

International transfer pricing practices in New Zealand

By Jian Li

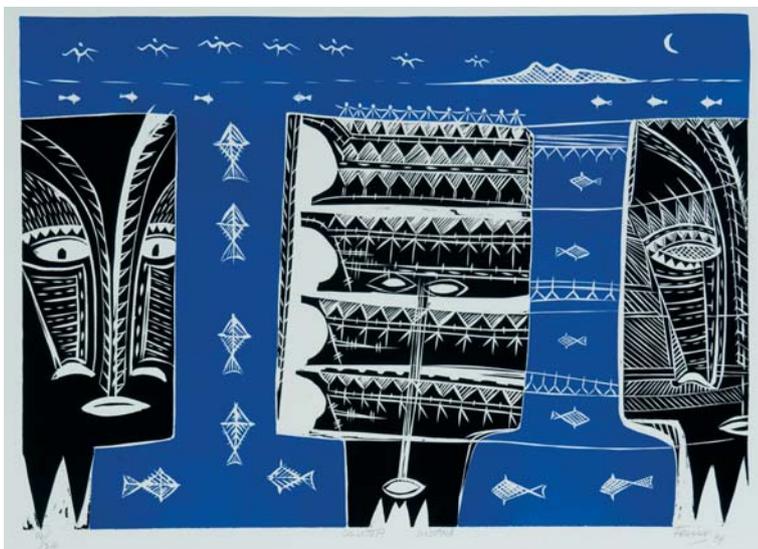
International transfer pricing involves goods and services transferred between related companies located in different countries. This research examines methods used by foreign-owned companies operating locally.

International transfer pricing (ITP) is the process of pricing of goods and services transferred between related companies located in different countries. This paper reports on the ITP methods used and the importance of environmental factors affecting the choice of methods by seventy-seven foreign-owned companies operating in New Zealand. The key findings include that the 'full plus fixed profit' is the most popular ITP method used by respondent companies. New Zealand subsidiaries now use market-based transfer prices for interna-

tional transfers more often than in 1995. Legal considerations were the most important variable considered by the respondent companies. Other important variables included corporate profit of the subsidiary, competitive position of the subsidiary and overall profit to multinational group.

Introduction

Transfer pricing is the price used for internal sales of goods and services between profit centres within the same firm.¹ The issue of transfer pricing has long been a source of frequent managerial concern and frustration² for multinational corporations (MNCs), which are far more complicated and exposed to a greater variety of environmental disturbances than domestic firms. The constantly changing international environment leads to a variety of approaches to multinational transfer pricing practices.³ The choice of transfer pricing approach chosen by firms in New Zealand and reasons for using that approach are the subject of this article.



Fatu Feu'u, Ulutoa moana, 1999, Woodcut, Auckland Art Gallery Toi o Tamaki, purchased 2002

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 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 countries.⁴ Owing to

“A market-based transfer pricing system is generally regarded as the most economically robust method in transfer pricing”

the dramatic changes in the New Zealand commercial, economic and regulatory environment over the past decades, a study concerned with ITP practices in New Zealand offers an opportunity to better understand connections between the business environment and business practices.

Transfer pricing options

In particular, this paper examines ITP methods used by foreign-owned New Zealand subsidiaries, and environmental factors associated with the choice of methods. It aims to provide MNCs and tax authorities with significant insights on ITP issues and practices in New Zealand and, especially, to enhance our understanding of various factors that enter into the decision-making process of New Zealand firms for ITP.

MNCs use a large variety of pricing methods for dealing with intercompany transfers crossing international boundaries. ITP methods can directly affect the amount of profit reported in a country by an MNC, which in turn affects the tax revenues of that country.⁵ Corporate internal pricing methods can be classified into a number of categories. Examples include full market price, adjusted market price, variable manufacturing costs and full costs. The costs can be either actual or standard. Some methods such as marginal cost, opportunity cost and mathematical programming models are theoretically effective but are rarely used in practice.⁶ Empirical studies on ITP methods concentrate on two major categories - cost-based and market-based prices.⁷

Cost-based methods have the advantage of being simple to use and based on readily available data. They are also generally easy to justify to tax authorities and are easily routinised – features which make cost basis a commonly used method. However, a cost based method 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% 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.⁸

A market-based transfer pricing system is generally regarded as the most economically robust 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.⁹ However, a market-based system is not always possible. A market price can be established only if identical goods and services are traded among unrelated entities. Or 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.¹⁰

Because of their widespread international operations, MNCs are exposed to a greater variety of environmental 'disturbances' than domestic firms and these environmental factors differ substantially from country to country. The way managers perceive these differences is likely to have a significant impact on, if not define, their international transfer pricing method choices. A number of environmental variables affecting ITP have been identified in previous studies.¹¹ Some of these explore the relationship between environmental variables and ITP methods used by MNCs. However, empirical research on the issue of ITP has focused mainly on the practices of large parent companies from the dominant industrial nations of the world such as the U.S.A., U.K., Japan, and Canada. It can be argued that corporate headquarters may not have all the facts about their foreign subsidiaries and the information they do have may be inaccurate, while a subsidiary's managers 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.¹²

TABLE 1: National ownership of respondent companies (n=77)

Parent company nationality	Number of companies	Percentage
United States	21	27.3
Australia	20	26.0
Japan	14	18.2
UK	6	7.8
Switzerland	4	5.2
Germany	3	3.9
Canada	2	2.6
Sweden	2	2.6
France	2	2.6
Finland	1	1.3
Denmark	1	1.3
Ireland	1	1.3
Total	77	100

Furthermore, despite the level of international research on the issue of ITP, there is no evidence on the subject in New Zealand except for Alam and Hoque.¹³ In 1995, Alam and Hoque surveyed New Zealand companies on their transfer pricing practices. They reported that most of the New Zealand companies used a 'full-cost' method to establish a transfer price, and 'divisional profitability' was the most important factor in determining the method of transfer pricing. Adding to the limited literature on the subject in the New Zealand context, this paper examines ITP methods used by foreign-owned subsidiaries in New

Zealand and the importance of environmental factors affecting the choices of methods.

The study

In April and May 2003, a questionnaire was addressed to the financial controllers of 300 foreign-owned subsidiaries operating in New Zealand. These samples were randomly drawn from Dun & Bradstreet's Business Who's Who (2001, 2002).¹⁴ After three mailings, a total of 140 (46.67%) responses were received, seventy-seven of which were usable, representing a usable response rate of 26%. The usable response rates were reasonably good, considering the highly sensitive nature of the information requested in the survey. Seventy-four companies addressed the questions on international transfer pricing methods used and seventy-seven companies answered the question on environmental factors affecting international transfer pricing. The respondent subsidiaries covered a range of industries, sizes and parent company nationalities. A breakdown of the sample according to national classification is presented in Table 1. Foreign direct investment in New Zealand is predominantly from OECD countries¹⁵ and all of our sample firms are owned by parent companies in these industrialised nations. U.S., Australia and Japanese foreign subsidiaries make up the largest group in the sample.

Findings

Table 2 compares the ITP methods used in 1995¹⁶ and 2003 by companies within our sample. It can be seen that 'full standard cost' was the predominant method used in 1995

TABLE 2: Comparison between transfer pricing methods in 1995* and 2003

Pricing methods	Number of firms (n=74)**	Number of firms (n=61)	Percentage (rounded)	Percentage (rounded)
	2003	1995	2003	1995
<i>Nonmarket-based methods</i>				
Full standard cost	6	23	8	38
Full actual cost	9	9	12	15
Full plus Fixed profit	21	5	28	8
Variable standard cost	0	4	0	7
Variable actual cost	2	2	3	3
Variable plus fixed contribution	4	0	5	0
<i>Subtotal for nonmarket-based methods</i>	42	43	56	70
<i>Market-based methods</i>				
Full market price	6	7	8	11
Adjusted market price	7	4	10	7
Negotiation based on market price	7	5	10	8
Negotiation based on costs	9	2	12	3
Unrestricted negotiations	3	0	4	0
<i>Subtotal for market-based methods</i>	32	18	43	30

*Manzurul Alam and Zahirul Hoque (1995). Transfer pricing in New Zealand. Chartered Accountants Journal. April, pp.32-34.

**Three firms failed to supply information on their transfer pricing methods used.

whereas in 2003 most New Zealand companies reported using 'full plus fixed profit' method. We can also observe that the New Zealand firms now use market based transfer prices for international transfers more often than in 1995. Table 2 also shows that in 1995 30% of the firms used market-based methods, but now 43% use market-based methods, although the data seem to suggest that the New Zealand firms still tend to use nonmarket-based transfer prices. The reason for more companies using market-oriented methods can be explained as being due to the intensified surveillance and investigation of multinational transfer pricing practices by the Inland Revenue Department.¹⁷ Foreign subsidiaries have to employ market prices in order to defend their pricing policies.

As for the use of individual transfer pricing methods, 'full plus fixed profit' (21, 28%) was most widely used by the respondent companies, following, in descending order of frequency of use, are 'full actual cost' (9, 12%), 'negotiation based on costs' (9, 12%), 'adjusted market price' (7, 10%), 'negotiation based on market prices' (7, 10%), 'full standard cost' (6, 8%), 'full market price' (6, 8%), 'variable plus fixed contribution' (4, 5%), 'unrestricted negotiations' (3, 4%), and 'variable actual cost' (2, 3%).

TABLE 3: ITP methods by national home base¹⁹

Pricing methods	U.S.A.		Australia		Japan		Europe	
	No.	%	No.	%	No.	%	No.	%
<i>Nonmarket-based methods</i>								
Full standard cost	1	5	3	16	1	7	1	5
Full actual cost	3	14	5	26	1	7	0	0
Full plus fixed profit	5	24	7	37	3	21	6	30
Variable standard cost	0	0	0	0	0	0	0	0
Variable actual cost	1	4	0	0	0	0	1	5
Variable plus fixed contribution	2	9	0	0	1	7	1	5
<i>Subtotal for nonmarket-based methods</i>	12	57	15	79	6	43	9	45
<i>Market-based methods</i>								
Full market price	0	0	2	11	1	7	3	15
Adjusted market price	3	14	0	0	2	14	2	10
Negotiation based on market price	1	5	1	5	2	14	3	15
Negotiation based on costs	4	19	1	5	1	7	3	15
Unrestricted negotiations	1	5	0	0	2	14	0	0
<i>Subtotal for market-based methods</i>	9	43	4	21	8	57	11	55
<i>Total – all methods</i>	21	100	19	100	14	100	20	100

A nationality breakdown of ITP methods used by the respondents is given in Table 3. It can be seen that U.S. and Australian firms tend to use cost-oriented methods, while no obvious tendency in system orientation is revealed for Japanese and European companies. The findings partially confirm the conclusion of Al-Eryani et al¹⁸ and Borkoski (1997a, b) that U.S. based firms prefer nonmarket-based methods.

After a review of the existing literature, seventeen environmental variables were selected in designing an instrument for data collection. A 5-point scale was used to rate the importance of each of these possible determinants of the methods adopted for ITP within our sample. Table 4 shows the relative importance attached by the sampled companies 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 5 for extremely important; 4 for very important; 3 for important; 2 for slightly important, and 1 for not important. The standard deviation of responses is also presented in the Table, indicating the extent of agreement in the rating of individual variables among the respondents.

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 high agreement among respondents on the importance of legal considerations. Other variables considered to be very important included 'corporate profit of the subsidiary', 'competitive position of the subsidiary' and 'overall profit to multinational group'. A brief discussion of these four key individual environmental variables affecting ITP policies in New Zealand can be presented as follows.

Comply with tax law and regulations

Burns²⁰ showed that both legal and tax variables are important factors to consider when selecting pricing strategies. Al-Eryani et al²¹ suggested that market-based methods are used more intensively by companies that are concerned about satisfying legal requirements. 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.

Corporate profit of the subsidiary

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

TABLE 4: Importance of environmental variables

Environmental variables	Mean	Rank	Standard deviation
Comply with tax law and regulations	3.96	1	1.069
Corporate profit of the subsidiary	3.38	2	1.089
Competitive position of the subsidiary	3.31	3	1.369
Overall profit to multinational group	3.05	4	1.157
Tax authority transfer pricing audits	2.82	5	1.254
Maintenance of cashflows	2.71	6	1.422
Performance evaluation	2.51	7	1.242
Differences in income tax rates	2.47	8	1.363
Restrictions on repatriation of income	2.43	9	1.261
Good relations with host government	2.18	10	1.262
Foreign currency exchange controls	2.09	11	1.248
Existence of local partner	2.07	12	1.258
Rates of customs duties	2.00	14	1.147
Import restrictions	2.00	13	1.192
Political and social pressure	1.96	15	1.094
Price controls of host government	1.95	16	1.210
Royalty restrictions	1.82	17	1.109

to balance the interests of the overall profit to the multinational group and that of the corporate profit of the subsidiary.

Competitive position of the subsidiary

43 (56%) companies consider this variable to be extremely important. It is understandable why so many firms pay great attention to their competitive position in the New Zealand market. Since 1984 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 firms.

Overall profit to multinational group

'Overall profit to multinational group' is given very high ratings by respondents. The maximisation of global profit is the major objective of a multinational group. MNCs 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. Eight variables were considered moderately important by the respondent firms. They were 'tax authority transfer pricing audits', 'maintenance of cashflows', 'performance evaluation', 'differences in income tax rates', 'restrictions on repatriation of income', 'good relations with host government', 'foreign currency exchange controls' and 'existence of local partner'. Variables which were considered of only slightly importance included 'import restrictions', 'rates of customs

duties', 'political and social pressure', 'price controls of host government' and 'royalty restrictions'.

The importance ranking of environmental variables by the respondents of different nationalities is given in Table 5. This study strongly supports the assertion made by Al-Eryani et al²² that MNCs operating in foreign countries perceived compliance with host legal regulations as the most important variable in the formulation of ITP policies. Understandably, all four national groups in the survey commonly selected 'comply with tax law and regulations' as the most important variable.

Three variables, 'corporate profit of the subsidiary', 'overall profit to multinational group', and 'competitive position of the subsidiary', were also consistently given high ratings among the seventeen listed environmental variables by all four national groups. This is not surprising since profitability has always remained the major objective of ITP and the competitive positions in foreign markets are vital to their survival.

Six variables, with a few minor variations, were considered least important to the respondents in the four groups. They included 'foreign currency exchange controls', 'import restrictions', 'good relations with host government', 'rates of customs duties', 'price controls of host government', and 'existence of local partner'. This could be owing to pervasive liberalisation and deregulation of the New Zealand economy pursued over the past decades.²³ Government induced market imperfections such as 'foreign currency exchange controls', 'import restrictions', 'rates of customs duties', and 'price controls of host government' are no longer considered as important issues by foreign companies in the formulation of ITP policies.

Several interesting differences between the four groups can also be observed. 'Restrictions on repatriation of income' and 'political and social pressure' were considered moderately important by U.S., Australian and Japanese companies. In contrast, European firms perceived the two variables as slightly important or not important at all. Compared with the other national groups, Japanese companies placed greater importance on 'tax authority transfer pricing audits'. This is natural in view of the fact that Japanese-owned companies are often frequently audited by host countries' tax authorities in the world²⁴ and must therefore recognise the importance of 'tax authority transfer pricing audits' in formulating their transfer pricing policies.

Conclusions

The results of multiple statistical tests reveal a high degree of consistency in ITP practice among multinationals operating in New Zealand, no matter where the Head Office is located. Specifically, the highest correlation existed between the rankings of variables by the Australian and Japanese firms. This means that there was substantial agreement between these two groups on the relative importance

TABLE 5: Importance of environmental variables different home nationalities (n=77)

Environmental variables	USA	Australia	Japan	Europe
Comply with tax law and regulations	1	1	1	1
Corporate profit of the subsidiary	1	3	3	2
Overall profit to multinational group	2	6	5	3
Competitive position of the subsidiary	3	2	2	4
Restrictions on repatriation of income	4	8	7	12
Maintenance of cashflows	4	4	6	8
Tax authority transfer pricing audits	5	5	4	5
Political and social pressure	6	11	9	16
Differences in income tax rates	7	7	6	6
Performance evaluation	7	9	7	10
Royalty restrictions	8	12	13	9
Foreign currency exchange controls	9	11	9	13
Import restrictions	10	11	12	11
Good relations with host government	10	12	7	7
Rates of customs duties	11	10	10	15
Price controls of host government	11	13	8	14
Existence of local partner	11	11	11	10

of the variables. The second-highest correlation was recorded between the rankings of variables by U.S. and Australian firms. The rankings of U.S. and European firms had the lowest correlation coefficient.

Many changes in the New Zealand economic and regulatory environment have had taken place since 1984. Some changes have far-reaching implications for multinational transfer pricing practices in the country, such as the finding here that New Zealand foreign subsidiaries now use market-based transfer prices for international transfers more often than in 1995. This is despite the fact that most New Zealand firms still tend to use cost-oriented transfer prices. For example, in 2003, the most popular ITP methods used by New Zealand companies included 'full plus fixed profit', 'full actual cost', 'negotiation based on costs', and 'adjusted market price'. A nationality breakdown of ITP methods used by respondent firms highlights that U.S. and Australian firms tend to use cost-oriented methods, while no obvious pattern in system orientation is revealed for Japanese and European companies.

'Legal considerations' was the most important environmental variable considered by the respondent companies. Other important variables included 'corporate profit of the subsidiary', 'competitive position of the subsidiary' and 'overall profit to multinational group'. A ranking of order for importance of environmental variables of national groups reveals that Japanese companies place greater importance on 'tax authority transfer pricing audits' than other national groups. One explanation for this result is that Japanese-owned companies are often frequently audited by host countries' tax authorities in the world. 'Tax authority transfer pricing audits', therefore, become an

important concern for Japanese firms in designing their ITP systems.

The results of this study point to a possible divergence between theory and practice with respect to the use of ITP methods. For example, the concepts and the use of marginal costs, opportunity costs and mathematical programming have been advocated by many researchers in business and economics literature, but none of the respondent firms used such methods. On the other hand, the findings of this study may serve as a useful reference for managers of foreign-owned companies in formulating their transfer pricing policies within New Zealand's economic and regulatory environment. The findings may also provide a reference for potential foreign investors or designers of ITP systems in planning their investment and operations in New Zealand, since the respondent companies covered a wide range of size, industries and business operations. With such a diverse set of companies, the findings from this survey should allow companies to benchmark their intercompany pricing strategies against those of other firms of similar size and orientation in New Zealand.

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Suggested further reading

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