mean a company's worldwide transactions with

related or unrelated parties, both domestic and international. The results are shown in Table 9.4.

Table 9.3
The Nationality of Respondent Companies and Top 15 Sources of FDIs in China

Nationality of respondent firms	Percentage	Top 15 Country/Region*	Percentage
Hong Kong	21.3	Hong Kong	45.7
United States	17.0	United States	8.9
Japan	12.8	Japan	8.1
Taiwan	10.6	Taiwan	7.4
Virgin Islands	2.1	Virgin Islands	5.4
Singapore	6.4	Singapore	4.8
Korea	6.4	Korea	3.4
UK	4.3	UK	2.4
Germany	2.1	Germany	1.8
France	6.4	France	1.2
Macao	2.1	Macao	1.1
Netherlands	2.1	Netherlands	1.0
Sweden	2.1	Cayman Islands	0.9
Italy	2.1	Canada	0.8
Thailand	2.1	Malaysia	0.6
		Others	6.6
Total	100	Total	100**

Note: 1) Shaded items are the countries not represented in the two categories. 2) Percentages may not add up to totals because of rounding.

Source: Ministry of Commerce of the People’s Republic of China’s website. The website address is <http://www.mofcom.gov.cn>

On average, the Chinese respondents engaged in a relatively wider range of related party transactions with overseas associates than their New Zealand and Australian counterparts. However, the results also reveal that nearly a third of New Zealand respondents – 26 or 35.1 percent – and Australian respondents – 19 or 31.7 percent are heavily engaged in intercompany international transfers with a volume of more than 85 percent, while only a small proportion of Chinese respondents – three or 6.4 percent – fall into the same category.

Given the mixed information revealed, it cannot be concluded that Chinese companies are more/less heavily engaged in international intercompany transfers than the New Zealand and Australian respondents in the sample. The respondents were further asked to indicate the nature and frequency of their international transfers with their foreign associates. The responses are shown in Table 9.5. It can be seen that there is a similar ranking of response for all three countries. The transfer of tangible goods is the most common business activity for multinational intercompany transfers in the three countries. The transfer of service is the second most common activity, while the transfer of financing is the third. The least common

business activity in the three countries is the transfer of intangibles. Additionally, it can be observed that the Chinese firms are relatively more heavily engaged in intercompany international transfers of financing and intangibles than companies in New Zealand and Australia.

Table 9.4
Intercompany Transfers as a Proportion of Total Company Transfers in 2002

	New Zealand		Australia		China	
The volumes of transfers	# of firms	%	# of firms	%	# of firms	%
Less than 5%	22	29.7	10	16.7	9	19.1
6% to 20%	7	9.5	12	20	12	25.5
21% to 50%	7	9.5	8	13.3	13	27.7
51% to 70%	5	6.8	6	10	6	12.8
71% to 85%	7	9.5	5	8.3	4	8.5
More than 85	26	35.1	19	31.7	3	6.4
Total	74*	100**	60	100**	47	100**

Note: * Three companies failed to supply information on their inter-company transfers.

** Percentages did not add up to 100 due to rounding error.

Table 9.5
The Frequency of the Different Types of Intercompany Transfers

	New Zealand		Australia		China	
Type of transaction	Mean	SD	Mean	SD	Mean	SD
Tangible goods	3.95	1.34	4.28	1.106	3.86	1.15
Services	3.18	1.39	2.94	1.28	3.14	1.23
Financing	2.37	1.23	2.55	1.316	2.76	1.39
Intangibles	1.98	1.19	1.89	1.23	2.38	1.32

Note: A number of companies declined to provide information on the percentages of intercompany transfers on intangibles.

The profiles of the respondent companies are featured and elaborated upon this section. Data on major characteristics such as industry types, sales/total revenue, nationality, and the volume, nature and frequency of intercompany transactions of the respondent companies are presented. The sample firms represented a large variety of industries. A number of the respondent firms reported having a significant amount of intercompany transfers crossing international boundaries. Therefore, ITP may be an important issue for those companies. The rest of this chapter reports on transfer pricing methods used by multinational subsidiaries operating in the three countries.

9.3 International Transfer Pricing Methods

9.3.1 Numbers of International Transfer Pricing Methods Used

Panel A of Table 9.6 shows the number of transfer pricing methods used by the respondent firms. About 58.1 percent and 55.2 percent of New Zealand and Australian respondent companies, respectively, used one pricing method, and those remaining (41.9 percent in New Zealand and 44.8 percent in Australia) used more than one pricing method in each country. In China, only 18.2 percent of respondents used one method, while 47.7 percent of Chinese firms used three methods. Noticeably, one New Zealand subsidiary in the Wholesale and retail trade industry used seven pricing methods.

9.3.2 Market-Based Versus Nonmarket-Based ITP Methods Used

Panel B of Table 9.6 was prepared (in descending order) using the proportions of New Zealand firms (giving the number and percentage of the respondent companies) that are using nonmarket versus market-based methods for ITP. Note that, with regard to the negotiated method, there is no consistent conclusion. Al-Eryani et al (1990) and Tang (1993) treated negotiated pricing as a nonmarket-based method but others grouped negotiated and markets together, as market-based methods (Chan and Chow, 2001). In this research, negotiation pricing approaches such as negotiation based on costs, negotiation based on method market price and unrestricted negotiations were classified in the market-based method group.

9.3.2.1 International Transfer Pricing Methods Used by New Zealand Companies

Panel B of Table 9.6 shows that 56.8 percent of the New Zealand respondent firms use nonmarket-based methods and 43.2 percent use market-based methods for all groups. In terms of percentage, it appears that the New Zealand firms tend to use nonmarket-oriented transfer prices. As for the use of individual transfer pricing methods, 'full plus fixed profit' (21, 28.4 percent) is most widely used by the respondent companies. Following, in descending order of frequency of use, are 'negotiation based on costs' (9, 12.2 percent), 'full actual cost' (9, 12.2 percent), 'adjusted market price' (7, 9.5 percent), 'negotiation based on market prices' (7, 9.5 percent), 'full standard cost' (6, 8.1 percent), 'full market price' (6, 8.1 percent), 'variable plus fixed contribution' (4, 5.4 percent), 'unrestricted negotiations' (3, 4.1 percent), 'variable actual cost' (2, 2.7 percent). The 'variable standard cost' is not used by companies in the sample.

9.3.2.2 International Transfer Pricing Methods Used by Australian Companies

Panel B of Table 9.6 shows that 61 percent of the Australian firms use nonmarket-based methods and 39 percent use market-based methods for the combined groups. Similar to their New Zealand counterparts, the Australian firms tend to use nonmarket-oriented transfer prices. As for the used of individual transfer pricing methods, ‘full plus fixed profit’ (19, 32.3 percent) is most widely used by the respondent companies. This is followed, in descending order of usage frequency, by ‘negotiation based on market prices’ (13, 22 percent), ‘full actual cost’ (6, 10.2 percent), ‘full standard cost’ (5, 8.5 percent), ‘variable plus fixed contribution’ (4, 6.8 percent), ‘adjusted market price’ (4, 6.8 percent), ‘full market price’ (3, 5.1 percent), ‘negotiation based on costs’ (3, 5.1 percent), ‘variable actual cost’ (2, 3.4 percent). ‘Variable standard cost’ and ‘unrestricted negotiations’ are not used by companies in the sample.

Table 9.6
ITP Methods Used by the Respondent Companies

	New Zealand		Australia		China	
Panel A: Number of methods used	# of firms	%	# of firms	%	# of firms	%
One	43	58.1	32	55.2	8	18.2
Two	21	28.4	19	32.8	7	15.9
Three	5	6.8	6	10.3	21	47.7
Four	3	4.1	1	1.7	5	11.4
Five	1	1.4	0	0	2	4.5
Six	0	0	0	0	1	2.3
Seven	1	1.4	0	0	0	0
Total	74	100*	58	100*	44	100*
Panel B: Pricing Methods						
<i>Nonmarket-Based Methods</i>						
Full plus fixed profit	21	28.4	19	32.2	3	6.8
Full actual cost	9	12.2	6	10.2	7	15.9
Full standard cost	6	8.1	5	8.5	1	2.3
Variable plus fixed contribution	4	5.4	4	6.8	3	6.8
Variable actual cost	2	2.7	2	3.4	0	0
Variable standard cost	0	0	0	0	1	2.3
<i>Subtotal for nonmarket-based methods</i>	42	56.8	36	61.0	15	34.1
<i>Market-Based Methods</i>						
Negotiation based on costs	9	12.2	3	5.1	8	18.2
Adjusted market price	7	9.5	4	6.8	6	13.6
Negotiation based on market price	7	9.5	13	22	7	15.9
Full market price	6	8.1	3	5.1	8	18.2
Unrestricted negotiations	3	4.1	0	0	0	0
<i>Subtotal for market-based methods</i>	32	43.2	23	39	29	65.9
<i>Total – all methods</i>	74*	100**	59*	100**	44*	100**

Note: *Three New Zealand firms, one Australian firm and three Chinese firms failed to supply information on their transfer pricing methods used.

** Percentages may not add up to totals because of rounding.

9.3.2.3 International Transfer Pricing Methods Used by Chinese Companies

Panel B of Table 9.6 shows that 34.1 percent of the Chinese firms use nonmarket-based methods and 65.9 percent use market-based methods for the combined groups. Compared with their New Zealand and Australian counterparts, Chinese companies tend to use market-oriented methods. As for the use of the individual pricing methods, 'full market price' (8, 18.2 percent) and 'negotiation based on costs' (8, 18.2 percent) are most commonly used by respondent companies. Following, in descending order of frequency of use, are 'full actual cost' (7, 15.9 percent), 'negotiation based on market prices' (7, 15.9 percent), 'adjusted market price' (6, 13.6 percent), 'full plus fixed profit' (3, 6.8 percent), 'variable plus fixed contribution' (3, 6.8 percent), 'full standard cost' (1, 2.3 percent), and 'variable standard cost' (1, 2.3 percent). 'Variable actual cost' and 'unrestricted negotiations' are not used by the Chinese respondents in the sample.

The transfer pricing methods used by the respondent firms have been reported in this section. A number of companies used two or more pricing methods, with one New Zealand firm using as many as seven pricing methods. Those companies using a variety of pricing methods may do so for different types of international dealings (Tang, 1981). In percentage terms, ITP methods of the Chinese respondent firms are more market-oriented than their New Zealand and Australian counterparts. With regard to the individual transfer pricing methods, 'full plus fixed profit' was most widely used by both the New Zealand and Australian respondent companies, whereas Chinese firms preferred to use 'full market price' and 'negotiation based on costs'.

The next section reports on a cross-national comparison of transfer pricing methods used by the New Zealand, Australian and Chinese respondent companies. In chapter 7, four hypotheses were developed for comparing ITP methods used by the respondent firms in the three countries. The following section provides descriptive statistics about the relevant survey responses and then tests the hypotheses using a variety of statistical techniques.

9.4 A Cross-National Comparison of International Transfer Pricing Methods Used

This section presents important findings on the different methods of ITP which are currently in use by companies in New Zealand, Australia and China, which are subsidiaries located in these three host countries, but are owned by parent companies located in other countries, as indicated in Table 9.2.

The order of use of each of the 11 possible methods by respondents in each of the three countries is presented in Table 9.6, Panel B. The 11 methods are then classified and re-analysed in two ways to test for variation in the different classifications. The first of these two supplementary analyses classifies the eleven methods as either cost-based methods, market-based methods or negotiation-based methods. The second way of classifying the eleven methods for supplementary analysis is to use only two categories – cost-based methods and market-based methods – since the negotiated method is combined identified with the market-based method. The negotiated method includes negotiation based on costs, negotiation based on market price and unrestricted negotiations. In this study, it is re-classified into the market-based method group for the second of the two supplementary analyses.

Hypothesis 0a:

There are no differences in ITP methods used by MNEs in New Zealand, Australia and China

To test the hypothesis that there are no differences in ITP methods used by MNEs in New Zealand, Australia and China, the respondents were asked to state the method most often used to price transfers of goods or services with their related parties across international boundaries. The responses are shown in Panel B of Table 9.6. The descriptive statistics provide preliminary evidence that international transfer pricing methods used by MNEs are different in the three countries. The noticeable differences between the three national groups were in the pricing methods most commonly used in each of the three countries. For example, ‘full plus fixed profit’ was most commonly used by both New Zealand (21, 28.4 **percent**) and Australian companies (19, 32.2 percent), while only 3 (6.8 percent) of Chinese firms used ‘full plus fixed profit’. In contrast, 8 (18.2 percent) of Chinese companies used ‘full market price’, while only 6 (8.1 percent) of New Zealand firms and 3 (5.1 percent) of Australian companies used that pricing method.

In Table 9.7, Panel A the 11 individual pricing methods are classified into three method groups, that is, cost-based, market-based and negotiation-based. It can be observed that ‘cost-based methods’ were predominantly used in New Zealand and Australia, while all three method groups (i.e., cost-based methods, market-based methods and negotiation-based methods) were evenly used by Chinese companies. The descriptive statistics provide evidence that at the aggregated levels ITP methods used by multinationals are different in the three countries.

Pearson's chi-square test was used to test whether differences among the companies of the three national groups in choosing ITP methods were significant at the aggregated levels. The results in Table 9.7, Panel B show that there is statistically a significant difference in responses in respect of ITP methods used at aggregated levels in the three national groups. The difference is significant at the 5% level.

The 11 individual pricing methods were further classified into two groups: nonmarket-based and market-based methods. Panel A of Table 9.8 shows that 56.8 percent and 61 percent of the New Zealand and Australian respondent firms, respectively, used nonmarket-based methods, while only 34.1 percent of Chinese firms used nonmarket-based methods. Compared to their New Zealand and Australian counterparts, Chinese companies tended to use market-based methods. The descriptive statistics provide support that, at the market-based versus nonmarket-based levels, ITP methods used by multinationals are different in the three countries.

Table 9.7
A Comparison of Classified Methods Used by New Zealand, Australian and Chinese Companies – Descriptive statistics

	New Zealand		Australia		China	
Panel A: Pricing Methods	# of firms	%	# of firms	%	# of firms	%
Cost-Based Methods	42	56.8	36	61.0	15	34.1
Market-Based Methods	13	17.6	7	11.9	14	31.8
Negotiation-Based Methods	19	25.7	16	27.1	15	34.1
Total – all methods	74	100	59	100	44	100
Panel B: A Chi-square test of Classified Methods Used						
Chi-Squared value	Degree of freedom		Significance. (2-tailed)		N	
10.042**	4		.040		177	

Note: **Significant at the 5% level.

Table 9.8
A Comparison of Market-Based and Nonmarket-Based Methods Used by New Zealand, Australian and Chinese Companies – Descriptive Statistics

	New Zealand		Australia		China	
Panel A: Pricing Methods	# of firms	%	# of firms	%	# of firms	%
Nonmarket-Based Methods	42	56.8	36	61.0	15	34.1
Market-Based Methods	32	43.2	23	39.0	29	65.9
Total – all methods	74	100	59	100	44	100
Panel B: A Chi-Square Test of Classified Methods Used						
Chi-Squared value	Degree of freedom		Significance. (2-tailed)		N	
8.234**	2		0.016		177	

Note: **Significant at the 5% level

Pearson's chi-square test was used to test whether differences among the companies of the three national groups in choosing ITP methods were significant for market-based versus nonmarket-based levels. The results in Table 9.8, Panel B show that there is a statistically significant difference at the 5% level, in responses in respect of ITP methods used in the three national groups.

The results in Table 9.7 and 9.8 provide evidence that there are statistically significant differences in ITP methods used across the three country groups at both individual and aggregated levels. Therefore, the hypothesis of no differences in ITP methods used by multinationals in New Zealand, Australia and China can be rejected.

Hypothesis 0b:

There are no differences in ITP methods used by MNEs in New Zealand and Australia

In comparing the ITP methods used by companies in New Zealand and Australia it was expected a *priori* that there would be no differences between them. Panel B of Table 9.6 contrasts transfer pricing methods used by the New Zealand and Australian firms. The descriptive statistics provide indications that there are few differences in the ITP methods used by multinationals in the two countries. ‘Full plus fixed profit’ is the most common pricing method used by multinationals in both countries. ‘Variable standard cost’ is used in neither of the two countries.

Table 9.9
A Chi-Square Test on Pricing Methods Used by New Zealand and Australian Companies

	Chi-Squared value	Degree of freedom	Significance. (2-tailed)	N
Panel A: Cost-, market- and negotiation-based methods	0.838	2	0.658	133
Panel B: Nonmarket Method and Market Method	0.101	1	0.750	133

In Panel A of Table 9.7, the 11 individual pricing methods are classified into three method groups – cost-based, market-based and negotiation-based – with a view to discovering any variation in such a basis. However, the descriptive statistics indicate that at the aggregated level, the ITP methods used by multinationals, when subject to such a classification, do not differ in the two countries.

Pearson’s *chi-square* test was used to test whether differences among the companies of the two national groups in their choice of ITP methods, on the basis of this classification, were significant at the aggregated levels. The results in panel A of Table 9.9 show that there is no statistically significant difference in responses in respect of ITP methods used at the aggregated levels in the two national groups.

The 11 individual pricing methods are further classified into two different groups – nonmarket-based and market-based methods. The descriptive statistics shown in Panel A of Table 9.8 provide support that for the market-based versus nonmarket-based levels the ITP methods used by multinationals show a similar pattern in the two countries.

Pearson’s chi-square test was used to test whether differences among the companies of the two national groups in choosing ITP methods were significant for the market-based versus nonmarket- based levels. The results in Panel B of Table 9.9 show that there is no statistically significant difference in the responses on ITP methods used in the two national groups.

The results in Table 9.9 provide evidence that there are no statistically significant differences across the two country groups regarding ITP methods used at both individual and aggregated levels. Therefore, the expectation of similarities arising from the assumption of common cultural factors over the adoption of particular ITP methods used by multinationals in New Zealand and Australia has some validity.

Hypothesis 0c:

There is no difference in ITP methods used by MNEs in New Zealand and China

Panel B of Table 9.6 contrasts transfer pricing methods used by New Zealand and Chinese firms. The descriptive statistics provide evidence that there are differences in ITP methods used by multinationals in the two countries.

Table 9.10
A Chi-Square Test on Pricing Methods Used by New Zealand and Chinese Companies

	Chi-Squared value	Degree of freedom	Significance. (2-tailed)	N
Panel A: Cost-, market- and negotiation-based methods	6.062**	2	0.048	118
Panel B: Nonmarket Method and Market Method	4.805**	1	0.028	118

Note: **Significant at the 5% level.

In Panel A of Table 9.7, the 11 individual pricing methods are classified into three method groups – cost-based, market-based and negotiation-based. The descriptive statistics provide evidence that at the aggregated levels ITP methods used by multinationals are different in the two countries.

Pearson’s chi-square test was used to test whether differences among companies of the two national groups in choosing ITP methods were significant at this aggregated level. The results in Table 9.10, Panel A show that there are statistically significant differences with respect of the ITP methods used in the two national groups at the aggregated level.

The 11 individual pricing methods were further classified into two different groups – nonmarket-based and market-based methods. The descriptive statistics indicate that for the market-based versus nonmarket-based level ITP methods used by multinationals in the two countries show differences, as shown in Table 9.8, Panel A.

Pearson’s chi-square test was used to test whether differences among companies in the two national groups in choosing ITP methods were significant at the market-based versus nonmarket-based level. The results in Table 9.10, Panel B show that there are statistically significant differences in the responses of companies with respect to the ITP methods used in the two national groups. The result is significant at the 5% level.

The results in Table 9.10 provide evidence that there are statistically significant differences across the two country groups with regard to the ITP methods used at both individual and aggregated levels. Hence, MNEs located in China use ITP methods that are different from those used by MNEs based in New Zealand.

Hypothesis 0d:

There is no difference in ITP methods used by MNEs in Australia and China

Panel B of Table 9.6 contrasts transfer pricing methods used by Australian and Chinese firms. The descriptive statistics indicate that there is a difference in the ITP methods used by multinationals in the two countries.

Table 9.11
A Chi-Square Test on Pricing Methods Used by Australian and Chinese Companies

	Chi-Squared value	Degree of freedom	Significance. (2-tailed)	N
Panel A: Cost-, market- and negotiation-based methods	9.019**	2	0.011	103
Panel B: Nonmarket Method and Market Method	6.272**	1	0.012	103

Note: **Significant at the 5% level.

In Table 9.7, Panel A, the 11 individual pricing methods are classified into three method groups – cost-based, market-based and negotiation-based. The descriptive statistics indicate that, at the aggregated level, ITP methods used by multinationals in the two countries may be different.

Pearson's chi-square test was used to test whether differences among companies of the two national groups in their choice of ITP methods were significant at an aggregated level. The results in Table 9.11, Panel A show that there is a statistically significant difference in the ITP methods used by respondents in the two national groups. The difference is significant at the 5% level.

The 11 individual pricing methods were further classified into a further two groups – nonmarket-based and market-based methods. The descriptive statistics as shown in Table 9.8, Panel A indicate that at the market-based versus nonmarket-based levels, the ITP methods used by multinationals in the two countries are different.

Pearson's chi-square test was used to test whether differences among companies of the two national groups in choosing ITP methods were significant at the market-based versus nonmarket-based level. The results in Table 9.11, Panel B show that there are statistically significant differences with respect to the ITP methods used in the two national groups.

The results in Table 9.11 provide evidence that there are statistically significant differences across the two national groups with regard to the ITP methods used by companies at both the individual and aggregated levels. Therefore, an expectation that the cultural contrasts between Australia and China might be subordinate to the imperatives of shared commercial interests, resulting in no differences in ITP methods used by multinationals in Australia and China, can be discarded.

9.5 Summary

This chapter started by describing some essential characteristics of the three national groups of respondent firms and the ITP methods used in each country. This was followed by conducting a cross-national comparison of transfer pricing methods used by New Zealand, Australian and Chinese respondent companies. Table 9.12 summarises the statistical test results. The survey results reveal statistically significant differences between the transfer pricing methods used by New Zealand and Australian companies on the one hand, and Chinese companies on the other. The next chapter examines policy determinants for the choice of multinational transfer pricing methods in the three countries.

Table 9.12
Summary of Statistical Results
Regarding the Methods Used by New Zealand, Australian and Chinese Companies

Country	Cost-Based Methods, Market-Based Methods and Negotiation Based-Methods	Nonmarket-Based Methods and Market-Based Methods
New Zealand and Australia and China	**	**
New Zealand and Australia	NS	NS
New Zealand and China	**	**
Australia and China	**	**

Note: ** Significant at the 5% level.
NS: Not significant.

Chapter 10

Survey Results of Environmental Factors Affecting International Transfer Pricing

10.1 Introduction

Chapter 9 reported on the ITP methods used by companies in New Zealand, Australia and China. This chapter reports on the environmental factors of ITP in the three countries, and includes a comparative study of the environmental factors affecting ITP policies of MNEs, with an emphasis on the identification of differences in pricing strategies of the New Zealand and Australian respondent companies on one hand, and Chinese respondent firms on the other.

10.2 Environmental Variables of International Transfer Pricing

Given the wide range of unstable conditions prevailing in the global trading market, it is only to be expected that the factors which actually govern the policies adopted about ITP would vary. A single, invariably efficacious method of ITP does not exist. If it did, the governments of host countries could marshal their defences with greater effectiveness and the whole issue of ITP would be less of a controversial subject and major concern.

In the studies undertaken for this thesis, therefore, it was expected that variety would prevail, but that some trends may be discovered. Hypothetically, and in particular, there was the possibility that the determinants of ITP might reveal major variations according to country location.

Therefore, to discover the realities in practice, seventeen environmental variables were selected in designing an instrument for data collection. A 5-point scale was used by respondent companies to rate the importance of each of these possible determinants of the methods adopted for ITP. In this chapter, Table 10.1 shows the relative importance attached by the sampled companies, in the three countries, for all these variables. The rankings of importance were made according to the mean scores of the variables. The mean for each variable was based on a 5-point scale using 1 for extremely important; 2 for very important; 3 for important; 4 for slightly important and 5 for not important. In using the recode function in the Statistical Package for Social Sciences (SPSS), the original Likert-like code was reversed. That is, on the 5-point scale, a 1 is recoded as a 5, a 2 is recorded as a 4, a 3 as a 3, a 4 as a 2

and a 5 as a 1. Thus, the higher the number, the greater the level of their importance. The standard deviation of responses is also presented in the Tables, indicating the extent of agreement in the rating of individual variables among the respondents.

A final return of 184 usable responses was achieved from the three countries. Table 10.1 and subsequent tables record the assessment of the importance these companies attached to the 17 environmental variables as determinants of their decisions regarding ITP, together with analytical treatments of the results.

It can be seen that ‘comply with tax law and regulations’ was perceived by the respondent firms as the most important variable in transfer pricing decisions. The low standard deviation for this variable indicates that there was relatively significant agreement among respondents on the importance of legal considerations. Other variables considered very important included ‘corporate profit of the subsidiary’, ‘competitive position of the subsidiary’ and ‘overall profit to multinational group’. Eleven variables were considered to be moderately important by the respondent firms. They were ‘maintenance of cashflows’, ‘tax authority transfer pricing audits’, ‘performance evaluation’, ‘differences in income tax rates’, ‘good relations with host government’, ‘restrictions on repatriation of income’, ‘rates of customs duties’, ‘foreign

Table 10.1
Environmental Variables Ranked by their Importance by Respondent Companies (n=184)

Environmental Variables	Mean	Rank	Standard Deviation
VAR 04 Comply with tax law and regulations	3.99	1	1.11
VAR 08 Corporate profit of the subsidiary	3.47	2	1.12
VAR 06 Competitive position of the subsidiary	3.46	3	1.28
VAR 07 Overall profit to multinational group	3.25	4	1.23
VAR 17 Maintenance of cashflows	2.90	5	1.38
VAR 03 Tax authority transfer pricing audits	2.86	6	1.27
VAR 14 Performance evaluation	2.73	7	1.26
VAR 01 Differences in income tax rates	2.69	8	1.40
VAR 11 Good relations with host government	2.57	9	1.35
VAR 05 Restrictions on repatriation of income	2.49	10	1.28
VAR 02 Rates of customs duties	2.48	11	1.38
VAR 10 Foreign currency exchange controls	2.34	12	1.33
VAR 13 Existence of local partner	2.30	13	1.33
VAR 09 Import restrictions	2.23	14	1.27
VAR 12 Price controls of host government	2.13	15	1.25
VAR 15 Political and social pressure	2.08	16	1.17
VAR 16 Royalty restrictions	2.03	17	1.16

Table 10.2

Correlation Matrix of Environmental Variables

Variable	Var. No.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
VAR 01	1																	
VAR 02	2	.62																
VAR 03	3	.35	.31															
VAR 04	4	.31	.24	.46														
VAR 05	5	.47	.53	.42	.30													
VAR 06	6	.16	.36	.26	.19	.34												
VAR 07	7	.36	.44	.41	.27	.47	.44											
VAR 08	8	.26	.47	.30	.27	.29	.47	.51										
VAR 09	9	.29	.55	.25	.22	.57	.41	.48	.43									
VAR 10	10	.37	.57	.24	.22	.53	.35	.45	.38	.76								
VAR 11	11	.35	.52	.42	.38	.49	.51	.52	.44	.55	.53							
VAR 12	12	.35	.44	.34	.28	.54	.34	.45	.37	.62	.59	.66						
VAR 13	13	.33	.51	.16	.12	.54	.41	.46	.34	.58	.57	.55	.53					
VAR 14	14	.27	.49	.35	.31	.46	.53	.49	.53	.52	.51	.54	.46	.57				
VAR 15	15	.34	.47	.43	.26	.60	.39	.49	.34	.57	.61	.61	.59	.54	.61			
VAR 16	16	.36	.48	.36	.20	.64	.31	.51	.32	.62	.58	.51	.59	.56	.50	.65		
VAR 17	17	.34	.47	.33	.33	.57	.43	.56	.45	.49	.56	.55	.40	.51	.60	.54	.57	

Note: Shaded items highlight those variables that are highly correlated, which are statistically significant at the 1% level.

currency exchange controls', 'existence of local partner', 'import restrictions', 'price controls of host government'. Variables which were considered only slightly important included 'political and social pressure', and 'royalty restrictions'.

To overcome the potential problem of multicollinearity and to identify a relatively small number of underlying dimensions or behaviour traits, an R-type, principal components factor analysis that is orthogonally rotated based on the Varimax procedure was performed on these data. Since factor analysis is concerned with relations among observations, it commonly starts with a matrix of correlations as its input (Tang, 1982). The correlation matrix of environmental variables in Table 10.2 shows that some variables are highly correlated. For instance, Variable 9 import restrictions and Variable 10 foreign currency exchange controls have a correlation coefficient of 0.76. Variable 11 good relations with host government and Variable 12 price controls of host government, have a correlation coefficient of 0.66, while Variable 15 political and social pressure and Variable 16 royalty restrictions, have a correlation coefficient of 0.65. The high correlation of the variables provided justification for performing a factor analysis.

The matrix shown in Table 10.3 and 10.4 is the product of a varimax rotation. Three factors (or dimensions) were extracted and labelled as follows:

Factor 1: Government restrictions.

Factor 2: Corporate competitive position.

Factor 3: Tax and legal considerations.

In Tables 10.3 and 10.4, the communality column shows the degree to which the factors account for or explain each of the variables. For a given variable, the three factors summarise between 54.7 percent (VAR 07) and 69.9 percent (VAR 9).

The eigenvalue of each factor is the sum of squares of the factor's unrotated loadings and is normally used to compute the fraction of total variance in the variable explained by the factor (Tang, 1982, p. 185). The percentage of total variance summarised by each factor is equal to its eigenvalue divided by 17 (the number of variables). For example, Factor 1 summarises 410.3 percent of the total variance, Factor 2 summarises 7.8 percent of the total variance and Factor 3 summarises 6.8 percent of the total variance. Together, the three factors summarise 62.9 percent of the total variance in the seventeen variables.

Cronbach's coefficient alphas for reliability were estimated for each of the factors to ascertain the extent to which variables making up each factor shared a common core and the extent to which items in the questionnaire related to each other. Cronbach's alpha is based on the average inter-item correlation. Panel B of Table 10.4 shows the high reliability held for item that comprised Factor 1, while the rest of the two factors were satisfactory or better. A consideration of the dimensionality of each of the factors follows.

Factor 1 is the most dominant factor. Within this factor, 'foreign currency exchange controls' is the most important variable, followed, in descending order, by 'royalty restrictions', 'import restrictions', 'existence of local partner', 'restrictions on repatriation of income', 'price controls of host government', 'political and social pressure', 'rates of customs duties', 'good relations with host government' and 'maintenance of cashflows'. This means that the respondents who placed a great deal of importance on 'foreign currency exchange controls' also tended to regard other variables that loaded highly on Factor 1 as important.

Factor 2 has very high loadings on 'competitive position of the subsidiary' and 'corporate profit of the subsidiary'. These two variables together form another important dimension of

environmental variables. Factor 3 has a high loading on ‘tax authority transfer pricing audits’ and ‘comply with tax law and regulations’.

Table 10.3
Factor Analysis of Environmental Variables

Variables	Factor 1	Factor 2	Factor 3	h ² (communality)
VAR 01 Differences in income tax rates	0.486	-0.098	0.600*	0.605
VAR 02 Rates of customs duties	0.628*	0.228	0.332	0.557
VAR 03 Tax authority transfer pricing audits	0.151	0.242	0.759*	0.657
VAR 04 Comply with tax law and regulations	0.029	0.241	0.751*	0.623
VAR 05 Restrictions on repatriation of income	0.719*	0.133	0.358	0.663
VAR 06 Competitive position of the subsidiary	0.206	0.780*	0.045	0.653
VAR 07 Overall profit to multinational group	0.407	0.535*	0.309	0.547
VAR 08 Corporate profit of the subsidiary	0.184	0.725*	0.214	0.606
VAR 09 Import restrictions	0.761*	0.346	0.026	0.699
VAR 10 Foreign currency exchange controls	0.788*	0.267	0.059	0.695
VAR 11 Good relations with host government	0.524*	0.503	0.313	0.626
VAR 12 Price controls of host government	0.689*	0.250	0.212	0.582
VAR 13 Existence of local partner	0.722*	0.359	-0.063	0.654
VAR 14 Performance evaluation	0.441	0.666*	0.164	0.666
VAR 15 Political and social pressure	0.682*	0.333	0.232	0.631
VAR 16 Royalty restrictions	0.771*	0.197	0.172	0.663
VAR 17 Maintenance of cashflows	0.510*	0.502	0.251	0.575
Sum of squares (Eigenvalue)	8.210	1.329	1.160	
Percentage of trace (Variance)	48.3	7.8	6.8	62.9

Note: * Indicates highest factor loading for variables.

Table 10.4
A Summary of Three Dimensions of Variables and Cronbach's Alpha Reliability Analysis

Panel A: Dimensions and Variables	Rotated Factor Loadings	Communality	Eigenvalue	Variance summarised (eignvalue/no. of variable)
Factor 1 Government restrictions			8.210	0.483
VAR 10 Foreign currency exchange controls	0.788	0.695		
VAR 16 Royalty restrictions	0.771	0.663		
VAR 09 Import restrictions	0.761	0.699		
VAR 13 Existence of local partner	0.722	0.654		
VAR 05 Restrictions on repatriation of income	0.719	0.663		
VAR 12 Price controls of host government	0.689	0.582		
VAR 15 Political and social pressure	0.682	0.631		
VAR 02 Rates of customs duties	0.628	0.557		
VAR 11 Good relations with host government	0.524	0.626		
VAR 17 Maintenance of cashflows	0.510	0.575		
Factor 2 Corporate competitive position			1.329	0.0782
VAR 06 Competitive position of the subsidiary	0.780	0.653		
VAR 08 Corporate profit of the subsidiary	0.725	0.606		
VAR 14 Performance evaluation	0.666	0.666		
VAR 07 Overall profit to multinational group	0.535	0.547		
Factor 3 Tax and legal considerations			1.160	0.0683
VAR 03 Tax authority transfer pricing audits	0.759	0.657		
VAR 04 Comply with tax law and regulations	0.751	0.623		
VAR 01 Differences in income tax rates	0.600	0.605		
Total				0.629
Panel B: Factors	Variables			Cronbach's Alpha
Factor 1 Government restrictions	VAR 02, VAR 05, VAR 09, VAR 10, VAR 11, VAR 12, VAR 13, VAR 15, VAR 16, VAR 17			0.9257
Factor 2 Corporate competitive position	VAR 06, VAR 07, VAR 08, VAR 14			0.7947
Factor 3 Tax and legal considerations	VAR 01, VAR 03, VAR 04			0.6318

10.3 A Multinational Comparison

In chapter 9 a comparison of the ITP methods actually used by the respondent companies showed that those for whom China was the host country different methods were adopted from those whose host countries were New Zealand and Australia. The sharp cultural differences between New Zealand and Australia on the one hand and China on the other might suggest that the respective business environments involved played an important determining influence and might be the origin for explaining the differences.

To discover any such determining influences from this source, the companies in the study were asked to assess the relative importance of each of a range of environmental factors that could affect their ITP decisions. This section, therefore, contains the responses from the multinational subsidiary companies operating in the three host countries, New Zealand, Australia and China, together with the results of statistical tests that were applied to the results to establish if any significantly different valuations were placed on the environmental variables according to the host country.

Hypothesis 0e:

There are no differences in the rating of environmental factors affecting ITP by multinationals in New Zealand, Australia and China

The ranking of the importance of each of a range of environmental variables by the respondent companies in New Zealand, Australia and China is given in Table 10.5. The ranking of importance is according to the mean scores of the variables. The standard deviation indicates the extent of agreement in the rating of individual variables among the respondents. It can be seen that the Chinese companies place more emphasis on nearly all of the 17 environmental variables than the New Zealand and Australian firms.

To investigate possible differences in the ranking of the environmental variables, A *Kruskal-Wallis test* was used for analysis. The results of the test are presented in Table 10.6. There are statistically significant differences in the ranking of these variables in the three countries, the environmental measure being significant at the 1% level.

To investigate further possible differences in the ranking of individual environmental variables, a *Kruskal-Wallis test* was employed to test each individual variable. The results of the test are presented in Table 10.7. Differences are found in the case of 15 environmental

variables, fourteen being significant at the 1% level, while that of ‘competitive position of the subsidiary’ is significant at the 5% level. No differences are recorded in the case of the ranking of two environmental variables, ‘comply with tax law and regulations’ and ‘tax authority transfer pricing audits’.

Hypothesis 0f:

There are no differences in the rating of environmental factors affecting ITP by multinationals in New Zealand and Australia

The ranking of the importance for the environmental variables by the respondent firms in New Zealand and Australia is given in Table 10.5. The rankings are according to mean scores of the variables. The standard deviation indicates the extent of agreement in the rating of individual variables among the respondents.

To investigate possible differences in the ranking of environmental variables, a *Mann-Whitney U Test* was used for analysis. The results of the test are presented in Table 10.8. There are no statistically significant differences in the ranking of these variables by members of the two national groups, the scores for environmental variables being not significant at even the 10% level.

To investigate further possible differences in the ranking of individual environmental variables, a *Mann-Whitney U test* was employed to test each individual variable. The results of the test are presented in Table 10.9. The scores of 16 environmental variables were not even significant at the 10% level. Only one environmental variable, ‘restrictions on repatriation of income’ was found to be significant at the 5% level.

Table 10.5
Comparison of Ratings of the Importance of Environmental Variables for
ITP by New Zealand, Australian and Chinese Companies – Descriptive Statistics

Environmental Variables	New Zealand			Australia			China		
	Mean	Rank	SD	Mean	Rank	SD	Mean	Rank	SD
VAR 04 Comply with tax law and regulations	3.96	1	1.069	4.05	1	1.166	3.96	3	1.134
VAR 08 Corporate profit of the subsidiary	3.38	2	1.089	3.14	3	1.206	4.04	2	0.842
VAR 06 Competitive position of the subsidiary	3.31	3	1.369	3.28	2	1.335	3.91	4	0.905
VAR 07 Overall profit to multinational group	3.05	4	1.157	2.86	4	1.317	4.07	1	0.827
VAR 03 Tax authority transfer pricing audits	2.82	5	1.254	2.79	5	1.321	3.00	13	1.229
VAR 17 Maintenance of cashflows	2.71	6	1.422	2.55	6	1.404	3.65	6	0.971
VAR 14 Performance evaluation	2.51	7	1.242	2.41	8	1.298	3.50	8	0.863
VAR 01 Differences in income tax rates	2.47	8	1.363	2.43	7	1.464	3.37	9	1.162
VAR 05 Restrictions on repatriation of income	2.43	9	1.261	1.97	12/13	1.169	3.26	10	1.084
VAR 11 Good relations with host government	2.18	10	1.262	2.26	9	1.292	3.59	7	1.045
VAR 10 Foreign currency exchange controls	2.09	11	1.248	2.12	10/11	1.326	3.04	12	1.228
VAR 13 Existence of local partner	2.07	12	1.258	1.84	15	1.203	3.24	11	1.119
VAR 02 Rates of customs duties	2.00	13/14	1.147	2.12	10/11	1.312	3.74	5	0.999
VAR 09 Import restrictions	2.00	13/14	1.192	1.97	12/13	1.199	2.96	14	1.246
VAR 15 Political and social pressure	1.96	15	1.094	1.71	16/17	0.975	2.74	16	1.273
VAR 12 Price controls of host government	1.95	16	1.210	1.95	14	1.300	2.65	17	1.320
VAR 16 Royalty restrictions	1.82	17	1.109	1.71	16/17	0.973	2.78	15	1.134

Table 10.6
A Kruskal-Wallis Test of the Ratings of the Importance of
Environmental Variables for ITP by New Zealand, Australian and Chinese Companies (n=177)

	New Zealand	Australia	China
Mean Rank	76.87	71.47	130.00
N*	76	55	46
Chi-Squared value	40.172***		
Degree of freedom	2		
Significance. (2-tailed)	0.000		

Note: * One New Zealand firms, five Australian firms and one Chinese firm failed to supply information on their transfer pricing methods used.

***Significant at the 1% level.

Table 10.7
A Kruskal-Wallis Test of the Ratings of the Importance of the Individual Items of
Environmental Variables Affecting ITP by New Zealand, Australian and Chinese Companies

Environmental Variables	Mean Rank			Test Statistics	
	New Zealand	Australia	China	Chi-Squared value	Significance (p)
VAR 04 Comply with tax law and regulations	89.02	95.63	90.36	0.621	0.733
VAR 08 Corporate profit of the subsidiary	86.08	76.71	117.26	17.95	0.000***
VAR 06 Competitive position of the subsidiary	86.94	84.25	107.93	6.73	0.035**
VAR 07 Overall profit to multinational group	81.95	75.69	125.46	28.87	0.000***
VAR 03 Tax authority transfer pricing audits	89.81	88.44	96.23	0.67	0.714
VAR 17 Maintenance of cashflows	84.20	78.21	118.51	18.40	0.000***
VAR 14 Performance evaluation	81.73	77.99	122.92	24.54	0.000***
VAR 01 Differences in income tax rates	83.13	81.16	116.59	15.54	0.000***
VAR 05 Restrictions on repatriation of income	88.47	69.58	122.25	27.93	0.000***
VAR 11 Good relations with host government	75.91	78.85	129.28	36.23	0.000***
VAR 10 Foreign currency exchange controls	81.25	81.54	119.24	19.34	0.000***
VAR 13 Existence of local partner	80.87	71.63	125.52	34.40	0.000***
VAR 02 Rates of customs duties	73.68	77.32	137.25	51.50	0.000***
VAR 09 Import restrictions	81.77	80.00	120.33	21.16	0.000***
VAR 15 Political and social pressure	84.82	73.41	116.58	20.71	0.000***
VAR 12 Price controls of host government	82.71	84.38	111.09	10.85	0.004***
VAR 16 Royalty restrictions	81.40	77.73	123.80	27.65	0.000***

Note: **Significant at the 5% level.

***Significant at the 1% level.

Hypothesis 0g:

There are no differences in the rating of environmental factors affecting ITP by multinationals in New Zealand and China

The rankings of importance for the environmental variables by the respondent firms in New Zealand and China are given in Table 10.5. The rankings are according to the mean scores of the variables. The standard deviation indicates the extent of agreement in the rating of individual variables among the respondents.

To investigate possible differences in the ranking of the environmental variables, a *Mann-Whitney U Test* was employed. The results of the test are presented in Table 10.10. There are statistically significant differences in the ranking of these factors by members of these two national groups, the differences being significant at the 1% level.

To further investigate possible differences in the ranking of individual environmental variables, the *Mann-Whitney U Test* was employed to test each individual variable. The results of the test are presented in Table 10.11. There are statistically significant differences in the case of 15 environmental variables. There are no significant differences in the case of the other two environmental variables, ‘comply with tax law and regulations’ and ‘tax authority transfer pricing audits’.

Hypothesis 0h:

There are no differences in the rating of environmental factors affecting ITP by multinationals in Australia and China

The rankings of the importance for the environmental variables by the respondents of Australia and China are given in Table 10.5. The rankings are according to the mean scores of the variables, while standard deviation indicates the extent of agreement in the rating of individual variables among the respondents.

Table 10.8
A Mann-Whitney U Test of the Ranking of the Importance
of Environmental Variables for ITP by New Zealand and Australian Companies

	New Zealand	Australia
Mean Rank	67.76	63.56
N	76	55
z-value	-0.626	
Significance. (p)	0.5320	

Table 10.9
A Mann-Whitney U Test of the Ratings of the Importance of the
Individual Items of Environmental Variables for ITP by New Zealand and Australian Companies

Environmental Variables	Mean Rank		Test Statistics	
	New Zealand	Australia	Z-value	Significance (p)
VAR 04 Comply with tax law and regulations	66.18	71.53	-0.832	0.405
VAR 08 Corporate profit of the subsidiary	71.25	63.68	-1.163	0.245
VAR 06 Competitive position of the subsidiary	68.80	66.94	-0.282	0.778
VAR 07 Overall profit to multinational group	70.48	64.71	-0.876	0.381
VAR 03 Tax authority transfer pricing audits	68.44	67.41	-0.156	0.876
VAR 17 Maintenance of cashflows	69.89	65.49	-0.668	0.504
VAR 14 Performance evaluation	69.34	66.22	-0.476	0.634
VAR 01 Differences in income tax rates	68.71	67.05	-0.254	0.800
VAR 05 Restrictions on repatriation of income	74.08	59.92	-0.2189	0.029**
VAR 11 Good relations with host government	66.59	68.69	-0.324	0.746
VAR 10 Foreign currency exchange controls	68.00	68.00	0.000	1.000
VAR 13 Existence of local partner	69.53	62.38	-1.157	0.247
VAR 02 Rates of customs duties	67.14	69.14	-0.313	0.755
VAR 09 Import restrictions	68.65	67.14	-0.239	0.811
VAR 15 Political and social pressure	70.06	61.52	-1.368	0.171
VAR 12 Price controls of host government	66.88	68.32	-0.231	0.818
VAR 16 Royalty restrictions	69.03	66.64	-0.393	0.684

Note: **Significant at the 5% level.

To investigate possible differences in the ranking of the environmental variable, a *Mann-Whitney U Test* was employed. The results of the test are presented in Table 10.12. There are statistically significant differences in the ranking of these factors by members of the two national groups, the scores for the environmental variables being significant at the 1% level.

To further investigate possible differences in the ranking of individual environmental variables, a *Mann-Whitney U Test* was employed to test each individual variable. The results of the test are presented in Table 10.13. There are statistically significant differences in the case of 15 environmental variables. There are no significant differences in the case of the remaining two environmental variables, ‘comply with tax law and regulations’ and ‘tax authority transfer pricing audits’.

This section reported on a comparative study of environmental factors affecting the ITP policies of MNEs, with an emphasis on the identification of differences in ITP strategies of the Australian and New Zealand respondent companies on the one hand, and Chinese respondent firms on the other. Statistically significant differences are indicated between the two sets of companies regarding the degree of emphasis they, respectively, place on environmental factors affecting their ITP policies. The statistical test results are summarised in Table 10.14.

Table 10.10
A Mann-Whitney U Test of the Ranking of the Importance
of Environmental Variables for ITP by New Zealand and Chinese Firms

	New Zealand	China
Mean Rank	47.61	84.46
N	76	46
z-value	-5.580	
Significance. (p)	0.000***	

Note: ***Significant at the 1% level.

Table 10.11
A Mann-Whitney U Test of the Ratings of the Importance of
the Individual Items of Environmental Variables for ITP by New Zealand and Chinese Companies

Environmental Variables	Mean Rank		Test Statistics	
	New Zealand	China	Z-value	Significance (p)
VAR 04 Comply with tax law and regulations	61.84	62.26	-0.066	0.947
VAR 08 Corporate profit of the subsidiary	53.82	75.68	-3.450	0.001***
VAR 06 Competitive position of the subsidiary	57.14	71.29	-2.219	0.026**
VAR 07 Overall profit to multinational group	50.47	81.30	-4.824	0.000***
VAR 03 Tax authority transfer pricing audits	60.36	64.74	-0.677	0.498
VAR 17 Maintenance of cashflows	53.31	76.54	-3.591	0.000***
VAR 14 Performance evaluation	51.39	79.76	-4.425	0.000***
VAR 01 Differences in income tax rates	53.42	76.37	-3.542	0.000***
VAR 05 Restrictions on repatriation of income	53.38	76.42	-3.566	0.000***
VAR 11 Good relations with host government	47.82	84.10	-5.626	0.000***
VAR 10 Foreign currency exchange controls	52.25	78.32	-4.048	0.000***
VAR 13 Existence of local partner	49.84	80.77	-4.836	0.000***
VAR 02 Rates of customs duties	45.53	89.57	-6.808	0.000***
VAR 09 Import restrictions	52.12	78.54	-4.119	0.000***
VAR 15 Political and social pressure	53.76	75.79	-3.448	0.001***
VAR 12 Price controls of host government	54.34	73.34	-3.035	0.002***
VAR 16 Royalty restrictions	51.37	79.79	-4.488	0.000***

Note: ** Significant at the 5% level;

***Significant at the 1% level.

Table 10.12
A Mann-Whitney U Test of the Ranking of the Importance of
Environmental Variables for ITP by Australian and Chinese Firms

	Australia	China
Mean Rank	35.91	69.04
N	55	46
z-value	-5.663	
Significance. (p)	0.000***	

Note: ***Significant at the 1% level.

Table 10.13
A Mann-Whitney U Test of the Ratings of the Importance
of the Individual Items of Environmental Variables for ITP by Australian and Chinese Companies

Environmental Variables	Mean Rank		Test Statistics	
	Australia	China	Z-value	Significance (p)
VAR 04 Comply with tax law and regulations	54.09	51.60	-0.443	0.658
VAR 06 Competitive position of the subsidiary	46.81	60.64	-2.407	0.016**
VAR 08 Corporate profit of the subsidiary	42.53	65.08	-3.926	0.000***
VAR 07 Overall profit to multinational group	40.48	67.65	-4.702	0.000***
VAR 03 Tax authority transfer pricing audits	50.53	54.99	-0.768	0.442
VAR 17 Maintenance of cashflows	42.22	65.47	-4.015	0.000***
VAR 01 Differences in income tax rates	43.60	63.72	-3.453	0.001***
VAR14 Performance evaluation	41.27	66.66	-4.390	0.000***
VAR 11 Good relations with host government	39.66	68.68	-4.982	0.000***
VAR 10 Foreign currency exchange controls	43.04	64.42	-3.692	0.000***
VAR 02 Rates of customs duties	37.68	71.18	-5.763	0.000***
VAR 05 Restrictions on repatriation of income	39.16	69.33	-5.206	0.000***
VAR 09 Import restrictions	42.36	65.28	-3.979	0.000***
VAR 12 Price controls of host government	45.56	61.25	-2.749	0.006***
VAR 13 Existence of local partner	37.74	68.25	-5.371	0.000***
VAR 15 Political and social pressure	39.89	64.28	-4.356	0.000***
VAR 16 Royalty restrictions	40.59	67.51	-4.725	0.000***

Note: **Significant at the 5% level; ***Significant at the 1% level.

Table 10.14
Summary of Results of the Relative Importance of
Environmental Variables Attached by National Groups for ITP

	New Zealand and Australia	New Zealand and China	Australia and China
VAR 01 Differences in income tax rates	NS	***	***
VAR 02 Rates of customs duties	NS	***	***
VAR 03 Tax authority transfer pricing audits	NS	NS	NS
VAR 04 Comply with tax law and regulations	NS	NS	NS
VAR 05 Restrictions on repatriation of income	**	***	***
VAR 06 Competitive position of the subsidiary	NS	**	**
VAR 07 Overall profit to multinational group	NS	***	***
VAR 08 Corporate profit of the subsidiary	NS	***	***
VAR 09 Import restrictions	NS	***	***
VAR 10 Foreign currency exchange controls	NS	***	***
VAR 11 Good relations with host government	NS	***	***
VAR 12 Price controls of host government	NS	***	***
VAR 13 Existence of local partner	NS	***	***
VAR 14 Performance evaluation	NS	***	***
VAR 15 Political and social pressure	NS	***	***
VAR 16 Royalty restrictions	NS	***	***
VAR 17 Maintenance of cashflow	NS	***	***

Note: ** Significant at the 5% level; *** Significant at the 1% level; NS = Not significant.

10.4 A Cross-National Analysis of key Determinants

It can be seen in Table 10.1 and 10.5 that four important variables affected ITP policies in the three countries. They are 'comply with tax law and regulations', 'corporate profit of the subsidiary', 'competitive position of the subsidiary' and 'overall profit to multinational group'. These shared factors vary in importance with the nature of the ITP in the three countries. For example, 'comply with tax law and regulations' was considered the most important variable by both the New Zealand and Australian respondent companies, whereas 'overall profit to multinational group' was considered as the most important variable by the Chinese respondent firms. In addition, differences exist in the rankings of each pair of the three countries on some of the environmental variables. The sharply different variables are 'rates of custom duties', 'tax authority transfer pricing audits' and 'restrictions on repatriation of income'. For example, the variable 'rates of custom duties' is ranked fifth by the Chinese respondents but thirteen/fourteen and tenth/eleventh by the New Zealand and Australian respondents, respectively. This section provides a brief discussion and analysis of these seven key individual environmental variables as they affect ITP policies in New Zealand, Australia and China.

Table 10.15**Comparison of the Ratings of Variables for ITP by New Zealand, Australia and China***Panel A: Variable 02 – Rates of customs duties*

Country	New Zealand		Australia		China		Overall	
N	77	100	58	100	46	100	181	100
Extremely important	3	3.9	5	8.6	10	21.7	18	9.9
Very important	5	6.5	4	6.9	21	45.7	30	16.6
Important	17	22.1	11	19.0	9	19.6	37	20.4
Slightly important	16	20.8	11	19.0	5	10.9	32	17.7
Not important	36	46.8	27	45.0	1	2.2	64	35.4
Rank	13/14		10/11		5		11	
Mean	2.00		2.12		3.74		2.48	
Standard Deviation	1.147		1.312		0.999		1.38	

Panel B: Variable 03 – Tax authority transfer pricing audits

Country	New Zealand		Australia		China		Overall	
N	77	100	58	100	46	100	181	100
Extremely important	7	9.1	7	12.1	6	13.0	20	11.0
Very important	16	20.8	10	17.2	11	23.9	37	20.4
Important	27	35.1	19	32.8	11	23.9	57	31.5
Slightly important	10	13.0	8	13.3	13	28.3	31	17.1
Not important	17	22.1	14	24.1	5	10.9	36	19.9
Rank	5		5		14		6	
Mean	2.82		2.79		3.00		2.86	
Standard Deviation	1.254		1.321		1.229		1.27	

Panel C: Variable 04 – Comply with tax law and regulations

Country	New Zealand		Australia		China		Overall	
N	77	100	59	100	46	100	182	100
Extremely important	31	40.3	26	44.1	21	45.7	78	42.9
Very important	20	26.0	21	35.6	9	19.6	50	27.5
Important	21	27.3	5	8.5	9	19.6	35	19.2
Slightly important	2	2.6	3	5.1	7	15.2	12	6.6
Not important	3	3.9	4	6.8	0	0	7	3.8
Rank	1		1		3		1	
Mean	3.96		4.05		3.96		3.99	
Standard Deviation	1.069		1.166		1.134		1.11	

Panel D: Variable 05 – Restrictions on repatriation of income

Country	New Zealand		Australia		China		Overall	
N	77	100	58	100	47	100	182	100
Extremely important	6	7.8	2	3.4	6	13.0	14	7.7
Very important	7	9.1	5	8.6	15	32.6	27	14.8
Important	27	35.1	11	19.0	11	23.9	49	26.9
Slightly important	11	14.3	11	19.0	13	27.7	35	19.2
Not important	26	33.8	29	50.0	1	2.1	56	30.8
Rank	9		12/13		10		10	
Mean	2.43		1.97		3.26		2.49	
Standard Deviation	1.261		1.169		1.084		1.28	

Panel E: Variable 06 – Competitive position of the subsidiary

Country	New Zealand		Australia		China		Overall	
N	77	100	58	100	47	100	182	100
Extremely important	15	19.5	11	19.0	13	27.7	39	21.4
Very important	28	36.4	18	31.0	21	44.7	67	36.8
Important	14	18.2	15	25.9	9	19.1	38	20.9
Slightly important	6	7.8	4	6.9	4	8.5	14	7.7
Not important	14	18.2	10	17.2	0	0	24	13.2
Rank	3		2		4		3	
Mean	3.31		3.28		3.91		3.46	
Standard Deviation	1.369		1.335		.905		1.28	

Panel F: Variable 07 – Overall profit to multinational group

Country	New Zealand		Australia		China		Overall	
N	77	100	58	100	47	100	182	100
Extremely important	7	9.1	7	12.1	15	32.6	29	15.9
Very important	21	27.3	13	22.4	21	45.7	55	30.2
Important	29	37.7	15	25.9	8	17.0	52	28.6
Slightly important	9	11.7	11	19.0	2	4.3	22	12.1
Not important	11	14.3	12	20.7	0	0	23	12.6
Rank	4		4		1		4	
Mean	3.05		2.86		4.07		3.35	
Standard Deviation	1.157		1.317		.827		1.23	

Panel G: Variable 08 – Corporate profit of the subsidiary

Country	New Zealand		Australia		China		Overall	
N	77	100	58	100	47	100	182	100
Extremely important	12	15.6	8	13.8	15	32.6	35	19.2
Very important	22	28.6	15	25.9	20	43.5	57	31.3
Important	33	42.9	19	32.8	9	19.6	61	33.5
Slightly important	3	3.9	9	15.5	2	4.3	14	7.7
Not important	7	9.1	7	12.1	0	0	14	7.7
Rank	2		3		2		2	
Mean	3.38		3.14		4.04		3.47	
Standard Deviation	1.089		1.206		.842		1.12	

10.4.1 Rates of Customs Duties

Panel A of Table 10.15 indicates the importance of the variable 02 – ‘rates of customs duties’ – as it affects the ITP policies of respondent firms operating in New Zealand, Australia and China. Compared with New Zealand and Australian companies, Chinese firms placed significantly greater importance on this variable. The mean rating of 3.74 for the variable given by the Chinese respondents is considerably higher than that of New Zealand companies at 2.00 and Australia at 2.12. The variable is ranked fifth by the Chinese respondents but thirteen/fourteen and tenth/eleventh by the New Zealand and Australian respondents, respectively. Overall, this variable is ranked eleventh by the three countries.

Partly because the possible savings are small, or partly because costly litigation can result (Caves, 1996, p.210), minimising customs duties is not considered to be as important for New Zealand and Australian firms as it is for Chinese firms. Traditionally, the customs duty is an important source of the financial revenue for the Chinese central government. However, since 1992 China has cut its customs tariffs on several occasions. These tariff rate cuts are in line with its commitment to reduce average imports as part of its WTO membership. In China, the current tariffs for the exports and imports of FIEs are quite preferential, with exports effectively being tariff free. Imports by FIEs which are used as investment goods and for producing exports are also tariff free. Only those imports by FIEs that are to be used in producing goods to be sold in the domestic market are subject to some import tariffs. Therefore, tariffs applied to export oriented FIEs in China are generous, and should generate no particular incentive for MNEs to practise transfer pricing manoeuvres (Chan and Chow, 1998; Sun, 1999).

When goods are transferred from a parent company abroad to a subsidiary in a host country, the host government may impose anti-dumping charges on the multinational group. This is done to protect its home industries against the dumping of excess production by companies in other countries (Belkaoui, 1991). Shortly before this study was undertaken, the Chinese customs offices had been investigating tax avoidance through multinational transfer pricing abuses and for alleged dumping violations as a result of underpricing intercompany transfers. The high importance of this variable by the Chinese respondents might be the result of the investigative action of current Chinese customs houses over the ITP practices of MNEs.

10.4.2 Tax Authority Transfer Pricing Audits

Panel B of Table 10.15 indicates the importance of the variable 03 – ‘tax authority transfer pricing audits’ – as it affects ITP policies of respondent firms operating in New Zealand, Australia and China. Transfer pricing auditing by tax authorities is not a significant concern for the Chinese respondents in formulating their ITP policies. Thirty-nine percent of the Chinese respondents considered the variable as only slightly important or not important at all. The mean rating 3.00 of the variable given by the Chinese respondents is slightly higher than that of their New Zealand and Australian counterparts, whose ratings are 2.79 and 2.82 respectively. Nevertheless, this variable is ranked fourteenth by the Chinese respondents but fifth by both the New Zealand and Australian respondents. Overall, this variable is ranked sixth by the three countries.

Literature (Brean, 1979, Plasschaet 1985, Al-Eryani, et al, 1990, Lin, et al, 1993) suggests that a great number of developed countries have enacted sophisticated tax regulations and own highly qualified professional tax experts to deal with the issue of ITP. On the other hand, although they may have become aware of the losses of tax revenues as a result of ITP manipulation, developing countries' governments find it difficult to deal with the problem as they lack the institutional framework and administrative expertise to analyse the complex set of factors at work. The governments of developing countries may find it even difficult to detect it at all, or when they are able to do so they simply do not have the resources to control and monitor it effectively.

The Chinese government has constituted a primary legal framework to deal with the taxation of foreign firms on ITP. The extant law and regulations of China grant the tax authorities power to perform tax auditing and to take legal action against multinational transfer pricing manipulation behaviour. In practice, however, tax auditing on transfer pricing by Chinese tax authorities is far from being fully implemented. This is due to the shortage of well-trained personnel to conduct tax auditing and pricing surveillance (for details, see the interview results in chapter 12). Hence, the threat of transfer pricing auditing by Chinese tax authorities might not be conceived as an imminent and realistic threat by the Chinese respondent multinationals.

10.4.3 Comply with Tax Law and Regulations

Panel C of Table 10.15 indicates the importance of the variable 04 – 'comply with tax law and regulations' – as it affects ITP policies of respondent firms operating in New Zealand, Australia and China. Respondents of the three national groups consistently consider the variable as highly important. Seventy-eight respondents consider this variable to be extremely important. The mean rating of 4.05 for the variable given by the Australian respondents is slightly higher than that of their New Zealand and Chinese counterparts, whose mean ratings are both 3.96. The variable is ranked first by both the New Zealand and Australian respondents and third by the Chinese respondents. Overall, this variable is ranked first by the three countries.

Burns (1980) showed that both legal and tax variables are important factors to consider when selecting pricing strategies. Al-Eryani et al (1990) suggested that market-based methods are used more intensively by companies that are concerned about satisfying legal requirements. Chan and Chow (1998) found that U.S.'s MNEs operating in developing countries perceive

compliance with tax and customs regulations as the most important variable in ITP decision. The findings of this survey corroborate those of previous studies. Comply with tax law and regulations is considered to be highly important to respondent firms when they are formulating their ITP policies.

10.4.4 Restrictions on Repatriation of Income

Panel D of Table 10.15 indicates the importance of variable 05 – ‘restrictions on repatriation of income’ – as it affects ITP policies of respondent firms operating in New Zealand, Australia and China. It is of moderate importance in the three countries. The mean rating 1.97 given by the Australian respondents is much lower than that of New Zealand at 2.43 and China at 3.26. This variable is ranked ninth and tenth by the New Zealand and Chinese respondents, respectively, but twelfth/thirteenth by the Australian respondents. Overall, this variable is ranked tenth by the three countries.

As with other countries, New Zealand, Australian and Chinese governments do not impose restrictions on foreign subsidiaries against the repatriation of their share of profits to their parent firms abroad. However, remittances of dividends, interests and royalties are subject to withholding tax. Most of the overseas investing countries in the world such as the U.S., the U.K., Japan and Germany adopt a system under which credit is allowed in respect of withholding tax charges levied by the host countries. Withholding tax in New Zealand, Australia and China on the payments of interest, rentals, and royalties to affiliated companies is levied at between 10 and 20 percent. Given that such withholding tax rates are lower than the home country income tax rate, a host country’s withholding tax on the payments can be waived or taken into account as a charge on the home country’s income taxes under bilateral tax treaties. Thus, ‘restrictions on repatriation of income’ is not considered important by all three countries.

It is worth noting, however, that, among China’s major investors, Hong Kong adopts a system of source based taxation whereby corporate taxes are charged only on income sourced in Hong Kong. Profits or revenues repatriated by foreign subsidiaries are exempt from Hong Kong taxation. For Hong Kong based FIEs, withholding taxes charged by Chinese fiscal authorities become an additional burden on the corporation’s tax charge (Chan and Chow, 1997b, p. 1274). Hence, Hong Kong based firms may placed greater importance on this variable.

10.4.5 Competitive Position of the Subsidiary

Panel E of Table 10.15 indicates the importance of variable 06 – ‘competitive position of the subsidiary’ – as it affects ITP policies of respondent firms operating in New Zealand, Australia and China. ‘Competitive position of the subsidiary’ is given fairly high ratings by the three national groups. The mean rating 3.91 given by the Chinese respondents is moderately higher than that of New Zealand at 3.31 and Australian at 3.28. The variable is ranked fourth by the Chinese respondents but third and second by New Zealand and Australian respondents, respectively. Overall, this variable is ranked third by the three countries.

Australia is vast country where lucrative opportunities exist but in a tough marketing condition. As a small economy, New Zealand has a comparatively low level of market competition. Until 1984 New Zealand was something of a command economy, but since then, the New Zealand government has freed prices, wages and interest rates, floated the exchange rate, progressively removed tariffs and subsidies, deregulated the financial system, introduced the GST and the Fringe Benefit Tax, reduced income tax rates, and encouraged overseas investment in the country. These New Zealand developments are observed as being more radical than those carried out in any other industrialised country (Lamminmaki and Drury, 2001, p.330). The pervasive liberalisation and deregulation of the New Zealand economy pursued over the past decade have engendered a competitive commercial environment in New Zealand, and thus dramatically increased the competitive pressure on New Zealand firms. Hence competitive position is now regarded as an important variable by the New Zealand respondents, as well as by their Australian counterparts.

As with their New Zealand and Australian counterparts, in the Chinese market, foreign companies also face tough competition from local producers. FDI is attracted to China in part because of China’s enormous domestic market (Chan and Chow, 1998). Because of their unfamiliarity with local market conditions, MNEs engaging in business are at a disadvantage compared to local firms. To compete successfully with local firms in China, MNEs must be able to exploit certain specific advantages, not possessed by their local competitors. A multinational group may use the ITP mechanism to enhance its subsidiary’s competitive position in the Chinese market to redress the balance. For instance, a foreign manufacturing firm may charge its related Chinese distributor a below market price as part of a market penetration strategy.

5.4.6 Overall Profit to Multinational Group

Panel F of Table 10.15 indicates the importance of variable 07 – ‘overall profit to multinational group’ – as it affects ITP policies of respondent firms operating in New Zealand, Australia and China. The Chinese respondents consider this variable to be very important. The mean rating of 4.07 given by the Chinese respondents is much higher than that of New Zealand at 3.05 and Australian at 2.86. The variable is ranked first by the Chinese respondents and fourth by both New Zealand and Australian respondents. Overall, this variable is ranked fourth by the three countries.

Twenty-nine companies consider this variable to be extremely important. It is understandable why so many subsidiaries pay great attention to the overall profit of their multinational group. The maximisation of global profit is the major objective of a multinational group. MNEs have often been accused of shifting income between different geographic regions to minimise global taxes, and, in turn, to maximise overall profit to multinational groups.

In China, foreign subsidiaries are heavily dependent on their overseas parent companies for supplies of materials and components. Subsidiary production and operational decisions are often controlled by their parent companies (for details, see chapter 12). Corporate policies in general and transfer pricing policies, in particular, are frequently set or directly affected by the parent companies, located overseas. For this reason, these companies may be more concerned with the overall group profitability than the corporate profits for themselves.

10.4.7 Corporate Profit of the Subsidiary

Panel G of Table 10.15 indicates the importance of variable 08 – ‘corporate profit of the subsidiary’ – as it affects ITP policies of respondent firms operating in New Zealand, Australia and China. Corporate profit of the subsidiary is given very high ratings by the three groups. The mean rating of 4.04 given by the Chinese respondents is higher than that of New Zealand at 3.38 and Australian at 3.14. The variable is ranked third by the Australian respondents and second by both New Zealand and Chinese respondents. Overall, this variable is ranked second by the three countries.

It is clear to see that ‘corporate profit of the subsidiary’ is consistently given very high ratings by all three national groups. The arbitrary shifting of profits from a foreign subsidiary through ITP, while enhancing overall corporate profitability, may affect the measured profitability of that subsidiary and, in turn, distort the performance of the subsidiary managers. Managers of foreign subsidiaries may have a stronger incentive to establish good profit records and,

therefore, would not want to establish prices that would reduce the profits of their own companies. In designing transfer pricing systems, local managers are likely to seek to balance the interests of the overall profit to the multinational group and that of the corporate profit of the subsidiary (Caves, 1996).

10.5 Summary

This chapter reported the findings on environmental factors of ITP in the three countries, and conducted a comparative analysis of environmental factors affecting ITP policies of MNEs, with emphasis placed on the identification of differences in ITP strategies of the New Zealand and Australian respondent companies on one hand, and Chinese respondent firms on another.

‘Tax authority transfer pricing auditing’ is an important concern in transfer pricing decisions for New Zealand and Australian companies. By comparison, it is regarded as relatively unimportant by the Chinese firms. The next chapter reports on ITP tax audits and factors that are likely to trigger ITP audits by tax authorities in the three countries.

Chapter 11

Survey Results of Audit of International Transfer Pricing

11.1 Introduction

Surveys prior to the mid-1990s tended to focus on the methods used from a managerial or motivational perspective. These sorts of surveys were directed at uncovering whether market-based, cost based or negotiated prices were in operation. In chapter 9, the managerial incentive transfer prices used by the respondent firms have been reported. This chapter begins by reporting on the survey results from respondent companies on their use of legally oriented transfer pricing methods and the extent of use of APAs by MNEs in the three countries. This is followed by reporting on corporate attributes associated with ITP tax audits.

11.2 The Legally Oriented Transfer Pricing Methods used

The respondents were asked to select one or more method (s) used in calculating/adjusting the value of transactions with their related parties, outside their local operations, for tax purposes. The results of an analysis of their responses are shown in Panel A and B of Table 11.1.

11.2.1 The Legally Oriented Transfer Pricing Methods Used by New Zealand Companies

Eleven companies used more than one ITP method. As shown in Table 11.1, Panel B the two most frequently used ITP methods were cost plus method and comparable uncontrolled price, which, together, accounted for 65.1 percent of the respondent companies. Resale price method, profit split method and comparable profit method were each used by nine firms. One company used the transactional net margin method. Two companies were using other methods – ‘agreed price’, and ‘contract manufacturer approach’, which are not specified by the IRD.

11.2.2 The Legally Oriented Transfer Pricing Methods Used by Australian Companies

Nineteen companies used more than one ITP method. As shown in Table 11.1, Panel B the three most frequently used ITP methods were cost plus method, comparable uncontrolled price and transactional net margin method, which together accounted for 80.3 percent of the respondent companies. Three companies used the profit split method and one company used the comparable profit method.

11.2.3 The Legally Oriented Transfer Pricing Methods Used by Chinese Companies

Twelve companies used more than one ITP method. Similar to their New Zealand and Australian counterparts, the two most frequently used ITP methods by Chinese firms were cost plus method and comparable uncontrolled price, which together accounted for 52.8 percent of the respondent companies. Ten companies used deemed profit method and seven companies used resale price method. The profit split method and comparable profit method were each used by six firms. Three companies were using transactional net margin method. Two companies used other methods – ‘global formulary apportionment’ and ‘going-rate pricing’, which are not specified by the SAT.

Table 11.1

The Legally Oriented Transfer Pricing Methods Used by the Respondent Companies

	New Zealand		Australia		China	
Panel A: Number of methods used	# of firms	%	# of firms	%	# of firms	%
One	67	85.9	44	78.6	25	58.1
Two	10	12.8	11	19.6	13	30.2
Three	1	1.3	1	1.8	4	9.3
Four	0	0	0	0	2	4.7
Total	78	100	56	100	43	100
Panel B: Pricing Methods						
Cost plus method	42	48.8	33	46.5	21	29.2
Comparable uncontrolled price	14	16.3	12	16.9	17	23.6
Resale price	9	10.5	10	14.1	7	9.7
Profit split	9	10.5	3	4.2	6	8.3
comparable profit method	9	10.5	1	1.4	6	8.3
The transactional net margin method	1	1.2	12	16.9	3	4.2
Deemed profit method	0	0	0	0	10	13.9
Others	2*	2.3	0	0	2*	2.8
Total	86**	100***	71**	100***	72**	100***

Note: *Other pricing methods include ‘Agreed price’, and ‘contract manufacturer approach’ for two New Zealand firms. ‘Global formulary apportionment’ and ‘going-rate pricing’ for two Chinese companies.

** Some of firms used more than one ITP method.

*** Percentages may not add up to totals because of rounding.

11.2.4 Legally Oriented Transfer Pricing Methods Used by Industry

Table 11.2 classifies pricing methods used by industry. It can be seen that the cost plus method is used predominantly in all industries. The resale price method is generally viewed as the most suitable pricing method used by sales and marketing companies (distributors), however, only 10 out of 88 companies in Wholesale and retail trade industries were using that method. Three Manufacturing and one Agriculture firm used other methods such as ‘agreed price’, ‘contract manufacturer approach’, ‘global formulary apportionment’ and ‘going-rate

pricing’, which are not specifically defined by the tax authorities. These methods, which differ from the recommended methods, could be as a result of the unique nature of their intercompany transactions.

Table 11.2
The Legally Oriented Transfer Pricing Methods Used by Industry

Industry	Cost plus	CUP	Resale price	Profit split	TNMM	CPM	Deemed profit	Others	Total
Wholesale & retail trade	31	17	10	6	10	11	3	0	88
Manufacturing	41	16	10	9	3	3	6	3	91
Services	11	8	4	2	2	1	0	0	28
Finance & insurance	5	2	1	0	0	0	0	0	8
Mining	1	0	0	0	1	0	0	0	2
Construction	5	0	1	1	0	1	1	0	9
Agriculture	2	0	0	0	0	0	0	1	3
Total	96	43	26	18	16	16	10	4	229

Note: CUP = Comparable Uncontrolled Price;
 TNMM = Transactional Net Margin Method;
 CPM = Comparable profit method.

11.3 Advance Pricing Agreements

In this study, the survey respondents were asked to state their status regarding APAs. The responses are shown in Table 11.3. Overall, seven respondents (4 percent) had signed off an APA with local tax authorities. Three respondents (1.7 percent) were currently negotiating with the local tax authorities for an APA. Sixteen respondents (9.1 percent) had not used an APA previously but would consider it in the future, while 96 respondents (54.5 percent) had no plans to apply for an APA, and the remaining 54 respondents (30.7 percent) had not considered the issue at all. The results of this survey are consistent with Borkowski’s findings that multinational firms typically appear uninterested in participating in APA programmes.

Table 11.4 shows the home country of the respondent firms that are currently using or considering APAs. It can be seen that Japanese-based subsidiaries paid greater attention to the use of APAs.

Table 11.3
The APA Status of Respondent Companies

	New Zealand		Australia		China		Overall	
Status regarding APA	# of firms	%	# of firms	%	# of firms	%	# of firms	%
Have concluded an APA with the local tax authority	2	2.7	4	6.9	1	2.3	7	4.0
Are currently negotiations with the local tax authority for an APA	0	0	1	1.7	2	4.7	3	1.7
Plan to apply for an APA with the local tax authority	5	6.7	3	5.2	8	18.6	16	9.1
Have no plans to apply with the local tax authority	37	49.3	38	65.5	21	48.8	96	54.5
Uncertain	31	41.3	12	20.7	11	25.6	54	30.7
Total	75*	100**	58*	100**	43*	100**	176	100**

Note: * Two New Zealand firms, two Australian firms and four Chinese firms failed to supply information on their transfer pricing methods used.

* Percentages may not add up to totals because of rounding.

Table 11.4
Home Country of the Respondent Companies that are Currently Using or Considering APAs

Home country of respondent firms	New Zealand	Australia	China	Total
USA	1	1	3	5
Australia	1	0	0	1
Japan	4	5	2	11
UK	1	0	0	1
Korea	0	1	1	2
Germany	0	1	0	1
Hong Kong	0	0	2	2
Taiwan	0	0	2	2
France	0	0	1	1
Total	7	8	11	26

11.4 Corporate Attributes Associated with ITP Tax Audits

Respondents to the study’s survey were asked if they had been the subject of an ITP audit since 1998. These responses are summarised in Table 11.5. Overall, 45 companies (26 percent) had been subject to ITP tax audits. The Table also shows that 33 percent of Chinese firms had been audited – a higher rate than companies from New Zealand (18 percent) and Australia (28 percent).

Table 11.5
Frequencies of ITP Audits Reported
by Respondent Companies in New Zealand, Australia and China Since 1998

	Audit		No audit		Overall	
	# of firm	%	# of firm	%	# of firm	%
New Zealand	13	18	58	82	71*	100
Australia	17	28	43	72	60	100
China	15	33	30	67	45*	100
Total	45	26	131	74	176	100

Note: * Six New Zealand firms and three Chinese firms did not provide information on ITP audits.

In chapter 7, the following hypothesis was formulated to test the relationship between ITP tax audits and a number of corporate attributes. For research convenience and consistency, this hypothesis was stated in the null form.

Hypothesis 0i:

There is no relationship between ITP tax audits and MNEs’ characteristics such as industry, nationality, company size, and the volume and types of intercompany transactions

11.4.1 The Chi-Square and the Spearman’s Correlation Coefficient Tests

This hypothesis is tested on both bivariate and multivariate levels. First, the bivariate *Chi-square* and the *Spearman’s correlation coefficient tests* were conducted to test the impact of the individual corporate attributes on ITP audits. The test results in Table 11.6 indicate that overall, except for two variables – Industry and Volume, all other six variables – Nationality, Size, Tangible, Intangible, Service and Financing – are significant at the 1%, 5% or 10% levels, and the signs (+/-) of the coefficients are positive. In the case of New Zealand, Size and Tangible are significant at the 1% and 10% levels, respectively, and the signs (+/-) of the coefficient are positive. In the case of Australia, Size, Nationality, Volume and Intangible are significant at the 1%, 5% or 10% levels, respectively, and the signs (+/-) of the coefficients

Table 11.6
Bivariate Test of Relationships between ITP Tax Audits and MNE Characteristics
Panel A: A Chi-Square Test

	Industry ¹²				Nationality ¹³			
	Overall	New Zealand	Australia	China	Overall	New Zealand	Australia	China
Chi-Squared value	0.161	0.995	0.847	1.879	10.838	0.522	5.728	2.049
Degree of freedom	1	1	1	1	1	1	1	1
Significance	0.689	0.318	0.358	0.170	0.001***	0.470	0.017**	0.152
Phi	-0.044	0.161	-0.156	-0.251	0.263	0.131	0.353	0.263
Significance	0.562	0.175	0.226	0.092	0.000***	0.268	0.006***	0.078
N	176	71	60	45	176	71	60	45

Panel B: Correlation Analysis

Overall results	Company size	The volumes of transfers	Tangible	Intangible	Financing	Service
Correlation Coefficient	0.225	0.071	0.111	0.115	0.134	0.113
Significance (1-tailed)	0.001***	0.177	0.073*	0.081*	0.048**	0.074*
N	176	174	171	150	156	164
New Zealand results						
Correlation Coefficient	0.306	0.007	0.167	-0.056	0.002	0.096
Significance (1-tailed)	0.005***	0.478	0.088*	0.333	0.493	0.220
N	71	69	67	62	63	67
Australia results						
Correlation Coefficient	0.571	0.190	0.006	0.220	0.098	0.161
Significance (1-tailed)	0.000***	.072*	0.481	0.071*	0.247	0.123
N	60	60	60	46	51	54
China results						
Correlation Coefficient	-0.345	0.118	0.251	0.181	0.255	0.120
Significance (1-tailed)	0.01***	0.221	0.050**	0.125	0.052*	0.221
N	45	45	44	42	42	43

Note: * Significant at the 10% level; ** Significant at the 5% level; *** Significant at the 1% level.

¹² Companies were re-categorised into two groups. Manufacturing firms formed one category and the remaining companies were combined into another category.

¹³ The Japan and Hong Kong-based firms formed one category and the remaining companies were combined into another category (for details, see chapter 7).

are positive. In the case of China, Size, Tangible and Financing are significant at the 1%, 5%, or 10% levels, respectively, but the sign (+/-) of the coefficient of Size is negative.

11.4.2 Logistic Regression Analysis

In chapter 7 a logit model has been developed to investigate the corporate attributes associated with ITP audits in a multivariate setting.

11.4.2.1 Correlation Matrix and Multicollinearity Issues

Multicollinearity exists when independent variables are highly correlated. Therefore, the simplest way of checking for multicollinearity is to run a correlation and check the strength of the correlations among the independent variables of interest. As a rule of thumb, correlations up around 0.8 or higher are generally reason for concern (Pallant, 2001). A correlation matrix of independent variables in Table 11.7 shows that the correlations between the independent variables of the model used are generally low (less than 0.4). Hence, multicollinearity does not appear to be a problem in the initial model.

11.4.2.2 Overall Results

The results of the logistic regression analysis of the significance of corporate attributes from the aggregated data of the New Zealand, Australian and Chinese respondent firms are shown in Panel A of Table 11.8. The model is significant at the 1% level. It has an overall predictive accuracy of 75.34 percent, indicating a good fit for the model. In the logit model, the Nationality variable is statistically significant at the 1% level, Size is statistically significant at the 10% level, and Financing is statistically significant at the 5% level. Referring to the results of the *Chi-square* and the *Spearman's correlation coefficient tests* for individual variables, the results of logistic regression confirm that the origin of the respondent firms, the size of the company and the transfer of financing are the most important variables in tax authorities' ITP auditing decisions. Hence, it can be concluded that the influences of these three variables on tax audits are significant both directly and interactively. The signs (+/-) of coefficients are positive, implying that all three variables are positively related to the dependent variable. The results indicate that tax authorities in New Zealand, Australia and China tended to focus their ITP tax audits on Japan or Hong Kong-based, large-sized subsidiaries, with greater volume of intercompany transactions in financing.

Table 11.7
Correlation Matrix of the Corporate Attributes

	INDUSTRY	NATIONALITY	SIZE	VOLUME	TANGIBLE	INTANGIBLE	FINANCING	SERVICE	HOST
INDUSTRY	1.000								
NATIONALITY	-0.072	1.000							
SIZE	0.093	0.200	1.000						
VOLUME	-0.100	0.145	0.132	1.000					
TANGIBLE	0.186	0.256	0.093	0.365	1.000				
INTANGIBLE	0.002	0.030	0.030	-0.052	0.007	1.000			
FINANCING	-0.050	-0.033	0.175	0.047	-0.020	0.336	1.000		
SERVICE	-0.003	-0.082	0.052	0.063	-0.065	0.318	0.337	1.000	
HOST	0.183	0.139	0.105	-0.160	-0.137	0.171	0.007	0.101	1.000

Table 11.8
Logistic Regression Analysis of the relationship between ITP audits and corporate attributes.

Panel A: Overall results	Predicted sign	Coefficient	Standard Error	Significance
Intercept	?	-2.8629	0.5956	0.000***
NATIONALITY	+	1.2161	0.4359	0.0053***
SIZE	+	0.2785	0.1448	0.0545*
Financing	+	0.3212	0.1529	0.0357**
		Number of observations: 146 Log likelihood: 150.532 Goodness of fit: 145.437		
Panel B: NZ results				
Intercept	?	-3.1961	0.8366	0.0001***
INDUSTRY	+	1.2800	0.7451	0.0858*
SIZE	+	0.6242	0.2919	0.0325**
		Number of observations: 59 Log likelihood: 49.428 Goodness of fit: 50.586		
Panel C: Australia results				
Intercept	?	-3.0553	0.8290	0.0002***
SIZE	+	0.8423	0.2844	0.0031***
		Number of observations: 45 Log likelihood: 41.540 Goodness of fit: 39.445		
Panel D: China results				
Intercept	?	-3.8430	1.9925	0.0538*
SIZE	+	-0.8182	0.3881	0.0350**
TANGIBLE	+	0.7818	0.4157	0.0598*
FINANCING	+	0.6096	0.3171	0.0545*
		Number of observations: 42 Log likelihood: 40.874 Goodness of fit: 39.586		

Note: * Significant at the 10% level.
 ** Significant at the 5% level.
 *** Significant at the 1% level.

11.4.2.3 New Zealand Companies

The results of the logistic regression analysis of the significance of corporate attributes for New Zealand firms are shown in Panel B of Table 11.8. The model is significant at the 1% level. It has an overall predictive accuracy of 81.36 percent, indicating a good fit for the model. In the logit model, both Industry and Size are statistically significant at the 10% and the 5% levels, respectively. These suggest that the industry type of the respondent firm and the size of the company are important variables in ITP auditing decisions for the New Zealand tax authority. Referring to the results of the *Chi-square* and the *Spearman's correlation coefficient tests* for individual variables, the results of logistic regression confirm that the size of the company is the most important variable in ITP auditing. Hence, it can be concluded that the influence of company size on tax audits is significant both directly and interactively. The

signs (+/-) of coefficients are positive. The results indicate that the IRD tended to focus its ITP tax audits on large-sized manufacturing firms.

11.4.2.4 Australian Companies

The results of the logistic regression analysis of the significance of corporate attributes for Australian firms are shown in Panel C of Table 11.8. The model is significant at the 1% level. It has an overall predictive accuracy of 77.78 percent, indicating a good fit for the model. In the logit model, the Size variable is statistically significant at the 1% level. Referring to the results of *Chi-square* and the *Spearman's correlation coefficient tests* for individual variables, the results of logistic regression confirm that the Size of the company is the most important variable in ITP auditing decisions of the Australian tax authority. Hence, it can be concluded that the influence of company size on tax audits is significant both directly and interactively. The sign (+/-) of the coefficient is positive, indicating that this variable is positively related to the dependent variable. The results indicate that the ATO tended to focus its ITP tax audits on large-sized firms.

11.4.2.5 Chinese Companies

The results of the logistic regression analysis of the significance of corporate attributes for Chinese firms are shown in Panel D of Table 11.8. The model is significant at the 1% level. It has an overall predictive accuracy of 78.57 percent, indicating a good fit for the model. In the logit model, Size is statistically significant at the 5% level, while both Tangible and Financing are statistically significant at the 10% level. Referring to the results of *Chi-square* and the *Spearman's correlation coefficient tests* for individual variables, the results of logistic regression confirm that the size of the company, the transfers of tangibles and financing are the most important variables in ITP auditing decisions by the Chinese tax authority. Hence, it can be concluded that the influences of these three variables on tax audits are significant both directly and interactively. The signs (+/-) of the coefficients are positive for Tangible and Financing, but negative for Size. The Size variable is, therefore, negatively related to the dependent variable. The results indicate that the Chinese tax authorities tended to focus their ITP tax audits on relatively small-sized firms with greater volume of intercompany transactions of tangibles and financing.

There is evidence that certain attributes of a company are more likely to be associated with ITP audits by the tax authorities (Jensen and Meckling, 1976, Chan and Chow, 1997, Atkinson and Tyrrall, 1999, Buckley and Hughes, 2001, Borkowski, 2001) The findings of

this survey provide further evidence that transfer pricing audits are associated with several types of corporate attributes in New Zealand, Australia and China.

The results of the survey suggest that transfer pricing tax audits are associated with certain corporate attributes. In interpreting the data, however, it is important to bear in mind that correlation does not automatically imply causation. The initiation of a tax audit on related party transactions, ultimately, depends on the extent of perceived tax risks associated with the affected company's transfer pricing practices.

11.5 Summary

This chapter reports on ITP tax audit practices in New Zealand, Australia and China. A number of companies used two or more ITP methods. The cost plus method is used predominantly in all industries. Japanese-based subsidiaries paid greater attention to the use of APAs.

Transfer pricing tax audits are associated with some types of corporate attributes. Overall, the influences of Nationality, Size and Financing on ITP audits are significant both directly and interactively. Hence, there is strong statistical support for the conclusion that tax authorities in New Zealand, Australia and China tended to focus their ITP tax audits on Japan or Hong Kong-based, large-sized subsidiaries, with greater volume of intercompany transactions in financing. Japan-owned subsidiaries are frequently audited by host countries' tax authorities around the world. Japanese companies might, therefore, employ APAs in order to defend their transfer pricing policies.

For New Zealand and Australia, the influence of company size on ITP audits is significant both directly and interactively. In the case of China, besides Size, two other variables, such as Tangible and Financing, are also significant on influences of tax audits both directly and interactively.

With these survey findings on ITP tax audits in mind, one further step was taken by looking at ITP issues from the perspective of the tax authorities. Four Chinese tax authorities were approached by personal contact, together with a further 38 Chinese tax authorities by means of a questionnaire. The next chapter reports on the results from these two investigations.

Chapter 12

Interview Results of International Transfer Pricing Tax Monitoring in China

12.1 Introduction

Chapter 8 provides a description of how the qualitative evidence from four Chinese tax authorities was obtained. The findings will be presented according to the order in which the interview questions were stated as set out in the interview questionnaire. Namely (1) What is the present extent of ITP abuse in China? (2) How do the Chinese tax authorities administer an ITP tax audit? (3) How adequate are the existing Chinese control measures? (4) What factors constrain the ITP monitoring system in China? and (5) How should the Chinese ITP monitoring system be improved? The purpose of this part of the study was to have an in-depth and on-site investigation of the Chinese ITP auditing system and practices and to investigate their effectiveness in restricting multinational transfer pricing manipulation in China.

Coupled with the presentation of the interview results, this chapter also presents the results of the questionnaire survey regarding Chinese ITP auditing practices, generated from 38 respondent tax authorities in China. The questionnaire consisted of five questions, of which four were closed. The survey allowed the qualitative evidence to be tested and to be generalised for the population. The following section describes the four research sites.

12.2 Taxation Administrative Units in the Study

The unit of analysis of these studies was four State Tax Bureaux (STB). Two of these were in a major coastal city with provincial status and two were in a medium-sized inland city, the capital city of its province. These two city locations are referred to as City A and City B.

Subject to the National SAT, City A's Municipal STB is responsible for tax investigation and collection. It supervises a large number of County STB and a few District STB, each of which selects FIEs to audit. In 2002, FIEs contributed about 21.8 percent of City A's total tax revenue. One, in particular, of these County STB, subject to the Municipal STB, has twelve departments, among which, its foreign tax department is responsible for transfer pricing audits throughout its area of the city.

In City B, the Inland Provincial STB, guided by goals established by the National SAT, is responsible for tax investigation and collection in the province. In the province in 2002, fifty-one FIEs that had business transactions with their associated enterprises were audited in the

province. As a result, the transfer prices of 36 FIEs were adjusted, resulting in an increase of taxable income by Renminbi 163.18 million. Eight FIEs were adjusted by adopting the comparable uncontrolled price method, two were adjusted by adopting the resale price method, seventeen were adjusted by adopting cost plus method, one was adjusted by adopting profit split method and eight were adjusted by adopting the deemed profit method.

These adjustments resulted in a total profit for nine FIEs for 2002, and this was sufficient to make up for the accumulated loss brought forward from the previous year, which, in turn, resulted in an increase of tax revenue by Renminbi 46.34 million.

In addition to the substantive responses by questionnaire from companies in New Zealand, Australia and China, and the responses secured by personal contact in China itself, the final group of responses elicited for the data collection consisted of tax officials in China, who were contacted by mail. As indicated in chapter 8, to overcome possible shortcomings arising from the data from other sources, and to permit the generalizability of the main findings from the interviews of the four tax authorities, a one page semi-structured questionnaire was sent to 80 Chinese tax authorities, representing a wide cross-section of the Chinese tax system. They included 26 provincial (municipal) tax bureaux and 54 city (district) tax bureaux located in the urban areas of China but only one of the six Autonomous Regions was selected for inclusion. Compared with the other areas of China, the Autonomous Regions attract few FDIs, Guangxi being the exception. ITP is therefore not considered a prominent issue for tax authorities in these regions. For the most part they have no officers in place specifically to deal with ITP.

12.3 What is the Current Extent of International Transfer Pricing Abuse in China?

Many FIEs are heavily engaged in transactions with overseas associates. A large number of FIEs have reported accounting losses (Chan and Chow, 1998). From the statistics of tax revenue, it appears that 35 percent to 40 percent of FIEs were in a loss-making position from 1988 to 1993. For 1994 and 1995, the percentage increased to between 50 percent and 60 percent. The percentage further increased to between 60 percent and 70 percent for 1996 (Cho, 1998).

The Chinese government suspects that transfer pricing has caused serious losses for tax revenue to the country. The foregoing data on losses may be taken as justification for that suspicion. In the interviews reported in this thesis, all the four tax authorities approached

expressed deep concern that FIEs were not actually paying their fair share of taxes in China. The tax officials justified their concern for the alleged transfer pricing abuse by citing the magnitude of accountable losses of taxable income relating to transfer pricing. Three out of four tax authorities considered that the issue of profit shifting through ITP manipulation in their province or city was significant. Their verbatim comments included the following:

We have noted that many FIEs report persistent losses but continue to expand their operations. Except for normal operating losses, a number of FIEs may engage in tax avoidance by transferring their profits abroad and reporting losses in China. FIEs rely highly on imported inputs including machinery and equipment, intermediate products and raw materials. Many FIEs have reported operating losses. Some of those FIEs may be engineering losses by importing materials and equipment into China from their overseas associates at a high price and exporting goods to their affiliated firms abroad at a low price. The issue of tax avoidance by transfer pricing is becoming all the more pressing as the number and types of cross-border transactions are expected to increase as the volume of MNEs doing business in China continues to grow¹⁴.

Many developing economies are so eager to attract foreign investment that they have little interest in ITP controls (Rahman and Scapens, 1986; Lin et al., 1993). China has long adopted a zone policy whereby preferential tax rates and tax incentives are available for FIEs that operate in the designated investment incentive cities and regions along the coast of China. As a result of the series preferential tax policies that have been adopted in their jurisdictions, FDIs are concentrated in the coastal provinces or cities.

The different tax treatment for FIEs causes some problems. For example, regional discrepancies at multiple levels in existing preferential tax policies hamper foreign investment in the development of inland, remote and poor areas. At the same time, it also triggers harmful competition between local governments by willfully formulating preferential policies, leading to unnecessary losses for the State.

ITP manipulation is not a significant practical concern to the tax authority in the inland city. The tax officers of the inland city tax authority explained the reasons for their lack of attention to ITP issues.

Compared to the coastal cities in China, ITP manipulation is not a serious concern to our tax authority. In the city, corporate income tax accounts form a relatively small proportion of total tax revenue. On average, corporate income taxes contributed only 16.7 percent of the total tax revenue in 2002. As an inland city, it is not easy to attract FDIs. The local government often attempts to provide an attractive investment environment for foreign investors and therefore is reluctant for the tax authority to adopt strict transfer pricing scrutiny for fear of inducing a flight of capital. In addition, from the government's viewpoint, the losses of corporate income taxes collected from FIEs can be more than compensated by a significant increase in FDI, because the

¹⁴ All quotes in italics are quotes from interviews.

increased foreign investment should produce significant increases in revenues from other more productive taxes such as VATs, consumption taxes and business taxes.

Another reason is that

most of the FIEs operating in the city are newly established and should still be covered by tax holiday and tax rate reduction periods. Income adjustments to related party transactions of these FIEs do not significantly affect the collection of tax revenue.

Although the inland city tax authority has not devoted much attention to ITP issues in the past, it has now started to challenge FIEs on the issue of ITP. The inland city tax authority has examiners who specialise in transfer pricing audits.

Although the auditing sector was erected in 1992, the government worries that the imposition of tight control practices might impede foreign investment in the city. For many years, our central objective was to attract foreign investments rather than to collect income tax revenue from FIEs. Not until very recently has our tax authority noted the ITP manipulation issue and taken steps to combat tax avoidance by transfer pricing abuses of FIEs in the city. At present, there are four tax officers who fully concentrate on ITP tax auditing in our tax authority.

Lall (1973) found that MNEs in Colombia over-priced their imports from 33 percent to over 300 percent in the pharmaceutical sector, and from 24 percent to 81 percent in the rubber and electrical industries. In the case of China, to shift profits made by a Chinese subsidiary to the home country of its parent company, the parent firm can use ITP manipulation in a simple form, such as deliberately overpricing imports sent by the parent company to its Chinese subsidiary, or intentionally undervaluing exports by the subsidiary to its parent firm. A tax officer interviewed describes the situation as follows:

It is often the case that an overseas parent company controls the purchases and sales of products of an FIE that operates in China. On the one hand, it intentionally inflates the price of equipment, raw materials and spare parts purchased and imported by the Chinese subsidiary. On the other hand, it suppresses the prices of finished products exported from China.

Besides cross-border transactions of goods or services, tax avoidance through the ‘thin capitalisation’ of Chinese subsidiaries of MNEs is also involved.

Foreign investors sometimes do not invest sufficient capital in their Chinese subsidiaries. The capital needed for operations has to be borrowed from parent companies abroad at high interest rates. As a result, the FIEs’ interest expenses are increased.

ITP abuses have severely harmed the economies of countries where MNEs operate, especially in developing countries that have poorly equipped legal systems and lack professional expertise, in comparison with developed countries, to thwart the attempts of MNEs to manipulate transfer pricing (Plasschaert, 1985). Lin et al (1993) indicated the costs of ITP manipulation to the host countries to be: (1) tax losses; (2) difficulty in auditing and evaluating firms; (3) monopolised markets; (4) difficulty in entering the international market; (5) worsening the foreign exchange situation. The interviewees admitted that ‘tax losses’ were the major concern of ITP manipulation. Other important concerns were that ITP abuses “increase the risk for credits and lenders”, “generate a negative impact on the balance of foreign exchange”, “worsen balance of trade” and “cause an unfair advantage of FIEs over domestic competitors”.

12.4 How do the Chinese Tax Authorities Administer an International Transfer Pricing Tax Audit?

12.4.1 The International Transfer Pricing Tax Auditing Procedures

The current Chinese transfer pricing regulations are used to govern the administration of tax audits to be conducted by tax authorities on related party transactions. The rules set out detailed procedures on how to carry out transfer pricing audits. In general, the tax audit procedures and approaches are classified as follows.

12.4.1.1 Identification of Related Party Transactions

Circular 59 classifies four major categories of reportable transactions with associated enterprises:

- purchases and sales, transfers and use of tangible assets including buildings, transportation vehicles, machinery and equipment, tools and merchandise (products);
- transfers and use of intangible assets, including land use rights, copyright, trademarks, brands, patents, proprietary technologies, industrial property rights and the provision of services relating to such transfers or right to use;
- financing, including short-term and long-term loans and guarantees, sales of securities, and all kinds of interest bearing prepayments and deferred payments; and
- provision of services, including provision of market research, marketing, management, administration, technical services, repairs, design, consulting, agency, research and development, legal and accounting services.

The tax auditors are required to record the details of these transactions on seven standardised forms which are then acknowledged and signed by the taxpayers.

12.4.1.2 Office (Desk) Auditing

On selecting the target, tax authorities will first start with office (desk) auditing and reviewing work papers, including all information provided by taxpayers. Attention will be given to (1) profit levels, return on assets or operating margins; (2) completeness of sales revenue; (3) reasonableness of costs and expenses; (4) reasonableness of interest rates; and (5) transfer prices of intangible property.

12.4.1.3 Field Auditing

Following the office audit, a field audit will be conducted, if its desirability is indicated. A designated tax team will visit the company and conduct an on-the-spot inspection. The field inspection will include the factory, warehouses, accounting books and records, vouchers, contracts and other related documents, and involves interviews with key personnel. In China, the efficiency of tax audits was constrained by both the lack of internal staff resources and the lack of a sound institutional framework to deal with the issue. Sophisticated techniques – for example, the functional and economic analyses of the relevant entities and transactions – which have been adopted widely by many developed nations to determine both the source of income (or loss) and the arm's length allocation, have been rarely used by Chinese tax authorities.

12.4.1.4 Transfer Pricing Tax Assessment

If the auditors are sure that the related party transactions were not conducted in an arm's-length manner, the tax authorities will adjust the FIE's taxable income using one of a range of methods, including the comparable uncontrolled price method; the resale price method; the cost plus mark-up method; the comparable profit method; profit split method; and transactional net margin method. Of the various methods, resale price and cost-plus tend to be used most often.

Generally, the statute of limitation for transfer pricing audits and adjustment is three years. In the case of adjustments made for previous years, the statute of limitation could be up to ten years (Article 37 of State Administration of Taxation Circular [1998] No. 59). If the taxpayer does not agree with the transfer pricing adjustments made by the tax authority, he can provide additional supporting documentation. Tax authorities may re-evaluate adjustments and consult

further with the taxpayer. On approval from the competent tax authority, a notice of payment for transfer pricing adjustment will be issued.

12.4.1.5 Penalties

The transfer pricing adjustments made can be punitive. Besides paying tax on the increased taxable income arising from a transfer pricing adjustment, if the enterprise does not also adjust its accounting books to reflect a receivable from the related party for the excess price/fee charged, the amount of the adjustment will also be treated as a deemed dividend. This deemed dividend, if deemed paid to a foreign party, will be subject to a 20 percent withholding tax. The withholding rate may be reduced under a tax treaty, depending on the definition of dividends in the particular treaty. For any adjustments made on a royalty or interests that have been paid to the foreign party and that have already been subject to withholding tax, no refunds on withholding tax previously paid will be granted (Article 10 of State Administration of Taxation circular [1992] No. 237, Oct. 1992). A late payment charge (0.2 percent daily) applies where a taxpayer fails to make a payment according to the due date set by the tax authorities on an amount resulting from a transfer pricing adjustment.

12.4.2 Circumstances under which Tax Authorities Initiate Audits

As a check for compliance with the arm's length pricing principle for related party transactions, the Chinese transfer pricing rules not only provide for the circumstances under which high-risk FIEs can be identified but also require the Chinese tax authorities to audit at least 30 percent of the enterprises on the target list. These circumstances include the following:

1. Production and operational decisions controlled by associated enterprises;
2. Large transaction amounts with associated enterprises
3. Long periods of losses – for more than two consecutive years;
4. Lower profits or losses for an extended period, but a continuously expanding scale of operations;
5. Fluctuating profit patterns, with frequent interchanging of profits and losses;
6. Transactions with associated enterprises established in tax havens;
7. Lower profitability than enterprises in the same industry;
8. Lower profit margins than other group companies;
9. Unreasonable expenses paid to associated enterprises; and
10. A sudden and significant drop in profits after a preferential tax treatment period, such as the expiration of a tax holiday period.

The interviewees were asked to express their relative concern about ITP abuses by FIEs under the above listed circumstances. 'FIEs whose production and operational decisions are controlled by associated enterprises' was commonly considered as their most significant concern. They also reported that

In addition, we also pay great attention to those FIEs whose supply of raw materials and sales of finished products are controlled by their overseas parent companies. These transactions may trigger transfer pricing audits when we consider that purchases are overpriced or sales underpriced and, because of the particular concern of pricing abuse in the area of intercompany transfers of tangible goods and properties, we are devoting increasing resources to auditing such sorts of transactions.

Other important concerns expressed included 'FIEs that have losses, but continuously expand the scale of their operations', 'FIEs with a fluctuating pattern of profits or losses, that is, FIEs that have a profit or loss every other year or in an irregular pattern' and 'FIEs with transactions with associated enterprises established in tax havens'. In conclusion, FIEs which are controlled by associated enterprises and consistently report substantial losses are particularly vulnerable to transfer pricing audits by tax authorities. In addition, FIEs continually reporting profit and losses fluctuations from year to year and those transacting with related enterprises in tax havens are also vulnerable to transfer pricing audits.

Based on the results of the interviews, a questionnaire was sent to 80 Chinese tax authorities to check how concerned they were about ITP abuse by each of the ten types of FIEs, with their related party transactions. The underlying assumption is that tax officers will intensify their scrutiny of those firms they suspect of ITP manipulation. Thirty-eight returns were obtained. The results from the 38 respondent tax authorities from this survey are shown in Table 12.1.

It can be seen that 'production and operational decisions are controlled by associated enterprises' was indicated by the respondents as the most significant concern for possible ITP abuses. Other significant concerns included 'lower profits or losses for an extended period, but continuously expands the scale of its operations', 'sudden and significant drop in profits after a preferential tax treatment period, such as the expiration of a tax holiday period', 'transactions with associated enterprises established in tax havens' and 'lower profitability than enterprises in the same industry'.

Table 12.1

Concerns about ITP Abuses Cited by Tax Authorities According to the Types of Firm

Types of Firms	Means	SD
VAR 1 Production and operational decisions are controlled by associated enterprises	4.68	0.525
VAR 4 Lower profits or losses for an extended period, but continuously expands the scale of its operations	4.53	0.603
VAR 10 Sudden and significant drop in profits after a preferential tax treatment period, such as the expiration of a tax holiday period	4.42	0.683
VAR 6 Transactions with associated enterprises established in tax havens	4.34	0.815
VAR 7 Lower profitability than enterprises in the same industry	4.34	2.507
VAR 2 Large transaction amounts with associated enterprises	4.32	0.525
VAR 9 Unreasonable expenses paid to associated enterprises	4.16	0.973
VAR 3 Long periods of losses (more than two consecutive years)	4.08	0.673
VAR 5 Fluctuating profit patters (with frequent interchanging of profits and losses)	3.97	0.716
VAR 8 Lower profit margins than other group companies	3.79	0.741

Note: The mean for each variable was based on a scale from 1 = very possible, to 5 = impossible. For an easier understanding, the original Likert-like code was reversed to 1 = impossible, to 5 = very possible, high means indicating a greater concern for ITP abuses. The standard deviation measures the volatility of a variable: the higher the standard deviation, the more volatile the variables.

Three variables were indicated as being of relatively greater concern by the respondent tax authorities. They are ‘large transaction amounts with associated enterprises’, ‘unreasonable expenses paid to associated enterprises’ and ‘long periods of losses-more than two consecutive years’. Variables that were of moderate concern included ‘fluctuating profit patterns, with frequent interchanging of profits and losses’ and ‘lower profit margins than other group companies’.

12.4.3 Related Party Transactions Investigated

FIEs typically engage in a wide range of related party transactions with overseas associates. Circular 59 classifies four major categories of reportable transactions with associated enterprises as follows.

1. purchases and sales, transfers and use of tangible assets;
2. transfers and use of intangible assets;
3. financing; and
4. provision of services. These transactions can be detailed as follows:

12.4.3.1 Purchases and Sales, Transfers and Use of Tangible Assets

FIEs often rely on associated enterprises outside China for raw materials, machines and

equipment, and sale of finished products to overseas affiliates. These sorts of transactions typically trigger transfer pricing examination when purchases are overpriced and sales underpriced, or leasing fees for equipment are excessive (Sun, 1999).

12.4.3.2 Transfers and Use of Intangible Assets

Transfer pricing of the use of intangible property includes patents and know-how owned by a foreign associated enterprise but licensed to an FIE in China for production or operational purposes. If the royalties and other payments for the transfer of intellectual property rights charged by an associated enterprise are not at arm's length, the tax authorities may adjust the amount of royalties claimed by the FIE for tax purposes (Sun, 1999).

12.4.3.3 Financing Transactions

Transfer pricing usually comes into consideration when the interest rate used by an FIE in such transactions is higher or lower than the normal interest rate for similar transactions. If an FIE borrows funds from a related party and is charged an excessive interest rate on the loan, transfer pricing would be triggered (Sun, 1999).

12.4.3.4 Provision of Services

Generally, when an FIE provides services to associated enterprises free of charge or with unreasonably low fees, or when an FIE pays excessive fees for services provided by associated enterprises, the Chinese tax authorities are likely to use fees for similar services provided by independent parties as the basis for an arm's length price (Sun, 1999).

The interviewees were asked to express their relative concern about ITP abuses of FIEs via the four types of transactions. A typical response was that "one of the most common forms of ITP abuses in China is when an FIE makes excessive payments to its overseas affiliates for importing of materials or equipment, and when the same FIE underprices its sales or exports of finished products to the overseas associates."

For that reason 'purchases and sales, transfers and use of tangible goods' was chosen as their most significant concern. Consequently, tax authorities would generally select transactions with the following features as targets for investigation, as quoted by the respondents:

1. Where machinery and equipment is provided to the FIE by its foreign affiliates;
2. Where the FIE's raw materials are supplied by its foreign affiliates; and
3. Where the FIE's products are sold to its foreign affiliates.

A questionnaire was sent to 80 Chinese tax authorities to check how concerned they were about ITP abuse by each of the four types of FIEs, with their related party transactions. The underlying assumption is that tax officers will intensify their scrutiny of those firms they suspect of ITP manipulation. The results from the 38 respondent tax authorities are shown in Table 12.2.

Table 12.2
Concerns about ITP Abuses Cited by
Tax Authorities According to the Type of Transaction between Related Parties

International transfers	Mean	Standard Deviation
Tangible goods	4.68	0.620
Intangibles	4.24	0.820
Financing	3.92	0.941
Services	3.82	1.062

Note: the mean for each variable was based on a scale from 1 = very possible, to 5 = impossible. For an easier understanding, the original Likert-like code was reversed to 1 = impossible, to 5 = very possible, high means indicating a greater concern for ITP abuses. The standard deviation measures the volatility of a variable: the higher the standard deviation, the more volatile the variables.

It can be observed that ‘the transfer of tangible goods’ and ‘the transfer of intangibles’ were cited by the respondents as being of great concern for potential ITP abuse, whereas ‘the transfer of financing’ and ‘the transfer of services’ were cited by the respondents as being of moderate concern for potential ITP abuse. This result is consistent with Chan and Chow (1997a, 2001) who found that, predominantly, tax audits (95 percent) were concerned with the buying and selling of goods and materials. Since financing through inter-group loans is not a common practice in FIEs, and thin capitalisation is unlikely to be a substitute mechanism for shifting profits out of China, ‘the transfer of financing’ is not a significant concern of tax authorities for ITP abuse in China.

12.4.4 Industry and Size of Targeted FIEs for Transfer Pricing Examination

Chan and Chow (1997a) detected income shifting behaviour of FIEs in certain industries, such as the manufacture of audio/video equipment, garments, and plastics raw materials/products. Chan and Chow (1997b) also found that, in 1992-1993, tax audits on transfer pricing were confined mainly to medium- and small-sized foreign investments.

The interview results confirm Chan and Chow’s finding. The four tax authorities focused their tax audit efforts on relatively small-sized FIEs in the electronic and telecommunications equipment, garment, plastics and other re-processing industries. The tax officials explained the reason as that

we are required to audit at least 30 percent of the high-risk enterprises identified on the target list. Audits of large FIEs require sophisticated techniques and are time consuming. At present, our tax authority lacks sufficient staff resources and experience to tackle large FIEs for transfer pricing issues although we believe that the problem of transfer pricing is more serious in large companies.

In addition,

a major goal for the local government is attracting foreign investment, particularly from large-sized multinational companies and for hi-tech projects. Excessively strict transfer pricing scrutiny may induce a flight of capital.

Under China's FIE income tax law, the corporate tax rate is 30 percent plus a 3 percent local tax on that sum, amounting to a 33 percent total tax rate. In order to attract more foreign investment, a package of special preferential tax treatments has been granted to FIEs based in designated cities and regions. These treatments include:

- (1) A preferential income tax rate of 15 percent granted to FIEs based in designed zones, including Special Economic Zones, Economic and Technology Development Zones, High-technology Development Zones and the Pudong New Development Zones in Shanghai;
- (2) A preferential rate of 24 percent offered to industrial FIEs based in Coastal Open Economic Zones and Cities, or in Old Urban Districts where Special Economic Zones and Economic and Technology Development Zones are located.

Due to these preferential tax policies, FIEs operating in different places may be subject to different tax rates. This has some tax planning implications for FIEs. For instance, an FIE located in an interior city can shift profits to its associates that operate in a coastal city where tax concessions are offered. Out of concern for the multinational tax avoidance issue due to income tax rate differentials between different regions in China, the Inland Province STB does not confine itself only to the evaluation of cross-border transactions. Related transactions conducted between associated enterprises within China are also targeted for transfer pricing examination.

12.4.5 Transfer Pricing Methods Enforced by Tax Authorities

Article 13 of the Chinese Tax Law provides that "the payment or receipt of charges or fees in business transactions between an enterprise with foreign investment, or an establishment, or a place set up in China by a foreign enterprise to engage in production or business operations, and its associated enterprises, shall be made in the same manner as the payment or receipt of

charges or fees in business transactions between independent enterprises. Where the payment or receipt of charges or fees is not made in the same manner as in business transactions between independent enterprises and results in a reduction of the taxable income, the tax authorities shall have the right to make a reasonable adjustment”.

Article 54 of the Tax Law stipulates that if the buying and selling between an enterprise and its associated enterprise are not priced at arm’s length, the tax authorities may adopt an appropriate method to make adjustments. Pricing methods include the comparable uncontrolled price method, cost plus and the resale price method. Owing to the lack of reliable public data in China, the tax authorities, in reality, also consider ‘other methods’ to include price transactions as appropriate methods. These are ‘profit-base’ methods such as the comparable profit method, profit split method, transactional net margin method, and deemed profit method.

The participants were asked to select one or more pricing method normally used in income adjustment. It appears that the cost plus method and the deemed profit method are most frequently used by the tax authorities during transfer pricing tax audits. The cost plus method involves the cost plus reasonable expenses and profit margin, as quoted.

In application of the cost plus method, we generally use the cost of the product for both accounting and income tax purposes and apply a reasonable deemed profit margin to arrive at an arm’s length price.

The reason given for the use of the cost plus method as a favourite pricing was that “it is simpler to administer and it is understandable. In addition, the data in using that pricing method are more readily available”. An important aspect of the cost plus method is to decide the appropriate mark-ups. In cases where it is difficult to decide mark-ups among comparable enterprises or where there are differences that materially affect the cost plus mark-ups earned in the controlled and uncontrolled transactions, ‘bargaining’ usually arises between the tax authorities and the taxpayers to negotiate a mutually acceptable pricing.

The deemed profit method is another popular method used by the tax authorities in the circumstances under which the FIE could not provide complete and accurate information associated with costs and expenses and did not calculate taxable income correctly. No detailed guidelines are issued on the application of this method. Tax authorities assess the taxable income of related party transactions by adopting a comparable profit margin. In the absence of

comparable transactions, tax authorities consider the deemed profit method as an option. The comparable uncontrolled price method uses the market price for the transferred goods and services and is often thought of as the ‘best pricing method’. The comparable uncontrolled price method is not used as often as expected by the tax authorities because “the comparable uncontrolled transaction required by using the comparable uncontrolled price method is often difficult to locate or it is not available in the Chinese market at all”. The results on methods used from the 38 respondent tax authorities are shown in Table 12.3.

Table 12.3
Legal Oriented ITP Methods
Enforced by Tax Authorities for Buying and Selling Goods and Materials

Pricing Methods	# of tax authorities	Percentage
Cost plus method	32	28.1
Deemed profit method	24	21.1
Comparable uncontrolled price method	23	20.2
Resale price method	17	14.9
Comparable profit method	10	8.8
Profit split method	5	4.4
Transactional net margin method	2	1.8
Other methods**	1	.9
Total	114*	100

Note: * 12 tax authorities used more than one ITP method.
 ** Other method is the global formulary apportionment.

It can be seen that the method most commonly used in income adjustments is ‘cost plus method’, which was adopted by 32 (28.1 percent) tax authorities in the sample. Other popular methods used are ‘deemed profit method’, ‘the comparable uncontrolled price method’, ‘the resale price method’ and ‘the comparable profit method’, used, respectively, by, 24 (21.1 percent), 24 (20.2 percent), 17 (14.9 percent) and 10 (8.8 percent) of the tax authorities. The least widely used methods by the tax authorities in the sample include ‘profit split’, ‘transactional net margin method’ and ‘other methods’ such as the global formulary apportionment.

12.4.6 Advance Pricing Agreement

APAs can be unilateral, bilateral, or multilateral in nature. Chinese transfer pricing regulations do not contain formal APA procedures. However, as indicated in the Chinese transfer pricing regulations, APAs are acceptable avenues of negotiation with local state tax authorities. To receive an APA approval, a taxpayer is required to submit an “application form for determining APAs”. Taxpayers can negotiate APAs with provincial state tax authorities, and no approval from the SAT, the highest tax authority in China, is required. Of the four STB,

only the Inland Province STB has established APAs with two large-sized FIEs. FIEs appear uninterested in participating in APA programmes. The tax officers explained the reason as:

The size of some FIEs may be too small to warrant an APA; the APAs established are not as efficient as expected because we have no formal APA procedures to refer to; we are not experienced with APAs; it is time consuming, for instance, it often takes several months, at least, to establish an APA; An APA programme may place a strain on transfer pricing audit resources as the process of initiating and negotiating an APA would divert resources earmarked for other purposes to the APA program; An APA must be initiated by the taxpayers but FIEs are not willing to apply for and negotiate an APA with the tax authority; and finally, the SAT has not issued clear guidelines on how to apply for an APA and on what kind of information is required for this exercise.

At the time of writing (January 2004), the SAT is attempting to establish formal APA procedures. It is reasonable to predict that APAs will be used more often in the future in China.

12.4.7 Sources of Comparable Pricing Information

The shortage of comparable pricing information is the main concern for Chinese tax authorities in conducting transfer pricing audits and adjustments. One source of information is from the taxpayers. Taxpayers transacting with their foreign affiliates are obliged to provide information on their associated enterprises, the value and amount of transactions between the associated enterprises and the FIEs. The Chinese tax authorities accumulate the pricing information reported by taxpayers and have established a network to store and share the information nationwide. In addition, the pricing information may be acquired via searching the relevant internet sites or other media. Besides the pricing information collected internally, the tax authorities could also acquire pricing information through other authorities in China, including customs, industry and commerce, foreign trade and foreign exchange control authorities and embassies. Finally, routine information exchanges with competent foreign authorities may allow the Chinese tax authorities to access financial information from overseas affiliates of FIEs. China has signed income tax treaties with more than 60 countries. The SAT is responsible for coordinating the information enquiry with competent authorities. Through the SAT, the Chinese tax authorities can exchange information with competent authorities in tax treaty countries.

12.5 How Adequate are the Existing Chinese Control Measures?

The four tax authorities were asked to comment on the existing transfer pricing auditing systems. Three tax authorities considered their auditing systems to be “moderately effective”.

One tax authority was not satisfied with its auditing system and considered the auditing system to be “ineffective”. The tax authorities pointed out that the most common problem encountered in the implementation of their ITP tax audits was “the difficulty in obtaining relevant pricing information of FIEs with their related companies outside China”. Another problem was the difficulty in determining the pricing of intercompany transfer of intangibles (e.g., research and marketing). “The transfer of intangibles is particularly difficult for the arm’s length principle to deal with as finding useful comparable data is very hard. The measures of such transactions such as payments for intellectual property rights, know-how and other payments of a similar nature cause the most problem for us”. Also, the tax authorities faced a difficulty in determining inter-group services and in calculating the fees.

It is often difficult for us to find a comparable price for such services provided to an FIE by its parent company abroad. If we deem that the fees charged are not comparable to fees which are agreed to by arm's length enterprises, adjustments may be made, accordingly, for tax purposes.

12.6 What Factors Constrain the International Transfer Pricing Monitoring System in China?

12.6.1 Factors Constraining the International Transfer Pricing Monitoring System

Brean (1979), Lall (1979), and Plasschaert (1985) argued that developing countries are more vulnerable to transfer pricing manipulation because of their greater ignorance of ITP matters. Even when they had strong suspicions that transfer pricing were being abused, they might lack the information, expertise and staff to tackle the issue.

The researcher investigated practical difficulties encountered by the Chinese tax authorities in auditing the related party transactions of FIEs. The interviewees were asked what factors constrained the ITP monitoring system in China and which, therefore, ultimately hampered tax collection and administration work. The issues identified through interviews with tax officials of the four tax authorities are summarised as follows.

12.6.2 Lack of Information Exchange with Foreign Tax Authorities and Lack of an Appropriate Transfer Pricing Computerised Information System

FIEs often purchase raw materials and machines and equipment from associated enterprises outside China, and then sell finished products to them. The unavailability of pricing information of the overseas companies often gives rise to an ‘information gap’ which makes the monitoring of ITP difficult. In addition, there is no effective nationwide computerised

information-sharing network for tax administration so far. Information exchanges with overseas fiscal authorities may be an alternative for solving the problem.

In the interviews, the respondents indicated that only the SAT, the highest tax authority in China, was responsible for coordination and exchange with foreign tax authorities in respect of information about transfer pricing, although local tax authorities can pass their pricing enquiry to the SAT for assistance.

During the interviews, the most often cited issue for transfer pricing monitoring was ‘lack of information exchange with foreign tax authorities’. The interviewees explained that

due to the lack of information exchange with foreign fiscal authorities in respect of information about transfer pricing, we cannot access financial information about foreign companies. It is a major challenge for us to determine pricing and income adjustments in cases where the raw materials or machines are purchased or the products are sold overseas by FIEs.

12.6.3 Lack of Well-Defined Transfer Pricing Legislation and Regulations and Lack of a Sound Institutional Framework for Transfer Pricing Auditing

Over the past decade, the Chinese government has made great efforts to counter ITP abuse through developing increasingly complex transfer pricing regulations. Yet, compared with the transfer pricing regulations of developed economies, the Chinese transfer pricing legislation is considered rudimentary and still needs to become more sophisticated. The tax authorities lack enforcement power to deal with transfer pricing issues. The current Chinese transfer pricing rules neither introduce guidelines on appropriate documentation in order to assist taxpayers in managing the compliance requirements nor cover the pricing of intangible or services or cost sharing arrangements. Moreover, although there are general non-compliance penalty provisions in the tax law, there is no provision in the transfer pricing regulations to impose specific penalties on transfer pricing cases. The penalty against transfer pricing tax evasion is mainly restricted to a fine of a relatively insignificant amount¹⁵. Painless penalties can hardly be a sufficient deterrent against tax evasion, and violators have little incentive to stop this behaviour.

¹⁵ The Chinese transfer pricing regulations stipulate that an delay for an enterprise in filing the required returns on related party transactions has a penalty of up to a mere 10000 yuan (U.S. \$1200). This hardly amounts to a strong deterrent.

12.6.4 Lack of Well-Trained Personnel to Conduct Tax Auditing and Transfer Pricing Surveillance.

The inland city tax bureau lags behind its counterparts located in the coastal cities in terms of training and technical competence. “Compared with coastal tax authorities, our tax authority (i.e., the inland city tax authority) has relatively less ability to deal with transfer pricing manipulation issues by audit activity”.

12.6.5 Shortage of Adequate Resources

The inland city tax bureau was not adequately resourced for tax audits on transfer pricing.

It is only in recent years that a separate division has been set up to fully concentrate on tax audits on transfer pricing for our tax authority. With inadequate staff resources, our tax authority is deterred from undertaking large scale audits or from adopting sophisticated techniques in tax audits.

12.6.6 Lack of Expertise and Experience to Tackle Transfer Pricing Issues

Circular 59 requires an actual audit coverage of at least 30 percent of the identified audit targets for each year. However, due to a shortage of staff and the lack of operational funds, it is difficult for the tax authorities to achieve this coverage. Although the Chinese tax authorities have recently allocated more resources to transfer pricing audits and investigations, they still suffer from a shortage of trained personnel and lack of adequate data gathering and processing facilities. These problems are likely to continue to impede efforts to deal with the complex issue of transfer pricing in the country. The results regarding constraining factors from the 38 respondent tax authorities are shown in Table 12.4.

It can be seen that most of the respondent tax authorities – 35, or 20.7 percent – considered ‘lack of information exchange with foreign tax authorities’ as the biggest factor constraining the Chinese ITP monitoring system. This is followed, in order, by ‘lack of an appropriate transfer pricing computerised information system’, ‘lack technical competence’, ‘lack of well-defined transfer pricing legislation and regulations’, ‘insufficient staff resources’, ‘lack of a sound institutional framework of transfer pricing auditing’, ‘lack expertise and experience’ and ‘other’, ticked, respectively, by, 30 (17.8 percent), 24 (14.2 percent), 24 (14.2 percent), 21 (12.4 percent), 16 (9.5 percent), 14 (8.3 percent) and five (3.0 percent) of the tax authorities in the sample.

Table 12.4
Factors Constraining the ITP Monitoring System

Factors	Number	Percentage
Lack of information exchange with foreign tax authorities	35	20.7
Lack of an appropriate transfer pricing computerised information system	30	17.8
Lack technical competence	24	14.2
Lack of well-defined transfer pricing legislation and regulations	24	14.2
Insufficient staff resources	21	12.4
Lack of a sound institutional framework of transfer pricing auditing	16	9.5
Lack expertise and experience	14	8.3
Others	5	3.0

Note: most tax authorities ticked more than one factor.

12.7 How Should the Chinese ITP Monitoring System be Improved?

The interviewer invited the participants to make suggestions on how the Chinese ITP monitoring system could be improved. Their suggestions can be summarised as follows.

12.7.1 Information Exchange with Foreign Tax Authorities

China has signed income tax treaties with more than 60 countries around the world. The SAT is responsible for exchanging information with the competent authorities of tax treaty countries.

An international exchange network can be set up and routine information exchanges with foreign tax authorities should be conducted. Information exchanges would allow us to access financial information from foreign companies.

12.7.2 Establishment of an Appropriate Transfer Pricing Computerised Information, Administrative and Monitoring System

As the highest tax authority in China, “the SAT should establish, nation-wide, transfer pricing related software to facilitate the collection of comparable information”. At the time of writing, the SAT is installing a transfer pricing related software. This national computer system can facilitate the ability of Chinese tax authorities at different levels to share pricing information.

12.7.3 Improving Technical Competence of Tax Officials

The Chinese tax authorities should provide training for tax officials on transfer pricing. Since 1991, China has been sending delegations of tax authorities to the Netherlands, Japan and the U.S. for training on transfer pricing. In addition, “the SAT has organised several transfer pricing training seminars for training tax officers from local tax authorities”. Components of

study include the OECD approach to transfer pricing, a functional and risk analysis, the identification of comparable transactions and comparable unrelated entities, and an evaluation of various transfer pricing methods. Transfer pricing specialist teams should be set up by all provincial level tax authorities. The transfer pricing specialist teams shall collaborate with other authorities in China to strengthen their transfer pricing audit capabilities.

China is a latecomer to the ITP field. Compared with the transfer pricing regulations of developed economies, the Chinese transfer pricing legislation is considered rudimentary. In China, the efficiency of tax audits is constrained by both internal staff resource shortages and the lack of a sound institutional framework to deal with the issue. On the improvement of the Chinese ITP monitoring system, some comments from an open question in the questionnaire survey to the provincial and city tax authorities are quoted as follows:

- *Tax examiners are often frustrated in their attempts to gather evidence of transfer pricing abuses. The exchange of tax information with domestic and overseas counterparts may allow them to obtain the necessary information in combating international tax evasion and avoidance.*
- *An international exchange network can be set up and routine information exchanges with foreign tax authorities should be conducted. To strengthen the enforcement of transfer pricing examinations, tax authorities should enhance cooperation with other authorities such as customs, industrial and commercial departments.*
- *One way to perform transfer pricing audits more efficiently is to establish internal databases to be available to the various levels of tax authorities by way of computer networks.*
- *Since no serious punishment is imposed on ITP abuse, even when we succeed in challenging a related party transaction, it will normally be worthwhile for an FIE to 'try it on'. To strengthen the enforcement of transfer pricing examinations, it is imperative to introduce specific transfer pricing penalties in the tax law. The current low penalty law must be changed to give violators real financial consequences if they fail to comply.*

In future, transfer pricing audits will become more rigorous as the Chinese tax authorities have been strengthening their administrative ability in tax collection, by using a greater degree of computerisation in tax administration, the establishment of a rigorous tax inspection system and formalised tax legislation procedures for dealing with transfer pricing manipulation. The comments from a tax officer of the SAT reflect the general points of most Chinese tax officers:

China is a developing country. Tax administration governing transfer pricing is in its infancy. We lack experience. What we must do now is to improve our tax laws, train our tax personnel, strengthen international co-operation, learn from international experience and carry forward our endeavours actively according to the Chinese circumstances (Cho, 1998, pp.99).

As the volume of FIEs doing business in China continues to grow, and the Chinese government continues to draw on the experience of the developed economies in enforcing its own transfer pricing rules, it can be anticipated that the tax authorities in China will intensify their investigations of related party transactions over time to prevent the loss of future income. FIEs need to prepare now, more than ever, to support their transfer pricing tax positions when managing their financial affairs involving substantial dealings with associated enterprises.

12.8 Summary

This chapter reports on the interview and survey results conducted with Chinese tax authorities. The next chapter will summarise the study results and present conclusions drawn from findings of this research. Policy implications and limitations of this study will also be presented.

Chapter 13

Conclusions, Limitations and Suggestions for Future Research

13.1 Introduction

This chapter presents conclusions drawn from the findings of this study. Policy implications of the findings for ITP theory and practices will be discussed. Finally, this chapter will also present limitations and suggestions for future research.

13.2 Conclusions and Policy Implications

13.2.1 Conclusions

The objectives of this study are four-fold. First, it investigates the similarities and differences in ITP practices by MNEs in New Zealand, Australia, and China. Second, it ascertains whether an ITP tax audit is an important concern of MNEs in formulating their ITP policies. Third, it identifies the characteristics of MNEs that make them more vulnerable to ITP tax audits. Fourth, it examines the ITP monitoring system in China.

The results of this study reveal statistically significant differences between the transfer pricing methods used by Chinese companies and their New Zealand and Australian counterparts. 65.9 percent of Chinese firms use market-based methods while only 43.2 percent and 39 percent of the New Zealand and Australian respondent firms respectively use market-based methods. Compared with their New Zealand and Australian counterparts, Chinese companies tend to use market-based methods. The findings of this study are consistent with Chan and Chow's studies (1998, 2001) who found that Chinese companies tended to use market-oriented methods. In their studies, 38 or 59 percent of Chinese subsidiaries used market-based methods, whereas 26 or 41 percent of Chinese subsidiaries adopted cost-based methods. With regard to the use of individual transfer pricing methods, 'full plus fixed profit' is widely used by both the New Zealand and Australian respondent companies, while Chinese firms prefer to use 'full market price' and 'negotiation based on costs'.

Statistically significant differences are also found between the two sets of companies regarding the degree of emphasis they place on environmental factors affecting their ITP policies. In this study, a number of environmental factors are virtually introduced by government policies,

especially those in developing countries. They include customs duties, restrictions on repatriation of income, import restrictions, foreign currency exchange controls, price controls of host government, political and social pressure, and royalty restrictions. The Chinese companies place more emphasis on almost all the 17 environmental variables than the New Zealand and Australian firms. The Chinese companies engage in a relatively wider range of intercompany transactions, and business operations in China are subject to more economic, political and social risks, owing to the particular vagaries of the Chinese business environment (Chan & Chow, 1998). Hence, the incentives and motives driving transfer pricing manoeuvres are stronger for the Chinese firms than for the New Zealand and Australian companies. These results support previous studies which argued that developing countries typically impose more restrictions on MNCs than developed countries, and thus government policies and regulations had encouraged MNEs to engage in ITP manipulation more often in developing countries than in developed countries (Lall, 1973, Plasschaert, 1985, Al-Eryani et al., 1990).

For New Zealand and Australia, the scores of 16 environmental variables are not significant. A difference is recorded in the case of the ranking of one variable, ‘restrictions on repatriation of income’. In contrast, for New Zealand and China, on the one hand, and Australia and China, on the other, there are significant differences in the case of 15 environmental variables. Only two variables, ‘comply with tax law and regulations’ and ‘tax authority transfer pricing audits’ are shown to have no significant differences. Therefore, it can be concluded that the New Zealand and Australian companies share a high level of agreement on the relative importance of the environmental variables, while significantly different values are placed on the same variables by the Chinese firms.

In this study, a conjecture was made that multinational transfer pricing practices in New Zealand and Australia would be similar as the multinationals in these two countries take similar environmental factors into consideration, but different ones from those of their Chinese counterparts. To verify the validity of this conjecture, eight hypotheses were developed. Table 13.1 summarises the results of the hypotheses testing. The results are classified as “accepted” or “rejected”. The results shown in Table 13.1 support the conjecture that different transfer pricing systems and strategies would be employed within the context of the different social, economic and legal environments of nations.

Table 13.1
Results of Hypothesis Testing

Hypothesis	Test results
Hypothesis 0a: There are no differences in ITP methods used by multinationals in New Zealand, Australia and China	Rejected
Hypothesis 0b: There are no differences in ITP methods used by multinationals in New Zealand and Australia	Accepted
Hypothesis 0c: There are no differences in ITP methods used by multinationals in New Zealand and China	Rejected
Hypothesis 0d: There are no differences in ITP methods used by multinationals in Australia and China	Rejected
Hypothesis 0e: There are no differences in the rating of factors affecting ITP in New Zealand, Australia and China	Rejected
Hypothesis 0f: There are no differences in the rating of factors affecting ITP in New Zealand and Australia	Accepted
Hypothesis 0g: There are no differences in the rating of factors affecting ITP in New Zealand and China	Rejected
Hypothesis 0h: There are no differences in the rating of factors affecting ITP in Australia and China	Rejected

With regard to the relative importance of the 17 environmental variables in each country, the variable 'tax authority transfer pricing auditing' is ranked only 13th by the Chinese respondents but fifth by both the New Zealand and Australian respondents. In other words, the tax authority transfer pricing audit is an important concern in transfer pricing decisions for New Zealand and Australian companies. In contrast, it was relatively unimportant to the Chinese firms. This is perhaps because the New Zealand and Australian tax authorities are more aggressive than their Chinese counterparts in administering and enforcing their transfer pricing rules. In comparison with China, therefore, ITP practices are more strictly constrained by the transfer pricing audits of New Zealand and Australian tax authorities. The global transfer pricing survey by Ernst and Young (2004) reveals that both New Zealand and Australian taxpayers ran a high risk of transfer pricing audits but this risk was only of a modest order for Chinese taxpayers. The result of this study is consistent with Ernst and Young (2004).

This study hypothesised that a number of a company's corporate attributes were likely to trigger ITP audits by tax authorities. The test results support the hypothesis that there is a relationship between ITP tax audits and corporate characteristics. Overall, the influences of Nationality, Size and Financing on ITP audits are significant both directly and interactively. Therefore, there is robust statistical support for the conclusion that tax authorities in the three countries tend to focus their ITP tax audits on Japan or Hong Kong-based, large-sized subsidiaries, with greater volumes of intercompany transactions in financing.

For individual countries, while New Zealand and Australian tax authorities tend to audit large-sized firms, the Chinese tax authority tend to focus their ITP tax audits on relatively small-sized firms. Jensen and Meckling (1976) contended that larger companies encountered more government scrutiny. This survey shows that the IRD and the ATO tend to audit large-sized multinationals. Large firms in non-competitive environments, whose internal transfer prices are not readily compared with market prices, can maintain complex transfer pricing systems aimed, in part, at tax-avoidance. Small firms facing more competition, whose transfer prices the tax officers can readily check against market prices, do not have the opportunity to use such

manoeuvres to their tax advantage¹⁶ (Caves, 1996). Another explanation is that the tax authorities would spend more time and effort scrutinizing larger transactions to enhance their tax revenues. There are much more tax dollars at stake in a large company. For example, if transfer prices are adjusted by 10 percent on a \$1 million transaction, the result will not be as significant a tax change as if there were a 10 percent adjustment on a \$10 million transaction. The New Zealand and Australian tax authorities, therefore, focus their tax audit efforts on large firms that lack arm's length bases for setting transfer prices. However, as the audits of large companies require sophisticated techniques, Chinese tax authorities claim that they lack sufficient staff resources and experience to tackle large multinationals over transfer pricing issues. These findings are consistent with Chan and Chow (1997, 1998) who found that tax audits on transfer pricing were confined mainly to medium- and small-sized firms in China. They argued that an effective audit of large MNEs required a costly and sophisticated audit unit which Chinese tax authorities could not provide or afford.

Four Chinese tax authorities were interviewed to further investigate ITP tax auditing practices in China. The interview results showed that the Chinese tax authorities considered that the issue of profit shifting through ITP manipulations in the country was significant. 'The transfer of tangible goods' and 'production and operational decisions are controlled by associated enterprises' were indicated by the respondent Chinese tax officials as of greatest concern for potential ITP abuses. The participants were asked to select one or more pricing methods normally used in income adjustment. The 'cost plus method' and the 'deemed profit method' were most frequently used by the tax authorities during transfer pricing tax audits. In this study, seven factors were also identified as constraining the Chinese ITP monitoring system. They are: 'lack of information exchange with foreign tax authorities', 'lack of an appropriate transfer pricing computerised information system', 'lack of technical competence', 'lack of well-defined transfer pricing legislation and regulations', 'insufficient staff resources', 'lack of well-defined institutional framework of transfer pricing auditing', and 'lack of expertise and experience'. The findings of this study partly support Brean (1979), Lall (1979), and Plasschaert (1985) who argued that tax authorities of developing economies have suffered from relative inexperience and insufficient resources. This made their economies more vulnerable to transfer pricing manipulation than those of developed countries.

¹⁶ Large firms have at least some monopoly control over the prices they charge. Small companies have little influence on market prices. They usually produce goods and sell them at market prices (Caves, 1996).

13.2.2 Policy Implications

A main requirement for doctoral research is to make an original contribution to knowledge. A PhD thesis can make a contribution to knowledge by “looking at areas that people in the discipline have not looked at before”. This study provides comprehensive statistical evidence about the ITP practices of both developing and developed economies. Specifically, this study investigated and compared multinational transfer pricing practices and tax audits in New Zealand, Australia and China. This has not been undertaken in the ITP literature before. In this study, the issue of ITP was examined from the perspectives of both the MNCs and the tax authorities. The combination of surveys of ITP practices and tax audits in developing and developed economies is both innovative and interesting. This study, therefore, provides a useful and original contribution to the understanding of transfer pricing theory and practices. The policy implications drawn from the findings of this study can be presented as follows.

MNEs use a large variety of pricing methods to deal with intercompany transfers crossing international boundaries. Contingency theory can be employed to explain a firm’s choice of transfer pricing method. The contingency theory approach states that companies choose the ITP systems that are perceived as optimal for their particular situation. (Borkowski, 1980).

In this study, the transfer pricing methods actually employed are systematically compared between the three Asia-Pacific economies involved to clarify the reality of what occurs in practice. The findings of the study indicate that the transfer pricing systems used differ between New Zealand and Australia on the one hand, and China, on the other. The explanations for the variations discovered are subsequently explored in the course of examining policy determinants in the three countries in the study. The results of this research support the contingency theory approach, in which an MNE chooses the pricing method that best fits its needs in the operating environment (Borkowski, 1990). Researchers may, in future, develop different transfer pricing theories and concepts within the context of the different social, economic and legal environments of developing and developed nations.

The findings of this study have implications for managers of foreign-owned companies in formulating their transfer pricing policies in New Zealand, Australia and China. One of the motivations of the research was to derive some guidelines about managing transfer pricing that would be useful for practice. The empirical research has provided generalisable conclusions

regarding the environmental determinants of ITP policies in New Zealand, Australia and China. In this study, there are four commonly important variables affecting ITP policies in the three countries. They are 'comply with tax law and regulations', 'competitive position of the subsidiary', 'overall profit to multinational group' and 'corporate profit of the subsidiary'. These findings suggest that complying with tax law and regulations, while maintaining competitive position and maximizing consolidated and subsidiary profits, predominantly affect the ITP decision-making process in the three countries. MNEs operating in the three countries can explore how to tailor their ITP strategies to 'fit' the environmental contexts.

This research has significant implications for New Zealand, Australian and Chinese transfer pricing legislation. Tax authorities can develop regulations that better reflect the economic, social and political realities of cross-border transfers. In addition, in this study, seven factors are identified as constraining the Chinese transfer pricing monitoring system. Guided by the findings, the Chinese tax authorities can now make efforts to improve their transfer pricing monitoring system.

13. 3 Limitations and Suggestions for Future Research

There are some limitations for the current research. These limitations provide a number of opportunities for future research on ITP practices.

First, the survey sample is foreign-controlled subsidiaries. Subsidiary managers must typically make periodic reports on their activities to their parent companies, and their accounting and other rules and regulations also have to meet requirements in their home countries. Depending upon the degree of subsidiary autonomy (decentralisation), their activities and practices are more or less limited by their parent companies (Yunkers, 1983, Oyelere et al., 1999). Since the headquarters of multinational firms are located in one or more foreign nations, each of which has its own economic, social and political system, the inter-country interactions may have an effect on the research findings. A study by Arpan (1972) indicated that the nationality of the parent company affects the transfer pricing system used by MNEs and showed the importance given to the various factors in setting transfer prices. Only parent firms may be knowledgeable about group pricing policies. Selecting overseas parent companies with subsidiaries in New Zealand, Australia and China might be an option but it was an impossible task for this researcher because of the diverse geographic area, linguistic issues, the time and budget.

Second, this empirical study has been carried out through a questionnaire survey. The weaknesses of such an instrument may affect the findings of the study. Corporate internal pricing is an extremely sensitive and secretive area for all firms, especially for multinational firms. Decisions about transfer pricing and its relevant practices generally are viewed by management as highly important matters. Out of confidential consideration, the firms investigated might be reluctant to divulge information relating to their operations and strategy (Plasschaert, 1979). The quantitative analysis using aggregated data to analyse the combined respondents could not capture all aspects of the corporate pricing strategy as a questionnaire cannot delve into the survey questions in depth (Chan & Chow, 2001). For example, the questionnaire survey has provided rankings for multinational transfer pricing motives. But the uniqueness of each company's transfer pricing environment makes it unrealistic to expect these rankings to be universally applicable. Individual companies may have specific ITP policies. Because a questionnaire survey can only monitor general trends in factors affecting ITP, some particular environmental variables affecting ITP policies in some MNCs might not have been identified by the questionnaire survey. In addition, respondent bias and the superficiality of the survey instrument are potential problems¹⁷. Additional research could take the form of a field/case study into one or more companies to explore in detail their ITP policies and the variables affecting their pricing decisions. However, a case study has its own drawbacks. In a case study, only a limited number of sites can be studied because of time and cost constraints. Also, the evidence and results of a case study are highly dependent on the researcher. Both researcher bias and misinterpretation may prejudice case study results (Fisher, 1995).

Third, the survey results show that the variable - 'tax authority transfer pricing auditing' - was ranked only 13th by the Chinese respondents but fifth by both the New Zealand and Australian respondents. In addition, while New Zealand and Australian tax authorities tended to audit large-sized firms, the Chinese tax authority tended to focus their ITP tax audits on relatively small-sized firms. Brean (1979), Lall (1979), and Plasschaert (1985) argued that developing countries are more vulnerable to transfer pricing manipulations. This could be due to the fact that governments in developing countries generally lack institutional frameworks, information, expertise and staff to tackle the ITP issue. To further investigate ITP audit issues in China as the largest developing country in the world, the researcher conducted face-to-face interviews with

¹⁷ The response rate varied from one research setting to another. The response rate for the Chinese firms was only 10.81 percent. This may have caused some unknown bias in the data (Tang, 1981).

Chinese tax officials. Because of the constraints of the time and budget, the researcher failed to interview the New Zealand and Australian tax authorities. This limitation might impair part of the comparative nature of this study.

Fourth, the research results cannot be generalised to firms based in other developing or developed economies, because the study focused on New Zealand, Australia and China and their idiosyncratic cultural characteristics, respectively, and also because the different tax and tariff requirements are specific to each particular country in the world. Thus, the findings of this research must be considered within the context of this limitation. Future research could be undertaken to compare multinational ITP practices between other developed and developing economies.

13.4 Summary

ITP has long been a contentious issue between MNEs and tax authorities in host countries and it remains one of the most subtle and complex areas of international business management (Tang, 1979; Rugman & Eden, 1985; Borkowski, 1997b). Owing to the increase of cross-border activity, ITP is likely to continue to be a popular research topic in the future. The current research has significant implications for ITP theory, and provides useful insights into ITP practices and audits across New Zealand, Australia and China, providing MNEs and other businesses, which already operate or intend to operate between these three markets, with better guidance for complying with the transfer pricing regulations of the three Asia-Pacific national economic regimes. This research, however, was not without limitations. The limitations of the study led to a number of suggested areas for future research.

Part E

Appendices and Bibliography

APPENDIX A

Cover Letter for NEW ZEALAND Companies

23 April, 2003

SURVEY OF INTERNATIONAL TRANSFER PRICES

We would like to invite you to take part in our survey of international transfer pricing practices of New Zealand companies. We would appreciate if you would complete the enclosed survey questionnaire and return it to us in the freepost envelope provided by Thursday 15 May 2003.

This survey is part of an authorised PhD research programme based at Lincoln University which observes the highest level of academic and professional integrity. The Institute of Chartered Accountants of New Zealand has provided funds for this research, which aims to enhance our understanding of how companies make international transfer pricing decisions and the conditions that influence such decisions. The results of the study should provide multinational companies with significant insights on international transfer pricing issues and practices in New Zealand.

In accordance with the highest principles and traditions of academic research, complete anonymity and confidentiality are guaranteed. A copy of the summary results from the survey will be provided to you if you request it.

If you have any questions regarding this research or concerns about the questionnaire, please do not hesitate to contact Jian Li by email at lij3@lincoln.ac.nz or by phone (03) 3253627. We are very grateful for your cooperation and thank you for your assistance.

Yours sincerely,

Jian Li

(This research is being carried out under the supervision of Dr Peter Oyelere and Professor Fawzi Laswad)

APPENDIX B

Survey Questionnaire for New Zealand Companies

TO THE RESPONDENT:

1. Your assistance is extremely important to us. Thank you for taking part in this survey.
2. Most of the questions may be answered by only ticking (✓) the appropriate box. All the information you give will remain completely anonymous and confidential.
3. We look forward to receiving your completed questionnaire in the **freepost** envelope provided by Thursday 15 May 2003 (**No stamp required**).

NOTES:

The following terms used in the survey questionnaire are explained below:

- **International transfer pricing** means the unit price assigned to goods or services transferred between your company and a related party outside New Zealand.
- **Your company** refers to your company and its operations in New Zealand (excluding your parent company, its other subsidiaries and/or operations outside New Zealand).
- **A related party** may be your parent company, other subsidiary, associate and foreign branch outside New Zealand.

SECTION I

General Information on Your Company and its Related Party Transactions

1. Which of the following best describes the primary industry of your company? (**please tick ONE only**).

Services	<input type="checkbox"/>	Manufacturing	<input type="checkbox"/>
Finance and Insurance	<input type="checkbox"/>	Construction	<input type="checkbox"/>
Mining	<input type="checkbox"/>	Electricity, Gas and Water Supply	<input type="checkbox"/>
Education	<input type="checkbox"/>	Agriculture, Forestry and Fishing	<input type="checkbox"/>
Transport & Storage	<input type="checkbox"/>	Wholesale Trade & Retail Trade	<input type="checkbox"/>
Other (please specify): _____			

2. In which country is your ultimate parent company located _____

3. What is the value of your company's total sales in 2002? (please give estimates if the exact figures are unknown or difficult to ascertain).

Less than NZ\$20 million	<input type="checkbox"/>	NZ\$201 million – NZ\$500 million	<input type="checkbox"/>
NZ\$20 million – NZ\$100 million	<input type="checkbox"/>	NZ\$501 million – NZ\$800 million	<input type="checkbox"/>
NZ\$101million – NZ\$200 million	<input type="checkbox"/>	More than NZ\$800 million	<input type="checkbox"/>

4. Please tick **every item** in the appropriate column to indicate the frequency of each of the following transfers (i.e. transfers of tangible goods, services, intangibles and financing) of your company with its related parties such as the parent company, other subsidiaries, associates and foreign branches outside New Zealand.

	Always	Often	Sometimes	Rarely	Never
Tangible goods	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Intangibles	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Financing	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Services	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

5. Of your company's total transfers of tangible goods, services, intangibles and financing in 2002, what proportion of its transfers is with its related parties outside New Zealand (please give estimates if the exact figures are unknown or difficult to ascertain)?

Less than 5%	<input type="checkbox"/>	51% to 70%	<input type="checkbox"/>
5% to 20%	<input type="checkbox"/>	71% to 85%	<input type="checkbox"/>
21% to 50%	<input type="checkbox"/>	More than 85%	<input type="checkbox"/>

6. Has your company been the subject of an international transfer pricing audit since 1998?

Yes ☐ No ☐

7. What is your company's status regarding advance pricing agreement (APA)? (please tick **ONE only**)

Have concluded an APA with the IRD	<input type="checkbox"/>
Are currently in negotiations with the IRD for an APA	<input type="checkbox"/>
Plan to apply for an APA with the IRD	<input type="checkbox"/>
Have no plans to apply with the IRD	<input type="checkbox"/>
Don't know	<input type="checkbox"/>

SECTION II

International Transfer Pricing Methods Used

8. Please tick **one or more** method (s) used by your company to price transfers of goods or services with its related parties outside New Zealand.

A. Cost-based price

- | | |
|-------------------------------------|--------------------------|
| 1) Full standard cost | <input type="checkbox"/> |
| 2) Full actual cost | <input type="checkbox"/> |
| 3) Full plus fixed profit | <input type="checkbox"/> |
| 4) Variable standard cost | <input type="checkbox"/> |
| 5) Variable actual cost | <input type="checkbox"/> |
| 6) Variable plus fixed contribution | <input type="checkbox"/> |

B. Market-based price

- | | |
|--------------------------|--------------------------|
| 7) Full market price | <input type="checkbox"/> |
| 8) Adjusted market price | <input type="checkbox"/> |

C. Negotiation-based price

- | | |
|---------------------------------------|--------------------------|
| 9) Negotiation based on market prices | <input type="checkbox"/> |
| 10) Negotiation based on costs | <input type="checkbox"/> |
| 11) Unrestricted negotiations | <input type="checkbox"/> |

D. Others (please specify)

- 12) _____

9. If you ticked more than one method above, which of one would you describe as the most often used? (select **ONE** only from the above methods by giving its number) _____

10. Listed below are the five pricing methods Section GD 13(7) of the Income Tax Act 1994 sets out for calculating an arms length consideration for setting international transfer prices.

Please tick **one or more** method (s) used in calculating/adjusting the value of transactions between your company and its related parties outside New Zealand.

- | | |
|--|--------------------------|
| ✓ Comparable uncontrolled price method | <input type="checkbox"/> |
| Resale price method | <input type="checkbox"/> |
| Cost plus method | <input type="checkbox"/> |
| Profit split method | <input type="checkbox"/> |
| Comparable profit methods | <input type="checkbox"/> |
| Other (please specify): | _____ |

Environmental Variables of International Transfer Pricing

11. This section presents a list of environmental variables that may influence the selection of international transfer pricing methods by multinational companies.

Please tick **every item** in the appropriate column to indicate your company's view of the importance of the item as it affects international transfer pricing method choice of your company.

Environmental variables	Extremely important ▼	Very important ▼	Important ▼	Slightly important ▼	Not important ▼
Differences in income tax rates	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Rates of custom duties	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Tax authority transfer pricing audits	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Comply with tax law and regulations	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Restrictions on repatriation of income	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Competitive position of your company	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Overall profit to multinational group	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Corporate profit of your company	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Import restrictions	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Foreign currency exchange controls	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Good relations with host government	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Price controls of host government	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Existence of local partner	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Performance evaluation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Political and social pressure	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Royalty restrictions	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Maintenance of cashflows	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Thank you for your cooperation in completing this questionnaire!



APPENDIX C

Cover Letter for New Zealand First Reminder

22 May, 2003

SURVEY OF INTERNATIONAL TRANSFER PRICES

On 23 April 2003, we sent you a questionnaire requesting your participation in a survey on international transfer pricing practices of multinational companies. If you have already completed and returned it, please disregard this reminder and accept our sincere thanks instead.

If you have not completed the questionnaire, please now find enclosed another copy. We would appreciate if you would complete the enclosed survey questionnaire and return it to us in the freepost envelope provided by Monday 16 June 2003.

This survey is part of an authorised PhD research programme based at Lincoln University which observes the highest level of academic and professional integrity. The research aims to enhance our understanding of how companies make international transfer pricing decisions and the conditions that influence such decisions. The results of the study should provide multinational companies with significant insights on international transfer pricing issues and practices in New Zealand. In accordance with the highest principles and traditions of academic research, complete anonymity and confidentiality are guaranteed. A copy of the summary results from the survey will be provided to you if you request it.

If you have any questions regarding this research or concerns about the questionnaire, please do not hesitate to contact us on (03) 3253627. We are very grateful for your cooperation and look forward to receiving the completed questionnaire.

Yours sincerely,

Jian Li



APPENDIX D

Cover Letter for New Zealand Second Reminder

18 June 2003

SURVEY OF INTERNATIONAL TRANSFER PRICES

On 23 April and 22 May, we sent you a questionnaire requesting your participation in a survey on international transfer pricing practices of New Zealand companies. If you have already completed and returned it, please disregard this reminder and accept our sincere thanks instead.

If you have not completed the questionnaire, please now find enclosed another copy. We would appreciate if you would complete the enclosed survey questionnaire and return it to us in the enclosed prepaid envelope provided.

However if you cannot return the questionnaire would you please tick any of the boxes below explaining your reason/s why and return this letter in the prepaid envelope provided. Please note that the deadline for responses has been extended to Friday 18 July 2003.

Reason	Tick if applicable
There are no international transfers to related firms	
The volume of international transfers to related firms is insignificant	
We have a standard firm policy of not responding to questionnaires	
The questionnaire is too sensitive to be answered	
I do not have time	
Other (please specify):	

Thank you for your time.

Jian Li



APPENDIX E

Cover Letter for Australian Companies

5 July, 2003

SURVEY OF INTERNATIONAL TRANSFER PRICES

We would like to invite you to take part in our survey of international transfer pricing practices of Australian companies. We would appreciate if you would complete the enclosed survey questionnaire and return it to us in the freepost envelope provided by Friday 25 July 2003.

This survey is part of an authorised PhD research programme based at Lincoln University which observes the highest level of academic and professional integrity. The Institute of Chartered Accountants of New Zealand has provided funds for this research, which aims to enhance our understanding of how companies make international transfer pricing decisions and the conditions that influence such decisions. The results of the study should provide multinational companies with significant insights on international transfer pricing issues and practices in Australia.

In accordance with the highest principles and traditions of academic research, complete anonymity and confidentiality are guaranteed. A copy of the summary results from the survey will be provided to you if you request it.

If you have any questions regarding this research or concerns about the questionnaire, please do not hesitate to contact Jian Li by email at lij3@lincoln.ac.nz or by phone (03) 3253627. We are very grateful for your cooperation and thank you for your assistance.

Yours sincerely,

Jian Li

(This research is being carried out under the supervision of Dr Peter Oyelere and Professor Fawzi Laswad)



APPENDIX F

Survey Questionnaire for Australian Companies

TO THE RESPONDENT:

1. Your assistance is extremely important to us. Thank you for taking part in this survey.
2. Most of the questions may be answered by only ticking (✓) the appropriate box. All the information you give will remain completely anonymous and confidential.
3. We look forward to receiving your completed questionnaire in the **freepost** envelope provided by Friday 25 May 2003 (**No stamp required**).

NOTES:

The following terms used in the survey questionnaire are explained below:

- **International transfer pricing** means the unit price assigned to goods or services transferred between your company and a related party outside Australia.
- **Your company** refers to your company and its operations in Australia (excluding your parent company, its other subsidiaries and/or operations outside Australia).
- **A related party** may be your parent company, other subsidiary, associate and foreign branch outside Australia.

SECTION I

General Information on Your Company and its Related Party Transactions

1. Which of the following best describes the primary industry of your company? (**please tick ONE only**).

Services	<input type="checkbox"/>	Manufacturing	<input type="checkbox"/>
Finance and Insurance	<input type="checkbox"/>	Construction	<input type="checkbox"/>
Mining	<input type="checkbox"/>	Electricity, Gas and Water Supply	<input type="checkbox"/>
Education	<input type="checkbox"/>	Agriculture, Forestry and Fishing	<input type="checkbox"/>
Transport & Storage	<input type="checkbox"/>	Wholesale Trade & Retail Trade	<input type="checkbox"/>
Other (please specify): _____			

2. In which country is your ultimate parent company located _____

3. Please tick **every item** in the appropriate column to indicate the frequency of each of the following transfers (i.e. transfers of tangible goods, services, intangibles and financing) of your company with its related parties such as the parent company, other subsidiaries, associates and foreign branches outside Australia.

	Always	Often	Sometimes	Rarely	Never
Tangible goods	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Intangibles	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Financing	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Services	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

4. Of your company’s total transfers of tangible goods, services, intangibles and financing in 2002, what proportion of its transfers is with its related parties outside Australia (please give estimates if the exact figures are unknown or difficult to ascertain)?

Less than 5%	<input type="checkbox"/>	51% to 70%	<input type="checkbox"/>
5% to 20%	<input type="checkbox"/>	71% to 85%	<input type="checkbox"/>
21% to 50%	<input type="checkbox"/>	More than 85%	<input type="checkbox"/>

5. Has your company been the subject of an international transfer pricing audit since 1998?

Yes ☐ No ☐

6. What is your company’s status regarding advance pricing agreement (APA)? (**please tick ONE only**)

- Have concluded an APA with the ATO ☐
- Are currently in negotiations with the ATO for an APA ☐
- Plan to apply for an APA with the ATO ☐
- Have no plans to apply with the ATO ☐
- Don’t know ☐

SECTION II

International Transfer Pricing Methods Used

7. Please tick **one or more** method (s) used by your company to price transfers of goods or services with its related parties outside Australia.

A. Cost-based price

- | | |
|-------------------------------------|--------------------------|
| 1) Full standard cost | <input type="checkbox"/> |
| 2) Full actual cost | <input type="checkbox"/> |
| 3) Full plus fixed profit | <input type="checkbox"/> |
| 4) Variable standard cost | <input type="checkbox"/> |
| 5) Variable actual cost | <input type="checkbox"/> |
| 6) Variable plus fixed contribution | <input type="checkbox"/> |

B. Market-based price

- | | |
|--------------------------|--------------------------|
| 7) Full market price | <input type="checkbox"/> |
| 8) Adjusted market price | <input type="checkbox"/> |

C. Negotiation-based price

- | | |
|---------------------------------------|--------------------------|
| 9) Negotiation based on market prices | <input type="checkbox"/> |
| 10) Negotiation based on costs | <input type="checkbox"/> |
| 11) Unrestricted negotiations | <input type="checkbox"/> |

D. Others (please specify)

- 12) _____

8. If you ticked more than one method above, which of one would you describe as the most often used? (select **ONE only** from the above methods by giving its number) _____

9. Listed below are the five pricing methods the ATO sets out for calculating an arms length consideration for setting international transfer prices.

Please tick **one or more** method (s) used in calculating/adjusting the value of transactions between your company and its related parties outside Australia.

- | | |
|--------------------------------------|--------------------------|
| Comparable uncontrolled price method | <input type="checkbox"/> |
| Resale price method | <input type="checkbox"/> |
| Cost plus method | <input type="checkbox"/> |
| Profit split method | <input type="checkbox"/> |
| Comparable profit methods | <input type="checkbox"/> |
| Other (please specify): | _____ |

Environmental Variables of International Transfer Pricing

10. This section presents a list of environmental variables that may influence the selection of international transfer pricing methods by multinational companies.

Please tick **every item** in the appropriate column to indicate your company's view of the importance of the item as it affects international transfer pricing method choice of your company.

Environmental variables	Extremely important ▼	Very important ▼	Important ▼	Slightly important ▼	Not important ▼
Differences in income tax rates	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Rates of custom duties	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Tax authority transfer pricing audits	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Comply with tax law and regulations	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Restrictions on repatriation of income	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Competitive position of your company	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Overall profit to multinational group	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Corporate profit of your company	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Import restrictions	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Foreign currency exchange controls	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Good relations with host government	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Price controls of host government	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Existence of local partner	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Performance evaluation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Political and social pressure	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Royalty restrictions	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Maintenance of cashflows	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Thank you for your cooperation in completing this questionnaire!

APPENDIX G

Cover Letter for Australian First Reminder

26 July, 2003

SURVEY OF INTERNATIONAL TRANSFER PRICES

On 5 July 2003, we sent you a questionnaire requesting your participation in a survey on international transfer pricing practices of multinational companies. If you have already completed and returned it, please disregard this reminder and accept our sincere thanks instead.

If you have not completed the questionnaire, please now find enclosed another copy. We would appreciate if you would complete the enclosed survey questionnaire and return it to us in the freepost envelope provided by Friday 8 August 2003.

This survey is part of an authorised PhD research programme based at Lincoln University which observes the highest level of academic and professional integrity. The research aims to enhance our understanding of how companies make international transfer pricing decisions and the conditions that influence such decisions. The results of the study should provide multinational companies with significant insights on international transfer pricing issues and practices in Australia. In accordance with the highest principles and traditions of academic research, complete anonymity and confidentiality are guaranteed. A copy of the summary results from the survey will be provided to you if you request it.

If you have any questions regarding this research or concerns about the questionnaire, please do not hesitate to contact us on **(03) 3253627**. We are very grateful for your cooperation and look forward to receiving the completed questionnaire.

Yours sincerely,

Jian Li



APPENDIX H

Cover Letter for Australian Second Reminder

3 September 2003

SURVEY OF INTERNATIONAL TRANSFER PRICES

In July and August, we sent you a questionnaire requesting your participation in a survey on international transfer pricing practices of Australian companies. If you have already completed and returned it, please disregard this reminder and accept our sincere thanks instead.

If you have not completed the questionnaire, please now find enclosed another copy. We would appreciate if you would complete the enclosed survey questionnaire and return it to us in the enclosed prepaid envelope provided.

However if you cannot return the questionnaire would you please tick any of the boxes below explaining your reason/s why and return this letter in the prepaid envelope provided. Please note that the deadline for responses has been extended to Friday 3 October 2003.

Reason	Tick if applicable
There are no international transfers to related firms	
The volume of international transfers to related firms is insignificant	
We have a standard firm policy of not responding to questionnaires	
The questionnaire is too sensitive to be answered	
I do not have time	
Other (please specify):	

Thank you for your time

Jian Li



APPENDIX I

Cover Letter for Chinese Companies

尊敬的财务负责人：您好！

我在新西兰林肯大学商学院攻读会计学博士学位。研究课题是关联企业转让定价分析。本项研究旨在通过对跨国公司转让定价实证分析，为公司经理和涉外财经管理人员提供一些参考意见。

贵公司所提供的支持对本项研究课题的顺利完成将十分重要。希望您能助一臂之力，在附上的问卷上按咨询问题赐笔。如问卷内容超出了您的业务范围，拜托您咨询或委托贵公司相关工作人员填写。本人郑重承诺，贵公司的答卷将会被绝对保密，并将只作为学术上的综合统计分析资料。

此项研究由中国对外经济贸易大学协助完成。随信附上该大学的回邮信封，因此您不必另外支付邮资。如果您希望收到一份本研究分析的结果，请填写信内的通讯地址回执栏，并将其与完成的问卷一起装入回邮信封寄给我即可。填妥之问卷，最好利用回邮信封于三月一日前寄出。

百忙当中，承蒙您鼎力协助，不胜感激！

顺祝

商祺！

新西兰林肯大学商学院
在读博士研究生：李俭
二〇〇三年二月十五日

APPENDIX J

Survey Questionnaire for Chinese Companies

SURVEY ON INTERNATIONAL TRANSFER PRICING PRACTICES OF FOREIGN FUNDED COMPANIES

2003 年度新西兰林肯大学商学院会计教育与研究中心博士论文科研课题:

关联企业转让定价研究

注意事项 (TO THE RESPONDENT) :

1.感谢您的积极支持。本次咨询不记姓名,所有问卷将只用于学术上的综合统计分析。Thank you for taking part in this survey. All the information you give will remain completely confidential and will be used only in aggregate form.

2.随函附有可直接寄往林肯大学的回邮信封。只须将填好的问卷装入该回邮信封内,投入就近的邮政信箱即可。无须另外支付邮资。Please return this survey by placing it in the pre-paid envelope provided and posting to us. No stamp is needed.

3.如果您希望收到一份本研究的结果,请填写信内的通讯地址回执栏,并将其与完成的问卷一起装入回邮信封即可。If you would like to receive a copy of the summary results of this survey, please note this in your reply.

基本概念 (NOTES) :

国际转让定价,此处指贵公司与境外关联企业之间进行商品、劳务或技术交易时所采用的内部价格。International transfer pricing means the unit price assigned to goods or services transferred between your company and a related firm outside China.

关联企业,系指母公司及其所属与贵公司有商品、劳务或技术交易的,在中国境外运营的企业。A related firm may be your parent company, other subsidiary, associate and foreign branch outside China.

第一部分

关联企业转让定价业务

General Information of Related Party Transactions

1、请指出贵公司 2002 年度与境外关联企业（含母公司）之间进行的以下各项业务往来发生的频繁程度？（请对每项以打“√”作答）。

	经常发生	较常发生	有时发生	很少发生	从未发生
有形财产的购销，转让和使用	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
无形财产的转让和使用	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
融通资金	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
提供劳务	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

2、请指出贵公司 2002 年度上述业务往来实际支出和收取的价格、费用金额（即贵公司与境外关联企业间业务往来交易额）占贵公司全部业务往来交易额的百分比（请选择其中一项以打“√”作答。如难以取得实际数据，请根据大致估计回答）。

低于 5%	<input type="checkbox"/>	51%至 70%	<input type="checkbox"/>
5% 至 20%	<input type="checkbox"/>	71% 至 85%	<input type="checkbox"/>
21% 至 50%	<input type="checkbox"/>	高于 85%	<input type="checkbox"/>

3、请问自 1998 年以来税务部门是否对贵公司与境外关联企业（含母公司）之间有
关产品、劳务、财产或技术内部交易价格及融资情况作过专项审计？

- 是的☐
- 没有☐

4、以下各种转让定价调整方法中，请问贵公司使用过其中哪些方法？（请以打“√”作答，选项不限）。

1) 独立价格法（又称可比非受控价格法）	<input type="checkbox"/>
2) 再销售价格法	<input type="checkbox"/>
3) 成本加成法	<input type="checkbox"/>
4) 可比利润法	<input type="checkbox"/>
5) 利润分割法	<input type="checkbox"/>
6) 交易净利润法	<input type="checkbox"/>
7) 核定利润率方法	<input type="checkbox"/>

如使用其他方法，请简单列示：

5、预约定价协议是纳税人预先将其和境外关联企业之间进行交易所采取的转让定价方法向税务机关报告，以确定该转让定价方法是否符合正常交易原则并为税务机关所接受。请指出预约定价协议方法在贵公司的采用情况（请选择其中一项以打“√”作答）。

1) 与当地税务部门签订了预约定价协议	<input type="checkbox"/>
2) 目前正在与当地税务部门协商签订预约定价协议	<input type="checkbox"/>
3) 考虑向当地税务部门申请签订预约定价协议	<input type="checkbox"/>
4) 没有考虑采用预约定价协议	<input type="checkbox"/>
5) 对预约定价协议情况不太清楚	<input type="checkbox"/>

第二部分

关联企业转让定价方法

International Transfer Pricing Methods Used

6、以下关联企业转让定价方法中，请问贵公司使用过其中哪些方法？（请以打“√”作答，选项不限）。

A、成本定价法

（成本定价法，即以成本为基础的内部转移价格计算方法）

1) 全部（或完全）标准成本法	<input type="checkbox"/>
2) 全部（或完全）实际成本法	<input type="checkbox"/>
3) 全部（或完全）成本加成法	<input type="checkbox"/>
4) 变动标准成本法	<input type="checkbox"/>
5) 变动实际成本法	<input type="checkbox"/>
6) 变动成本加成法	<input type="checkbox"/>

B、市场定价法

（市场定价法，即以市场为基础的内部转移价格计算方法）

7) 完全建立在市场价格基础上的定价方法	<input type="checkbox"/>
8) 在市场价格基础上进行调整的定价方法	<input type="checkbox"/>

C、协商定价法

（协商定价法，即关联企业之间经过协商形成的产品、劳务、财产或技术转移价格方法）

9) 在市场价格基础上协商的定价方法	<input type="checkbox"/>
10) 在产品成本价格基础上协商的定价方法	<input type="checkbox"/>
11) 自由协商的定价方法	<input type="checkbox"/>

如使用其他方法，请简单列示：

7、以上 11 种关联企业转让定价方法中，如贵公司使用过两种以上的定价方法，请指出其中哪种方法使用最为频繁？（只需在此处注明该方法所在数字即可）：

第三部分

影响关联企业转让定价政策形成的因素
Environmental Variables of International Transfer Pricing

8、跨国公司集团内部关联交易转让定价政策的制订通常需要考虑多方面因素。请指出以下各方面对关联企业转让定价政策形成的重要程度（请对每项以打“√”作答，对不能确定的因素可根据适当估计作答）。

影响因素	十分重要	比较重要	一般重要	不太重要	根本不重要
1) 各国所得税税率差异	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2) 进出口海关关税	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3) 税务部门转让定价审计	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4) 服从中国税收法律规定	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5) 存在利润汇出限制	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6) 加强公司竞争地位的需要	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7) 公司集团利润最大化的需要	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
8) 贵公司本身利润最大化需要	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
9) 所在国商品进口限制	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
10) 所在国实行外汇交易控制	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
11) 与当地政府建立良好的关系	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
12) 所在国实行商品价格限制	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
13) 存在当地合资或合作方	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
14) 评价公司经营绩效的需要	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
15) 政治或社会风险	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
16) 所在国对专利权转让的限制	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
17) 维持适当的公司现金流量	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

再次感谢您的积极参与！
Thank you for your cooperation in completing this questionnaire!

APPENDIX K

English Version Interview Questions for Chinese Tax Authorities

What is the present extent of transfer pricing abuse in China?

1. In your opinion, do you think the foreign investment enterprises (FIEs) are actually paying their fair share of taxes in your province (or city)?
2. Do you think the issue of profit shifting through transfer pricing manipulations in your province (or city) to be significant, moderately significant or not significant at all?
3. Please briefly assess the profit shifting issue through transfer pricing manipulations in your province (or city).
4. What is your major concern with the effects of transfer pricing abuse in your province (or city)? Why?

How do the Chinese tax authorities administer a transfer pricing tax audit?

5. For FIEs under the following circumstances, please indicate those that your tax authority is most concerned about regarding potential transfer pricing abuse in your province (or city)? Why?
 - ☐ Production and operational decisions are controlled by associated enterprises
 - ☐ Large transaction amounts with associated enterprises
 - ☐ Long periods of losses
 - ☐ Lower profits or losses for an extended period, but continuously expands the scale of its operations
 - ☐ Fluctuating profit patterns
 - ☐ Transactions with associated enterprises established in tax havens
 - ☐ Lower profitability than enterprises in the same industry
 - ☐ Lower profit margins than other group companies

- ☐ Unreasonable expenses paid to associated enterprises
 - ☐ Sudden and significant drop in profits after a preferential tax treatment period, such as the expiration of a tax holiday period.
6. For the following intercompany transfers, please indicate those that your tax authority is most concerned about regarding potential transfer pricing abuse in your province (or city)? Why?
- ☐ Transfer of tangible goods
 - ☐ Transfer of intangible goods
 - ☐ Transfer of financing
 - ☐ Transfer of services
7. Does your tax authority focus its tax audit efforts on certain industries?
- ☐ Yes (go to question 8) ☐ No (go to question 9)
8. What are the major industries that are subject to the greatest scrutiny by your tax authorities?
9. Does your tax authority focus its tax audit efforts according to a certain size of enterprise?
- ☐ Yes (go to question 10) ☐ No (go to question 11)
10. What group of enterprises does your tax authority focus its tax audit efforts on?
- ☐ Large-sized enterprises
 - ☐ Medium-sized enterprises
 - ☐ Small-sized enterprises
11. Of the seven transfer pricing methods used to adjust taxable income of FIEs for related party transactions, please indicate those that are often used by your tax authority.
12. What are the main motives for your tax authority to use cost plus method?
13. What are the main motives for your tax authority to use the deemed profit method?
14. Please briefly explain the use of the deemed profit method.

15. An Advance Pricing Agreement (APA) is a binding legal agreement between taxpayers and the tax authority. Has your tax authority ever signed an APA with the taxpayer(s)?

☐ Yes (go to question 16) ☐ No (go to question 20)

16. In your opinion, what are the main benefits or advantages of the use of the APAs in your tax authority?

17. Does your tax authority have any difficulty in the use of an APA?

☐ Yes (go to question 18) ☐ No (go to question 20)

18. What is the difficulty for your tax authority in the use of an APA? (go to question 20)

19. Please briefly explain the reason why it is unavailable for your tax authority to have an APA with the taxpayer.

20. How does your tax authority obtain related party transfer information of a FIE?

How adequate are the existing Chinese control measures?

21. Do you think the existing transfer pricing auditing system in your tax authority to be effective, moderately effective or ineffective?

22. What is the main difficulty encountered in the implementation of a transfer pricing tax audit for your tax authority? Why?

What factors constrain the transfer pricing monitoring system in China?

23. What factors constrain the transfer pricing monitoring system in China?

24. In your opinion, are there any areas in the transfer pricing monitoring system that should be further improved?

How should the Chinese transfer pricing monitoring system be improved?

25. What are your suggestions for improving the transfer pricing monitoring system in China?

APPENDIX L

English Version Survey Questionnaire for Chinese Tax Authorities

TO THE RESPONDENT:

- 1). Your assistance is extremely important to us. Thank you for taking part in this survey.
- 2). All data are collected anonymously and will be used exclusively for the research, with results reported in aggregate form. We assure you that your responses will remain completely confidential.
- 3). Please return this survey by placing it in the pre-paid envelope provided and posting to us. No stamp is needed.

1. For the following ten types of enterprises, please indicate your concern about possible transfer pricing abuse by each of them with its related parties.

1 means very possible, 5 means impossible.

Production and operational decisions are controlled by associated enterprises	1	2	3	4	5
Large transaction amounts with associated enterprises	1	2	3	4	5
Long periods of losses	1	2	3	4	5
Lower profits or losses for an extended period, but continuously expands the scale of its operations.	1	2	3	4	5
Fluctuating profit patters	1	2	3	4	5
Transactions with associated enterprises established in tax havens.	1	2	3	4	5
Lower profitability than enterprises in the same Industry	1	2	3	4	5
Lower profit margins than other group companies.	1	2	3	4	5
Unreasonable expenses paid to associated enterprises.	1	2	3	4	5
Sudden and significant drop in profits after a preferential tax treatment period	1	2	3	4	5

2. Please indicate your concern about the possible transfer pricing abuse by a multinational enterprise through the following transactions with its related parties.

1 means very possible, 5 means impossible.

Tangible goods	1	2	3	4	5
Intangibles	1	2	3	4	5
Financing	1	2	3	4	5
Services	1	2	3	4	5

3. Listed below are seven transfer pricing methods used to adjust taxable income of multinational enterprises for related party transactions. Of the seven pricing methods, please tick those which are often used by your tax authority.

- Comparable uncontrolled price method ☐
 - Resale price method ☐
 - Cost plus ☐
 - Comparable profit method ☐
 - Profit split method ☐
 - Transactional net margin method ☐
 - Deemed profit method ☐
 - Others (please describe):
-

4. Listed below are a number of respects which may require improvement in auditing multinational transfer pricing. Please indicate those which need to be improved in your tax authority.

- | | |
|---|--------------------------|
| Lack of technical competence | <input type="checkbox"/> |
| Lack of information exchange with foreign tax authorities | <input type="checkbox"/> |
| Insufficient staff resources | <input type="checkbox"/> |
| Lack of expertise and experience | <input type="checkbox"/> |
| Lack of well-defined transfer pricing legislation and regulations | <input type="checkbox"/> |
| Lack of a sound institutional framework of transfer pricing auditing | <input type="checkbox"/> |
| Lack of an appropriate transfer pricing computerised information system | <input type="checkbox"/> |
| Others (please describe): | |

5. What are your suggestions for improving the transfer pricing monitoring system in China?

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