Accounting Research Workshop | TRR 266 Research Series

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Topic: The relation between tax rates, tariffs, and transfer pricing components

Abstract: While evidence on profit shifting by transfer pricing to reduce the income tax burden is rather extensive, comparable evidence with respect to reducing tariff payments is limited. In addition, little is known about the components of the transfer price that are used to reduce the income tax and tariff burden. Using a unique confidential dataset of actual transfer prices for international trades by a large multinational corporation (MNC), we analyze how internal transfer prices and their components vary differently, compared to external prices, with the income tax rates, tariff rates, and the tradeoff between these two. We find that for this MNC that uses one set of books, the cost prices of internal transactions already reflect tariff-reducing efforts. Tariffs are by far the more costly burden compared to tax rate differentials. While the head-office markups reveal mostly efforts to reduce the income tax burden, the price adjustments at the business unit level reflect both income tax and tariff considerations. We furthermore provide evidence of strategic cost allocation among business units to reduce the income taxes: for internal transactions the business unit chooses incoterms (which determine the allocation of costs among trading partners) to allocate costs to the higher tax country without adjusting the transfer price accordingly.

We thank Saskia Kohlhase for the great opportunity to learn more about the relation between tax rates, tariffs, and transfer pricing components. We wish her all the best and much success with the paper!