

The effects of transfer pricing on tax avoidance, investment decisions and location choice by multinational companies - A literature review

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By choosing prices on intra-firm transactions, the companies can affect the income reported in different countries. The study investigates the effects from transfer pricing on investment choice and location decisions faced by multinational companies. Theory suggest that tax auditing based on deviation from arm's length pricing will lead to adjustments in multinational companies' production structure, and that the effective average tax rate is important for the choice of location of subsidiaries. Empirical evidence suggests that there are positive effects from profit shifting on investment in high-tax countries.

A substantial part of the literature on tax competition and tax avoidance presumes that economic activity is diverted away from high-tax countries when multinational companies establish tax haven operations and engage in profit shifting activities. However, opposed to this, some recent studies suggest that the use of profit shifting and transfer pricing has positive effects on economic activity in high-tax countries. This is, however, not clear from a theoretical point of view.

Policy makers naturally aim at curbing the undesirable profit shifting behavior by multinational companies, while at the same time disrupt the companies' real activities as little as possible. Nielsen, Schindler and Schjelderup (2014), model how transfer pricing and firm behavior are affected by the concealment costs of employing transfer pricing and the probability of being detected by tax authorities. One main finding is that the optimal transfer price will depend on the probability of detection and auditing by tax authorities. By studying two methods of government auditing, they find that transfer pricing in intermediate production factors does not affect real activity if tax authorities base their audits on the total amount of profits shifted. However, if tax authorities base their audits on the deviation between the transfer price and the true market price, it is shown that transfer pricing will lead to adjustments in the multinational companies' production structure. This method of auditing coincides with the main arm's length principle proposed by the OECD.

Using a different framework, Devereux and Maffini (2006) analyses multinational companies' choice of location of new subsidiaries. From a theoretical point of view, the discrete choice of location should be based on an evaluation of the net after-tax profits possible to generate in each location. The role of taxation should thus be captured by the effective average tax rate. Empirical studies suggest that there are positive effects from profit shifting on investment in high-tax countries. The importance of the effective average tax rate in determining the choice of location is also confirmed, providing indirect evidence for the effects of profit shifting on the choice of location of new subsidiaries.