

## TRANSFER PRICING IN INTERNATIONAL BUSINESS

### 1. WHAT IS TRANSFER PRICING?

Transfer prices are the prices charged on intrafirm [intra-corporate] trade in goods, business services and/or intangibles; i.e. trade between affiliated businesses. Transfer prices are set for internal reasons [motivate managers, monitor affiliate performance] and external reasons [taxes and tariffs]. Transfer prices can be based on market prices or not based on market prices [i.e. could be based on cost plus, or negotiated between the affiliates]. About 2/3 of MNEs say they use non-market based transfer pricing methods.

Transfer price manipulation [TPM] -- as distinct from transfer pricing -- is the over or underinvoicing of transfer prices so as to avoid or evade government regulations and policies [e.g. reduce tax payments]. That is, TPM is the deliberate setting of transfer prices either too high or too low so as to avoid government regulations. TPM must occur relative to some benchmark - you must be too high or too low relative to something else. In this case, "too high or too low" refers to the transfer price that would have been set by unrelated parties engaged in the same transaction (the arm's length price). More on the arm's length price below.

What are the government regulations that could lead an MNE to engage in transfer price manipulation? The enclosed table illustrates some of the external motivations that MNEs have to manipulate transfer prices. These include: differentials in corporate income tax rates between countries, restrictions on remitting foreign exchange, customs duties, and so on.

<b>Government Regulation</b>	<b>Motivation for Transfer Price Manipulation</b>
Ad valorem (% of value) tariffs on imported goods	Underinvoice to avoid paying customs duties
Differences in Corporate Income Taxes between countries	Shift tax deductions (expenses) to the high-tax country and taxable items (revenues) to the low-tax country so as to minimize total tax paid to the two countries.
Host government foreign exchange restrictions	If can't directly remit profits to MNE parent because of host country FOREX restrictions, overinvoice exports to the foreign affiliate and underinvoice exports from the foreign affiliate as an alternative method to shift profits out of the country.
Host country requires the MNE to share ownership with a host-country firm (joint venture)	This means profits are shared with a foreign firm, in effect, putting a tax on MNE profits in the host country. The MNE may use transfer price manipulation to shift profits out of the host country.

*Exercise: Can you think of other types of regulations that could lead to transfer pricing manipulations?*

### 2. DOES TRANSFER PRICING MATTER?

Transfer pricing is a critical issue for both MNEs and nation states. Transfer pricing is the most important international taxation issue facing multinational enterprises in the 1990s, according to one recent, representative study (Ernst & Young 1995). Ernst & Young interviewed 210 MNEs outside the United States and 50 U.S. firms about transfer pricing and MNE tax planning in 1995. Over 80 per cent of the respondents name transfer pricing (that is, how they set the prices for intrafirm transactions) as the major international tax issue facing MNEs in general, and half the respondents say it is the most important international tax issue facing their own enterprise. This compares to a second place issue (different tax

rates/regimes in different countries, 13%) and third place choice (allocation of costs/overheads, which is also a transfer pricing issue, 12%).

Over 80 per cent of the MNEs admit to facing a transfer pricing enquiry from local or foreign tax authorities at some time, and almost half are currently facing inquiries. Ernst & Young note an increased tendency for tax authorities to target foreign-owned MNEs. The study shows that the crossborder transactions most likely to be audited and subject to dispute with tax authorities are administrative and management fees (54%), royalties for intangibles (44%), transfers of finished goods for resale (46%). Those least likely to be disputed are technology cost-sharing arrangements (25%) and sales of raw materials (29%).

Perhaps because of the increased surveillance, about one-third of the respondents now tailor their transfer pricing policies to local government transfer pricing regulations. Over 90 per cent of U.S. MNEs state that they take into account, to some or great extent, the possibility of a tax audit when setting their transfer pricing policies. This is well above levels reported for MNEs headquartered in other countries which averaged about 80 per cent. Ernst & Young note that this supports the view that the new IRS enforcement tools and penalties may be causing MNEs to over comply, reporting too much income in the United States. The study concludes that there may be a global tax war underway, and argues that transfer pricing will continue to remain the focus of attention for both firms and governments. Thus transfer pricing *does* matter. Why is transfer pricing such a contentious issue?

### **3. THE PROBLEM: MULTINATIONALS ARE INTEGRATED BUSINESSES**

Transfer pricing is so contentious because multinational enterprises create particular problems for tax authorities that do not occur in taxing domestic firms. These problems arise because the MNE is an integrated or unitary business. The MNE consists of two or more firms, located in different countries, but under common control, with a common pool of resources and common goals. The enterprise is an interlocking network of activities, working more or less in tandem depending on the control exercised by the parent firm. Its goals are to survive, make profits, increase market share, and grow. The enterprise's rivals are other large multinationals. Its actions are developed as strategic responses to those rivals in an environment of market imperfections, oligopolistic behaviour, and substantial risk and uncertainty. Since its activities cross national borders, the MNE poses several problems to regulatory authorities:

MNEs have a global reach whereas governments are limited by their geographic boundaries to a national reach. This creates jurisdictional problems for domestic governments, and limits their effectiveness in taxing MNEs.

- MNEs with large international networks make decisions with a global perspective and in a global context; this affects the sovereignty of both host and home countries.
- The overriding goal of the MNE group is maximization of global after-tax profits. Individual affiliates therefore have conflicting goals with national governments.
- Since the MNE has common overheads and resources it has additional advantages of economies of scale and scope not available to domestic firms. These resources allow the MNE to escape national jurisdiction. They can also cause problems for tax authorities in deciding where the tax base is located and how to allocate the income and expenses of the MNE group among various national jurisdictions.

Thus, it is the fear that MNEs will engage in transfer pricing manipulations that will affect (1) government tax and customs duty revenues, (2) home and host country balance of payments and (3) the location of international production and employment, that leads governments to regulate transfer prices. It is not transfer pricing, per se, that is the problem; it is the potential for transfer price manipulation which governments fear and want to prevent through regulations.

#### 4. GOVERNMENT RESPONSE: TRANSFER PRICING REGULATION

Governments regulate TPM by requiring firms to follow the arm's length standard - i.e. the price two unrelated parties would have chosen if they had traded the same product under the same circumstances. The most common solution that tax authorities have adopted to reduce the probability of the transfer price manipulation is to develop particular transfer pricing regulations as part of the corporate income tax code. These regulations (e.g. U.S. Internal Revenue Code section 482, the Canadian Income Tax Code section 69, the OECD transfer pricing reports) are generally based on the concept of the arm's length standard, which says that all MNE intracorporate activities should be priced as if they took place between unrelated parties acting at arm's length in competitive markets. The arm's length price is the price two unrelated parties would reach through bargaining in a competitive market.

The 1979 OECD transfer pricing report defines the arm's length standard (ALS) as: " prices which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market" (OECD 1979, 7).

The arm's length standard asks the question: What would the parties have done had they been unrelated? What price would they have negotiated? Since the firms are related in the transaction under scrutiny by the tax authorities, any answer to this question must be hypothetical. The best answer is a proxy, done in one of two ways.



In the first method, the price negotiated by two other unrelated parties, which were engaged in the same or comparable transaction under the same or comparable circumstances, is a proxy for the arm's length price (ALP) in the transaction between the two related firms. The regulator looks for two other firms (firms C and D), which are unrelated and engaged in similar activities as the related parties in question, and then uses the price negotiated by the unrelated firms, adjusted if necessary for differences in product and functional characteristics, as the ALP. The ALP negotiated between firms C and D is used to proxy for the transfer price between A and B.



In the second method, the price set by one of the related parties in a comparable transaction under comparable circumstances with an unrelated party could be used as an estimate. Where the MNE either buys outside or sells outside, in comparable circumstances (e.g. product characteristics, functional level, time horizon, risks taken), the price negotiated with unrelated parties can be used as the ALP. That is, in the figure, the arm's length price that A charges unrelated firm C is used to proxy for the transfer price that A charges related firm B.

In practice, which method is used will depend on the available data. Are there unrelated parties engaged in the same, or nearly the same, transactions under the same, or nearly the same, circumstances? Does one of the related parties also engage in the same, or nearly the same, transactions with an unrelated party under the same, or nearly the same, circumstances? Where there are differences, are they quantifiable? Do the results seem reasonable in the circumstances? If the answers to these questions is "yes", then the arm's length standard will yield a reasonable result. If the answer is "no", then alternative methods must be used. We provide an illustration of the arm's length standard as it was used in an actual court case: *J. Hofert vs. the Minister of National Revenue* (DTC 1962) at the end of this lecture.

## 5. THE US RESPONSE: INTERNAL REVENUE CODE SECTION 482

Section 482, in one form or another, has been "on the books" as part of the US corporate income tax system since 1917. I have highlighted the key words in section 482 below:

The purpose of section 482 is to ensure that taxpayers **clearly reflect income** attributable to controlled transactions, and to **prevent the avoidance of taxes** with respect to such transactions. [Italics added]. Section 482 **places a controlled taxpayer on a tax parity with an uncontrolled taxpayer** by determining the **true taxable income** of the controlled taxpayer. The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such a case, the **district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations)**. The appropriate allocation may take the form of an increase or decrease in any relevant amount. In determining the true taxable income of a controlled taxpayer, **the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer**. A controlled transaction meets the arm's length standard **if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)**. However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. The arm's length result of a controlled transaction must be determined under the method that, **under the facts and circumstances**, provides the **most reliable measure of an arm's length result**.

## 6. ACCEPTABLE TRANSFER PRICING METHODS

Governments normally require the MNE to use one of several transfer price methods to satisfy the arm's length standard. This is true for both corporate income taxes and tariffs. These methods are:

Transactions-based methods:

- the comparable uncontrolled price (CUP) method
- the resale price method
- the cost plus method

Profit-based methods:

- the transactional net margin method (TNMM)
- the comparable profits method (CPM)
- the profit split method

Unspecified methods

- other methods

Here we look only at the three transactional based methods because these are the most commonly used and accepted methods of transfer pricing regulation worldwide. For analysis of the other methods, see Lorraine Eden, 1998, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press).

## 6.1. The Comparable Uncontrolled Price [CUP] Method

The CUP Method is the price set in a comparable uncontrolled transaction. CUP can be determined in one of three ways:

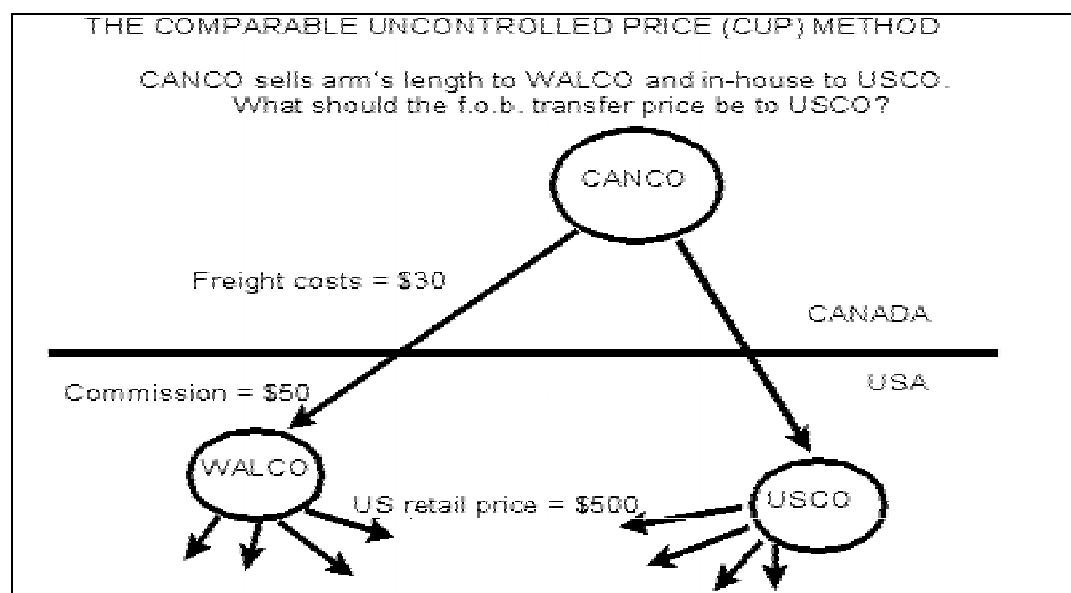
- if the MNE sells [or buys] the same product under the same circumstances to [from] an unrelated third party, that price can be used to proxy a CUP, or
- if two unrelated parties exchange the same product under the same circumstances, the price they set is a CUP, or
- if there are some differences in the products traded or in the circumstances in either of the two other cases, and adjustments can be made to the price to take account of these differences then that adjusted price can be used as a CUP.

The CUP method looks for a comparable product to the transaction in question, either in terms of the same product being bought or sold by the MNE in a comparable transaction with an unrelated party, or the same or similar product being traded between two unrelated parties under the same or similar circumstances. The product so identified is called a *product comparable*. All the facts and circumstances that could materially affect the price must be considered, e.g. the characteristics of the product, the market location, the trade level of the firms, and the risks involved. Adjustments are made to the external price to more closely estimate the ALP. Box 2 provides a numerical example of the CUP method.

<b>Box 2: The CUP Method</b>	
Assume CANCO sells television sets directly to its US subsidiary USCO. CANCO and other Canadian firms also sell TV sets in the United States to unrelated parties through a US department store chain WALCO. CANCO's product is sold FOB (free on board; i.e. without freight or insurance added) to both USCO and WALCO. The average US retail price, based on sales by WALCO, is \$500 per TV set. WALCO charges, on average, 10 percent of the retail price as its commission for selling the TV sets.	
Under the CUP method, the arm's length price should be the price that CANCO sells to unrelated customers, assuming the same or comparable transactions under the same or comparable circumstances. CANCO sells the same product to its US subsidiary and to the unrelated department store WALCO so that these unrelated US sales can be used to generate an arm's length price that can be used to provide a CUP. We know the retail price of TVs in the US market is \$500. We also know the mark-up charged by WALCO. Since we want the FOB transfer price from CANCO to USCO, we must also subtract the freight costs of moving the TV sets from Canada to WALCO in the United States. The transfer price per television set is calculated as follows:	
Average retail price in the United States	\$ 500.00
MINUS	
WALCO commission agent	50.00
Freight adjustment (from CIF to FOB)	30.00
EQUALS	
Transfer price using the CUP method	420.00

This is an example of the second method for determining an arm's length price. Where the MNE sells the same product under the same circumstances both inside and outside the enterprise, the outside price can proxy for the transfer price. In this case, the products are the same but the circumstances are slightly

different (i.e. there is a sales agent and freight costs are incurred in the outside sales) so some adjustment is required to find the correct price.



Tax authorities prefer the CUP method over all other pricing methods for at least two reasons. First, it incorporates more information about the specific transaction than does any other method; i.e. it is transaction and product specific. Since the arm's length standard is a transactional approach to valuing the MNE, the best method is the method that focuses most closely on the product and the transaction under consideration. Second, CUP takes both the interests of the buyer and seller into account since it looks at the price as determined by the intersection of demand and supply. The method assumes two firms are willing to bargain and that the comparable uncontrolled price is the outcome of that bargaining.

Where no CUP can be found [which is generally the case], the MNE can "back into" the transfer price using:

- Resale price (RP) Method: the transfer price is determined by subtracting from the [known] retail price the distributor's margin, where the margin should be what comparable distributors would charge to distribute the product for the seller.
- Cost plus (C+) method: the transfer price is determined by the costs of the supplying affiliate as average costs plus a markup, where the markup should be what comparable supplier firms would charge to supply the product to the buyer.

We look at each in turn.

## 6.2 The Resale Price (RP) Method

Where a product comparable is not available, so that the CUP method cannot be used, an alternative method is to focus on one side of the transaction, either the manufacturer or the distributor, and to estimate the transfer price using a functional approach. Under the resale price method, the tax auditor looks for firms at similar trade levels that perform similar distribution functions (i.e. a functional comparable). The RP method is best used when the distributor adds relatively little value to the product so that the value of its functions is easier to estimate. The assumption behind the RP method is that

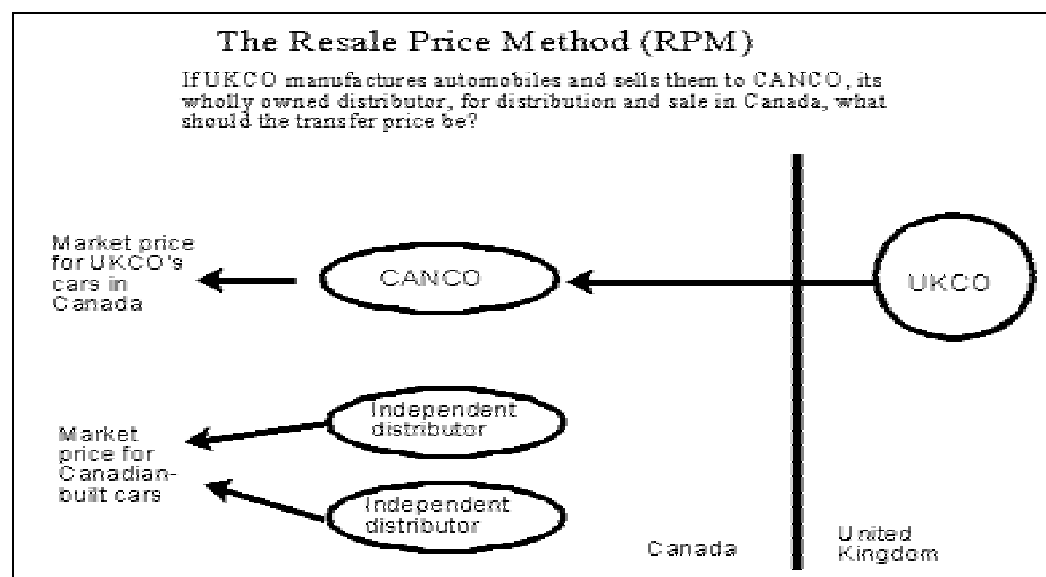
competition among distributors means that similar margins (returns) on sales are earned for similar functions. A distributor is likely to charge the same or a similar sales margin for carrying TV sets as for carrying washing machines or other white goods. Given a large number of distributors, averaging over these unrelated firms can be used to proxy for the margin that the distribution affiliate would have earned in an arm's length transaction. Subtracting this margin from the retail price (the price to the consumer, which is known), one can estimate the transfer price. In Box 3 we give an example of the resale price method for the case of a Canadian distributor of British made cars.

### Box 3: The Resale Price Method

CANCO is the Canadian distributor for its British parent's established line of automobiles. Comparable independent distributors in Canada earn gross profit margins of 10%. What should the transfer price be for exports from the UK parent to CANCO?

Under the Resale Price Method, the transfer price to CANCO for a particular automobile should be calculated as the final retail price in Canada minus the gross margin earned by comparable Canadian distributors. This assumes that the arm's length price for CANCO is the same gross profit margin as is earned by other distributors in Canada of similar products under similar circumstances. If other comparable distributors earns 10% margins, on average, the arm's length margin for CANCO should also be 10%.

Final retail price in Canada	\$ 20,000.00
MINUS	
Margin earned by comparable Canadian distributors (10 % of retail price)	2,000.00
EQUALS	
Transfer price using the Resale Price Method	\$ 18,000.00



Thus the resale price method "backs into" the transfer price by subtracting a profit margin, derived from margins earned by comparable distributors engaged in comparable functions, from the known retail price to determine the transfer price. As a result, the RP method evaluates the transaction only in terms of the buyer. The method ensures that the buyer receives an arm's length return consistent with returns earned

by similar firms engaged in similar transactions. Since the resale margin is determined in an arm's length manner, but nothing is done to ensure that the manufacturer's profit margin is consistent with margins earned by other manufacturers, the adjustment is one-sided. Under the RP method, having determined the buyer's arm's length margin, all excess profit on the transaction is assigned to the seller. Thus the resale price method tends to overestimate the transfer price since it gives all unallocated profits on the transaction to the upstream manufacturer. We can call this the contract distributor case since, effectively, the manufacturer is contracting out the distribution stage to the lowest bidder.

### 6.3 The Cost Plus (C+) Method

In the cost plus method, the tax auditor looks at the other side of the transaction: the manufacturer. The method starts with the costs of production, measured using recognized accounting principles, and then adds an appropriate markup over costs. The appropriate markup is estimated from those earned by similar manufacturers. The assumption is that in a competitive market the percentage markups over cost that could be earned by other arm's length manufacturers would be roughly the same. Thus, this method is also a functional comparable like the RP method. The cost plus method works best when the producer is a simple manufacturer without complicated activities so that its costs and returns can be more easily estimated. Box 4 gives an example of a perfume manufacturer, CANCO, that manufactures perfume for its two European sister affiliates at a standard cost of \$5.00 per ounce.

#### Box 4: The Cost Plus Method

CANCO, a wholly owned subsidiary of a French perfume multinational, produces an expensive perfume for sale to its two sister affiliates in Europe using active ingredients purcha.1(unc)3.3(o iw)-3.3(o )-24.7(+e7(o)5



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Advantage - was the largest transfer pricing case in history. Can you find the "true needle in the haystack" -- the arm's length prices for Christmas trees and crude oil?

## **7. SEARCHING FOR A CUP: THE CHRISTMAS TREE CASE**

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J. Hofert was a U.S. parent firm in the Christmas tree business, with a Canadian subsidiary that harvested and shipped Christmas trees to its parent. The tax dispute arose over the transfer price for the Christmas trees.

### The Facts of the Case

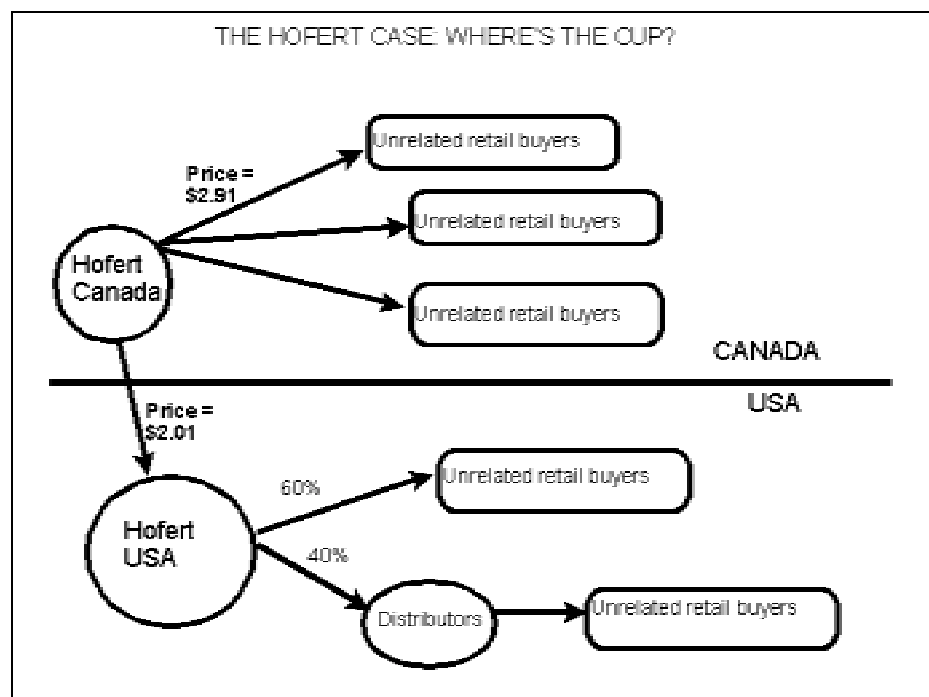
The Christmas tree industry is a natural resource industry, based on the harvesting, processing, and shipping of evergreen trees for sale during the December holiday season. Trees are grown year around, cut in the late fall, checked for size and quality, and shipped in bulk by truck or rail boxcar to urban centres, where they are distributed for sale primarily in small lots adjacent to shopping malls. It appear to be a reasonably simple business, with a readily ascertainable price for the tree, depending on its height, type and quality. Therefore a comparable uncontrolled price should be readily available; the Hofert case demonstrates that there can be many slips between the CUP and the transfer price.

J. Hofert Company was a U.S. corporation, headquartered in Los Angeles. In 1946, the firm (hereinafter referred to as Hofert USA) set up a Canadian subsidiary, J. Hofert Limited (hereinafter referred to as Hofert Canada), located in British Columbia. The subsidiary's purpose was to harvest and ship Christmas trees under long-term contract to its parent. In the early 1960s, Hofert USA was the largest dealer in Christmas trees in the United States.

The contract between Hofert USA and its Canadian subsidiary, originally written in 1946 and still in force in 1962 at the time of the court case, obliged Hofert Canada to sell and deliver each November as many Christmas trees to Hofert USA as the parent required. The subsidiary was to deliver trees of "merchantable quality....free from disease" and "subject to inspection by Buyer, which shall have the right, prior to shipment thereof, to reject any trees not in conformity with the specifications...." (J. Hofert Limited versus the Minister of National Revenue. 62 DTC, 50, Tax Appeal Board).

The parent firm paid its subsidiary for the costs of "buying, hauling, inspecting, grading, tagging, tying and loading" the trees onto railroad cars plus a mark-up of eight per cent over cost (62 DTC, 51). Where Hofert Canada cut down trees from its own lands, Hofert USA paid its subsidiary for the costs of cutting down the trees plus ten cents for each delivered bale of trees (A bale contained between one and eight trees depending on the size of the tree; the shorter the tree the larger the number in a bale). In addition, Hofert USA supplied Hofert Canada with twine, labels and staples free of charge and advanced \$5,000 to the subsidiary as part payment for the trees; final payments were made in May of the following year.

The tax issue arose because Hofert Canada not only sold Christmas trees to its U.S. parent, but also sold them to unrelated buyers in Western Canada. Revenue Canada argued that Hofert Canada's sales to its U.S. parent had not been negotiated at arm's length, and that the price charged the parent firm (which averaged \$2.01 per bale) was far lower than the price charged to unrelated Canadian customers (an average of \$2.91). The average difference over the three-year period between the two prices was 90 cents, making the U.S. price approximately 31 per cent below the average Canadian price. Citing section 17(2) of the Income Tax Act which requires the transfer price to be set at arm's length (fair market value), the department argued that the taxpayer had sold the trees to a related buyer at a price less than fair market value. Hofert Canada appealed the assessment.



#### The Tax Appeal Board Decision (1962)

Judge R.S.W. Fordham, Q.C., heard the case at the Tax Appeal Board. The judge's decision began by defining fair market value as a "commercial and not a legal term .. [that] involved a question of fact into which many considerations might enter" (62 DTC, 52). He then asked for the facts. "[W]hat was the fair market value of Christmas trees in Western Canada in 1954, 1955 and 1956 and how was it determined?" (62 DTC, 52). Unfortunately, he said, the department had not provided any facts, other than the prices at which Hofert Canada sold trees to unrelated buyers in Canada. However, these prices, he argued, were not fair market value because the circumstances were "entirely different from those that prevailed where the American purchaser was concerned" (62 DTC, 52). Judge Fordham then proceeded to outline the differences between the two sets of prices.

First, he noted, it cost Hofert Canada more to sell trees in Canada than to its U.S. parent because the trade levels were different. Hofert USA was a middleman, buying the trees and reselling them to distributors, wholesalers and retailers in the U.S. market. About 60 per cent of the parent's sales were directly to retailers. Canadian sales, however, were all to retailers. Therefore the subsidiary's expenses were higher on its Canadian sales because the firm was responsible for distribution and wholesale costs, for which it was not responsible on sales to its U.S. parent. These additional costs included "the payment of wages and other expense incurred between roadside and delivery points...of 55 cents, 71 cents and 98 cents per bale" respectively (62 DTC, 52). These additional costs, averaging 70 cents per bale, account for almost 80 per cent of the average price difference (that is, \$0.70/\$0.90).

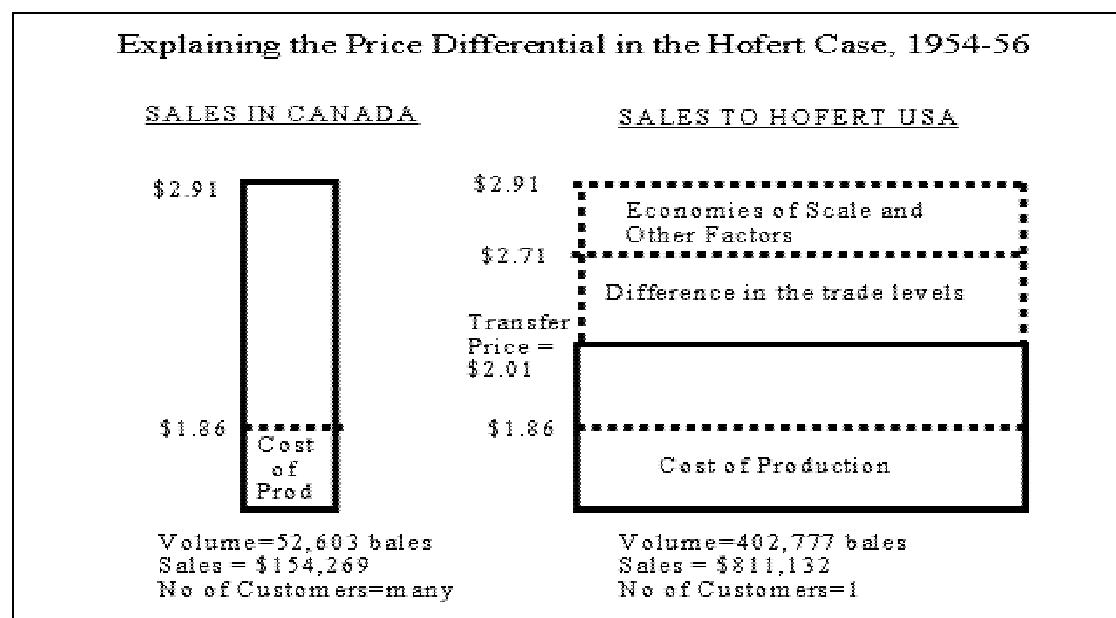
Second, the volume of sales differed significantly. Over 80 per cent of Hofert Canada's shipments went to its parent firm. Since bulk buying offers certain economies of scale, the U.S. price should be lower, reflecting these economies.

Third, in spite of the contract which allowed Hofert USA to reject any trees that did not conform with its specifications, in practice, all bales purchased by the parent firm were paid for by the parent even if some of the trees were unsatisfactory. The subsidiary's Canadian customers, on the other hand, did not pay for unsatisfactory trees. In addition, if trees were not sold by the end of the Christmas season, Hofert Canada

had to take back the Canadian ones but not those sold to its parent. Therefore the U.S. price should be somewhat lower than the Canadian price, reflecting these differences.

Fourth, the parent firm provided twine, labels and staples free of charge to the subsidiary, and also advanced it \$5,000 in funds to carry out the agreement; again justifying a lower price.

Lastly, the judge noted that the yearly net profit on Hofert Canada's local sales was no higher than on sales to its U.S. parent. Since the profit-to-sales ratios were similar, Judge Fordham concluded it was difficult to argue that preferential treatment had been given to the parent firm. He therefore concluded that there was no essential relationship between the Canadian and U.S. prices and found in favor of the taxpayer.



### An Economic Analysis of the Hofert Case

The Hofert case demonstrates that an appropriate transfer price depends on the facts and circumstances of the case. The price Hofert Canada charged its parent for Christmas trees was clearly less than the price the subsidiary charged its Canadian customers. That, however, did not automatically mean that Hofert Canada was undercharging its parent. The key issues, both identified by Judge Fordham, were (i) whether the two prices were comparable, and, if not, (ii) what was a comparable uncontrolled price (CUP)?

On the first issue, the court rejected the Canadian price as the fair market value on the grounds that the volume of shipments and the functions the taxpayer performed differed between the two types of sales. Thus the terms and conditions of sale varied so much that the prices were not comparable. This is illustrated in Figure 1 which shows prices, quantities and sales by Hofert Canada to its U.S. parent and to unrelated Canadian customers.

On the second issue, the judge noted that no one had presented evidence for another suitable CUP. There was evidence that the differences in terms and conditions justified the U.S. price being lower than the Canadian one, and some evidence presented that perhaps eighty per cent of the difference (an average of 70 cents) could be explained simply by differences in trade levels. Adding volume discounts, credit advances and provision of free inputs, the judge concluded that the differences in the terms and circumstances fully explained the price differential.

As a check against his calculations, the judge also used the rate of return Hofert Canada earned on sales, arguing that the net profit rates it earned on Canadian and U.S. sales were similar. Although the calculations are not presented in the case, we can interpret the judge's argument as follows.

Hofert USA paid its subsidiary for basic costs plus eight per cent; thus the subsidiary was a cost center for the parent firm, and paid on a cost plus basis. The final price was only known when the total amount paid by Hofert Canada was calculated on a per-bale basis; that is the U.S. price was  $(1 + 0.08)$  times the average cost of production. Since the U.S. price was almost constant over the 3-year period, this meant Hofert Canada's average costs were also constant. An average price of \$2.01 implies an average cost of \$1.86 and a mark-up over costs of 15 cents. Since Hofert Canada incurred these basic costs on both its Canadian and U.S. sales, if we add in the costs due to the difference in trade level, and subtract that total from the Canadian price, we can calculate an upper bound to the firm's per-unit profit on its Canadian sales; that is,  $\$2.91 - (\$1.86 + \$0.70) = \$0.35$  per bale of trees. (Annual estimates are shown in Table 1.) This mark-up is more than double the average mark-up over costs for U.S. sales of \$0.15. As a per cent of the basic cost level of \$1.86, the mark-up on Canadian sales averages 18 per cent compared to 8 per cent for U.S. sales. Clearly, some portion of the difference in mark-ups -- perhaps as high as 10 points -- is really a discount to Hofert USA for its volume purchases, as was argued by Judge Fordham. A closer look at the data suggests this, in fact, is the case.

As Table 1 shows, the price in Canada rose 16 per cent over the three year period, from \$2.75 to \$3.19, while the price to Hofert USA hardly moved from its initial level of \$2.00. Since the basic cost of production also hardly moved, this meant either that some other costs associated only with Canadian sales increased between 1954 and 1956, or that Hofert Canada raised its price as the Canadian market tightened. Since Hofert USA's share of the subsidiary's total sales varied little over this period (between 83 and 86 per cent), we can rule out changes in purchasing economies as responsible for the increasing gap between the two prices. In addition, other terms of the long-term contract (e.g. the financial advance, provision of free inputs) did not change.

In fact, as the data show, one cost that did substantially increase over the period was that associated with the difference in trade levels; this cost increased by more than 50 per cent, from 75 cents to \$1.15 over the three years. If we calculate the profit mark-up (after the difference in trade levels) over basic costs, the mark-up on Canadian sales stays roughly constant at 17-19 per cent of basic costs (see the table). The mark-up on U.S. sales is eight per cent each year, according to the long-run contract. Therefore, even though the two price series diverge over the period, the mark-ups over cost do not change.

#### Lessons Learned from the Hofert Case

The Hofert case is a nice example of a dispute over the pricing of a tangible. Christmas trees vary by height, quality and volume; the producer can sell at different trade levels in markets that vary by distance; the contract terms can vary in length and financial conditions. Each of these factors is part of the facts and circumstances of the case -- facts and circumstances that can turn an apparent CUP into an irrelevant comparison, as Judge Fordham properly concluded.

#### Discussion Questions:

1. How comparable was the price Hofert Canada charged its US parent for Christmas trees compared to the price the subsidiary charged Canadian customers? What could explain the differences?
2. Was Hofert Canada engaging in transfer price manipulation by selling Christmas trees to its US parent at one price and charging its Canadian customers a higher price? Why or why not?
3. How could the arm's length transfer price be estimated using the Comparable Uncontrolled Price, Cost Plus and Resale Price methods?

<b>Hofert Table 1: Hofert Canada's Total Sales, 1954-56</b>				
	<b>1954</b>	<b>1955</b>	<b>1956</b>	<b>Total</b>
Number of bales to Hofert USA	124,824.00	138,491.00	139,462.00	402,777.00
<b>Price to Hofert USA</b>	<b>\$2.00</b>	<b>\$2.00</b>	<b>\$2.04</b>	\$2.01
Total sales to Hofert USA	249,648	276,982	284,502.48	811,132.48
Number of bales sold in Canada	18,309.00	20,246.00	14,048.00	52,603.00
<b>Price to Canadian buyers</b>	<b>\$2.75</b>	<b>\$2.87</b>	<b>\$3.19</b>	\$2.91
Total sales in Canada	\$50,349.75	\$58,106.02	\$44,813.12	\$153,268.89
Intrafirm sales as a percent of total sales	83.22%	82.665	86.39%	84.11%
Canadian price minus US price	\$0.75	\$0.87	\$1.15	\$0.90
Difference due to trade level	\$0.55	\$0.71	0.98	\$0.70
Price difference as % of the Canadian price	27.27%	30.31%	36.05%	30.93%
Basic cost of production	\$1.85	\$1.85	\$1.89	\$1.86
Estimated unit profit on Canadian sales	\$0.35	\$0.31	\$0.32	\$0.35
Estimated markup over basic cost on Canadian sales	18.92%	16.76%	16.93%	18.82%

\* average price charged (total sales divided by total quantity sold).

## calculated as the sum of the products of the price difference multiplied by the U.S. quantity, all divided by the total U.S. quantity.

Source: based on data in J. Hofert Ltd. v. Minister of National Revenue 62 DTC, pages 51-53.

## **8. ARAMCO ADVANTAGE: THE BIGGEST TRANSFER PRICING CASE IN US HISTORY**

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OPEC is a cartel of 12 oil-producing countries, mostly located in the Middle East. The largest member of OPEC is Saudi Arabia. OPEC attempts to control the world oil price by assigning production quotas to its members. By limiting the overall supply of crude oil, OPEC was successful in quadrupling world oil prices in 1973-74 from \$4 per barrel to \$12 per barrel.

The primary producer of Saudi crude during this period was Aramco, the Arabian American Oil Company, owned by four US corporations: Exxon, Texaco, Chevron and Mobil Corporation. Aramco held the concession granted by the Saudi Arabian Government [SAG] under which the government permitted the firm to extract crude oil in exchange for payment of taxes and royalties to the SAG.

Aramco extracted the oil and sold it at the Official Selling Price [OSP], or posted price, to US subsidiaries of the Aramco owners. These domestic subsidiaries, called "ofttakers", physically loaded the oil obtained under the concession and then sold the Saudi crude to affiliated refining and marketing entities in the US and elsewhere, as well as to unrelated parties. The oftakers priced their sales at Interaffiliate Billing Prices [IABPs] which were directly based on the OSPs set by the OPEC governments, regardless of the

source or actual cost of the crude. The offtakers, as US firms, were subject to US corporate income tax, whereas their foreign affiliates were not subject to tax until they repatriated profits to their US parents. Shifting profits offshore to refining affiliates in lower tax locations was therefore one method for increasing global after-tax profits of the Aramco shareholders.

Beginning in 1977, Saudi Arabia began selling crude oil at a price -- the Saudi Arabian Government Price [SAGP] -- below the OSP, in order to moderate the rising world price of oil. At the same time, the Saudi oil minister, Sheik Yamani, told Aramco shareholders by letter that they must agree not to sell the oil for more than the SAGP and that a certified public accountant must supply audit certificates providing that Aramco had complied with the terms of the letter.

Oil prices remained in the \$15-\$20 range until the fall of the Shah of Iran in 1978. During the political chaos, Iranian oil exports were severely restricted and world oil prices rose as high as \$40 per barrel. In response to the higher prices and huge potential profits, several members of the OPEC cartel began to cheat by selling oil in excess of their production quotas. This greatly disturbed the Saudis.

In January 1979, as a short-run lesson to the smaller OPEC members, a lesson designed to ensure adherence to existing production quotas, Saudi Arabia decided to flood the world market with lower priced crude. The SAG set its price for SA crude oil, the SAGP, at a price well below -- perhaps by \$6 per barrel -- the market price. Keeping the SAGP below OSP was designed to lower the world price of crude; the SAG used this method to show its power over world prices to the other members of the cartel.

At the same time [Jan. 1979] Minister Yamani sent another letter to the Aramco shareholders informing them that they must not sell Saudi oil to third parties at prices in excess of the prices specified in the letter. This "1979 restriction" was designed to moderate the impact of the loss of Iranian oil exports on world oil prices. In response to this restriction, the Aramco offtakers invoiced their oil exports, both to related and unrelated refining firms, at the SAGP. This passed the substantial cost savings downstream from the offtakers to the refining affiliates. At the same time, Aramco shifted as much of its sales as possible to related parties so as to capture the maximum benefit from the "Aramco advantage". Since the offtakers were US firms, while most of the refining affiliates were foreign, this transferred substantial amounts of taxable income out of the United States.

When the IRS audited the tax books of the four Aramco shareholder firms, the Service argued that the Saudi price restriction was superficial and that the firms had used transfer price manipulation [section 482] to underinvoice their exports of crude oil in order to minimize their US taxes. The firms, on the other hand, argued that the SAG restriction prohibited them from keeping the income at the offtaker stage of production and there was not tax evasion. The IRS increased the income of all four Aramco shareholder firms by the years 1979-81 under Income Tax Act sections 482 and 61. Both Exxon and Texaco paid the tax assessment and appealed. Chevron and Mobil settled out of court, for roughly \$400 million each in taxes and penalties.

In 1991, the US Tax Court heard the case for Exxon. Judge Whitaker found that the 1979 restriction was a "valid and binding" prohibition imposed by the SAG on Aramco, and that the firms complied with the restriction. The IRS presented evidence that the prices for crude oil charged to downstream related party affiliates were less than those charged to unrelated firms; however, the judge concluded Exxon did comply "in all significant respects with the 1979 resale price restriction". He therefore found in favor of the oil companies. The court also found in favor of Texaco.

The IRS appealed but lost both appeals. The Supreme Court decided yesterday not to hear the Texaco case, so that the lower court ruling applies. The IRS will have to refund \$700 million in taxes and interest payments to Texaco. The Supreme Court is also expected to choose not to hear the Exxon case, implying that the IRS will have to refund several hundred million dollars also to Exxon.

Thus the Internal Revenue Service has lost the largest transfer pricing case in US history, almost twenty years after the original events occurred.

*Questions:*

1. Briefly explain the facts and circumstances of the case.
2. Identify the intrafirm transactions in this case and the opportunities where transfer price manipulation might occur.
3. In the period before 1977, what profits were earned by the offtakers? In the period during the Aramco advantage?
4. What pricing methods under Section 482 could have been used to determine the arm's length price for crude oil during this period?
5. Do you think the courts' decision was the correct one? Why or why not?

#### **BACKGROUND READING**

My transfer pricing website is posted at: <http://cibs.tamu.edu/eden/transferpricing.html>  
See, in particular:

<http://cibs.tamu.edu/Eden/TransferPrice.htm><http://cibs.tamu.edu/Eden/TransferPrice.htm>

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