

TRANSFER PRICING AND ITS ROLE IN TAX AVOIDANCE AND FLIGHT OF CAPITAL: SOME THEORY AND EVIDENCE

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Abstract

In conventional accounting literature, 'transfer pricing' is portrayed as a matter of searching for a technique for optimal allocation of costs and revenues amongst divisions, subsidiaries and joint ventures within a group of related entities. This paper argues that 'transfer pricing' is deeply implicated in social conflict and enables companies to avoid taxes and encourage flight of capital. Such practices enable companies to report higher earnings, but many societies are impoverished as a result. The paper locates corporations within the dynamics of capitalism and argues that globalisation has given companies and business advisors unprecedented opportunities to craft transfer prices to advance their private economic interests. Evidence is provided by examining some of the transfer prices practices used by corporations to avoid taxes in developing and developed economies.

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Accounting practices shape social conflict and are deeply implicated in transfers of income, wealth and risks to (re)constitute and transform social relations (Lehman, 1992; Arnold and Hammond, 1994). ‘Transfer pricing¹’ has become a key site for social conflict as it plays a major role in relocating corporate profits, facilitating tax avoidance and flight of capital (Armstrong, 1998; Baker, 2005; Gramlich and Wheeler, 2003; KPMG, 2004; Oyelere and Emmanuel, 1998; UK Africa All Party Parliamentary Group, 2006; US General Accounting Office, 1995).

Transfer prices matter to corporations because they affect calculations of divisional, segmental, product and global profits. The reported profits matter to stock markets because they affect earnings, dividends, share prices and return on capital. They matter to company executives because their financial rewards are linked to corporate earnings. Transfer prices matter to the state because they affect the taxes that it can levy upon corporate profits to finance public goods. Through transfer pricing companies can avoid taxes and export capital to more favourable locations but this can cause a severe shortage of funds and have a negative impact of the local economy. ‘Transfer pricing’ is considered to be one of the biggest issue facing international corporations (Ernst & Young, 2005) and is also a major growth area for international accountancy firms marketing “creative and practical solutions for your transfer pricing needs” (Ernst & Young, 2005, p. 68). It is at the centre of social conflict where the parties involved use a variety of tactics and strategies to gain an advantage.

¹In management accounting text-books (for example see Horngren et al., 2002; Atkinson, Kaplan and Young, 2004) ‘transfer pricing’ is commonly understood as the price that a company charges for a product, service, loan and the use of intangibles to a related organisation, including a division, subsidiary, affiliate and a joint venture. It acts as a device for allocation of costs, income, revenues and profits to various subunits. Traditional views conjure up images of transfer prices for tangible goods and services, but in a world where corporations are seeking to report higher shareholder values transfer prices cover leasing, intellectual property, royalties, interest payments, expenses, fees, management charges, advisory services and virtually everything that a company can buy or sell.

This paper seeks to contribute to the emerging literature by examining the role of ‘transfer pricing’ practices in social conflict². It is organised in three further sections. The first section provides a framework for understanding the role of ‘transfer pricing’ in social conflict. It locates transfer pricing decisions within the dynamics of capitalism. The second section provides some evidence of the way in which transfer pricing practices are implicated in tax avoidance and flight of capital, both in developing and developed economies. The third section summarises the paper and considers the broader social impact of transfer pricing policies.

Perspectives on Transfer Pricing

With the contemporary triumph of capitalism, corporations dominate the economic, political and social landscape of most nations (Korten, 1998; Monbiot, 2000; Klein, 2001). In accordance with the logic of capitalism, corporations are required to increase profits and dividends for the benefit of capital. In this process corporations develop new products, services and niches and also squeeze a variety of stakeholders to achieve higher shareholder value (Kennedy, 2000). This has been accompanied by financial engineering designed to improve corporate earnings. As Froud et al. (2000) put it, “even in blue-chip companies, whose management once built factories and market share, operating management becomes an endless series of cheap financial dodges: this year’s target is met by ending the defined benefit pension scheme, which saves labour costs, and next year’s dodge is leasing the trucks so that capital appears in someone else’s balance sheet. This work is punctuated by and interrupted by major restructurings and changes to ownership where it is financial engineering which is crucial”.

In this context, taxation is considered to be just another avoidable cost rather than a contribution to society or investment in social infrastructure that corporations use. As an Ernst & Young partner put it, “Tax is a cost of doing business so, naturally, a good manager will try to manage this cost and the risks associated with it” (Irish Times, 7 May 2004). Reducing or eliminating taxes boosts shareholder value, post-tax earnings

² Transfer prices can also provide a cover for illicit and anti-social corporate behaviour (United Nations Department of Economic and Social Affairs, 1976, paras 51-59). Sydney Morning Herald reported that “transfer pricing” is the biggest method for laundering money (23 January 2006).

and returns to shareholders. It also boosts company dividends and executive rewards since they are frequently linked to reported earnings. Since the amount of tax payable is dependent on 'costs' and 'income', corporate attention is focused on 'transfer pricing' strategies. Transfer prices have implications not only for the evaluation of performance of corporate divisions, subunits, departments and subsidiaries, but also for the taxes that domestic and foreign governments might be able to levy on corporate profits to finance public goods.

Under the influence of microeconomic theories, there is a tendency to regard the impact of transfer pricing as 'neutral' (OECD, 1979) and that it "has no direct effect on the entire company's reported profit. It is like taking money out of one pocket and putting it into another" (Garrison et al., 2005, p. 654). However, such interpretations are problematic due to the contradictions of capitalism and policies of the competing nation states. Under the influence of liberalist ideologies, the state is excluded from the organisation of capitalist production and the allocation of private capital (Jessop, 1990). At the same time, the political processes encourage the belief that the state can meet popular demands, provide social welfare, make investment in social infrastructure and deliver public goods. Failures to meet public expectations threaten social stability and the state's own legitimacy and survival (Offe, 1984). Since the state is deprived of its own means of production, its legitimacy, survival and performance is dependent upon revenues originating from outside its immediate control. Its revenues are primarily raised through taxation on wages and profits predominantly generated by the private sector. The levying of taxes on corporate profits helps to demonstrate that capital has social obligations, but such levies also antagonise capitalists as they reduce the returns available to providers of capital.

Since the state's own survival is dependent upon the long-run welfare of capital, it routinely stimulates the economy and supports capital through a variety of contradictory processes, including subsidies, tax shelters, tax incentives and sweeteners. A whole variety of industries, such as aerospace, armaments, biotechnology, coal, engineering, energy, farming, information technology, motor vehicles, movies, real estate, shipping, steel, telecommunications, transport and waste disposal have received special tax incentives and subsidies. Corporate activity is also supported through a variety of state sponsored export subsidies, loans, guarantees,

insurances, market research, storage, transportation and reimbursement of costs for attending trade promotions and fairs. Since the amount of tax incentives and subsidies is frequently dependent upon notions of costs and revenues, a company producing say furniture and movies has incentives to devise and charge suitable transfer prices to its movies division so that it can secure maximum benefit of the tax concessions and subsidies to increase its reported profits. The transactions may be between independent organisations, but they can enter into novel contracts to design appropriate transfer prices and take advantage of tax laws.

As the levying of taxes is closely connected with the operation of transfer prices, nation-states have sought to regulate the use of transfer pricing. Most states use some variant of the “arm’s length rule” to determine transfer prices (Picciotto, 1992a, 1992b; OECD, 2001) which requires that a transfer price be equivalent to an open market price. However, in the absence of an active market and comparable market transactions, such a price may not be easily ascertainable³ especially where companies use trade marks, patents, brands, logos and a variety of company specific intangible assets⁴. The tax authorities can adjust the transfer prices used by companies, assuming that they tax corporate profits and have the necessary administrative and enforcement resources⁵. The state may use its lawmaking powers to curb arbitrary calculations but law itself is the outcome of politics and through lobbying and patronage of political institutions corporations may dilute threatening legislation⁶. In any case, notions of costs, revenues, prices and profits are highly contestable (Buchanan and Thirlby, 1973) and open to competing interpretations (Berry et al., 1985). ‘Costs’ also consist of a variety of components, including overhead allocations, which are arbitrary and

³ Therefore companies and tax authorities use a variety of proxies, such as cost Plus, Resale Price, Profit Split , comparable uncontrolled price method (CUP), resale price method (RPM), cost plus method (CPM) , Profit split method (PSM) and Transactional net margin method (TNM) to estimate transfer prices. (Deloitte, 2004)

⁴ Court cases such as the US case of *Eli Lilly & Co v. Commissioner*, 84 T.C. 996 (1985) draw attention to difficulties of assigning a price to the use of company specific intangible assets.

⁵ Following the OECD model companies and tax authorities can enter into Advance Pricing Agreements (APA) and agree in advance the appropriate approach to determine the "arm's length" price for transactions between related entities.

⁶ The language of law, in common with any other language, is capable of alternative interpretations and cannot fix the meaning of ‘transfer pricing’ and its components in any permanent sense (Volsinov, 1973).

“incorrigible” (Thomas, 1969, 1974). Such ambiguities give corporations considerable flexibilities in devising transfer prices.

The conflict around ‘transfer prices’ is deepened by the advance of economic globalisation where corporations roam the world in search of lower costs and higher profits. As Marx and Engels observed, nearly 160 years ago, capital is always in “need of a constantly expanding market for its products, chases the bourgeoisie over the whole surface of the globe. It must nestle everywhere, settle everywhere, establish connections everywhere” (Marx and Engels, 1992, p. 6). Whilst there are competing perspectives on the significance and extent of contemporary globalization, it is often understood as a form of international economic integration that transcends the nation-states which make up the world system. It refers to processes where events and decisions, such as those relating to production of goods, financing of trade and tax rates, in one part of the world can have significant consequences for societies in distant parts of the world. In this sense, globalisation is much more than just the flow of goods and services and shapes the policy choices and strategies through complex networks of production and exchange. The abandonment of foreign exchange controls and other restrictions has accelerated the mobility of capital and corporations can easily relocate profits to more favourable locations (Lash and Urry, 1994). Advances in information technologies have enabled corporations to develop a variety of internal and external linkages to execute transactions in different economies and implement desirable cost structures to advance their economic interests. Such strategies are also aided by global networks of accountancy firms who are “beefing up their transfer pricing departments. In Britain alone, the combined numbers employed by the four-biggest accounting firms in transfer pricing has tripled in recent years, even though their clients have themselves also been employing more people to deal with tax issues” (The Economist, 29 January 2004).

Globalisation has freed corporations from the prison of territorial jurisdictions and they can easily establish subsidiaries, affiliates, joint ventures, special purpose entities and trusts in favourable geographical locations to take advantage of low taxes, subsidies and a desirable environment. For example, oil companies have production, refining, distribution, marketing, sales and research and development spread across many countries and can structure transactions and prices to eke out the best tax

advantage to report higher earnings. Developments in intellectual property are also creating new challenges to transfer pricing practices. For example, due to localised advantages subsidiaries of multinational corporations can develop know-how in country A and another subsidiary can register a patent in country B whilst subsidiary in country C manufactures the item and global marketing rights are conferred on another subsidiary in country D, which charges royalties for the use of trade marks and patents⁷. Such a maze creates immense possibilities for transfer pricing and relocation of profits from high tax jurisdictions to low tax ones. The power of corporations is also strengthened in that under the ideologies of capitalism, nation-states compete to attract investment funds to stimulate domestic economies and offer numerous subsidies and tax incentives. Such competition creates opportunities for corporations to devise transfer pricing policies to take advantage of tax differentials and play-off one nation-state against another. There is an increasing tendency for corporations to boost their post-tax earnings by reporting ‘higher taxable profits in countries where taxes are lower’ (The Economist, 29 January 2004) and the finance director of BMW has publicly stated that “his corporation tried to shift costs to where taxes are highest” (cited in Weichenrieder, 1996, p. 38).

The possibilities of ‘transfer pricing’ are increasingly being shaped by the emergence of microstates (commonly known as offshore financial centres or tax havens) considered to be “the cornerstone of the process of globalization” (Palan et al., 1996, p. 180). These 70 or so microstates⁸ have used their sovereign legislative powers to enact secrecy, light regulation, low/no tax and persuade companies to set-up skeletal administrative structures and book their transactions and easily create new assets and intellectual property (Mitchell et al., 2002; also see United Nations Economic and Social Council, 2001). Nearly half of all world trade appears to pass through offshore financial centres, even though these jurisdictions account for only about 3 per cent of global GDP (Christensen, Coleman and Kapoor, 2005, p. 67). They account for 1.2% of world population, but 26% of the assets and 31% of the net profits of American multinational corporations are located in tax havens (Hines and Rice, 1994). Some 3,600 major US corporations are known to be sheltering in the US Virgin Islands and

⁷ Subsidiaries in high tax countries can also be financed by debt to enable transfers of profits.

⁸ For a list of tax havens see Tax Justice Network (2005) and Baker, 2005.

Barbados alone (Rugman, 2000, pp. 22-23).. It is estimated that some US\$11.5 trillion of assets (approximately equivalent to ten times the UK GDP) reside in offshore havens (The Observer, 27 March 2005). Each year some 200,000 new companies⁹ are being formed in tax havens and the cumulative numbers could be as high as three million¹⁰ (Baker, 2005), enabling corporations to devise complex corporate structures, suitable transfer prices and tax reduction strategies. Places like the Cayman Islands do not levy taxes on corporate profits, consequently the local tax authorities have little reason to be concerned with transfer pricing practices. The secrecy provides spaces to park transactions in shell corporations and indulge in creative transfer pricing schemes that bear little relationship to any open market price (Brittain-Catlin, 2005).

The sheer scale, power and complexity of global corporations pose challenges to conventional thinking on 'transfer pricing' as domestic companies have become multinationals and foreign companies have either set up businesses in new jurisdictions or operate joint ventures with local companies. The combined sales of top 200 corporations are bigger than the combined economies of all countries minus the biggest 10. Multinational corporations dominate virtually every sector of the economy and account for some 27.5% of world economic activity (Anderson and Cavanagh, 2000) and 60% of world trade consists of internal transfers within multinational enterprises (OECD Observer, April 2002¹¹). For 2001, the related party trade accounted for US\$526 billion (46 per cent) of the \$1.133 trillion in US imports and 223 billion (33 per cent) of the \$731 billion exports (US Treasury, 2003, p.1-2). The concentration of economic power gives corporations considerable scope for controlling markets, defining costs and 'arms' length' prices to arrive at favourable transfer prices. The deepening of globalisation inevitably raises issues about the allocation of corporate profits to defined geographical jurisdictions to enable nation states to levy taxation. Consequently, nation-states have been obliged to enter into a variety of bilateral and multilateral agreements to regulate transfer pricing (Picciotto,

⁹ The most favourite offshore vehicle is the International Business Corporation (IBC) which can be owned by a trust. The trusts are frequently fronted by accountants, lawyers and nominee directors. There are no public documents and the identities of the real owners are not known.

¹⁰ This figure does not include trusts as little is known about the number, their functions or controllers.

¹¹ http://www.oecdobserver.org/news/fullstory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html; accessed on 10 October 2005.

1992a, 1992b; European Commission, 2004). Such agreements adopt variants of the ‘arm’s length’ rule and seek to simultaneously support international trade and constrain competing interpretations of ‘transfer pricing¹²’ (OECD, 1979, 2001). Whilst countries with considerable administrative resources could challenge the transfer prices used by corporations, many developing countries are poorly equipped and tax authorities have relatively little capacity to scrutinise the complex structures and practices (Plasschaert, 1985).

Some Evidence

Emerging and Transitional Economies

China is considered to be an emerging economic superpower. Its recent export-led economic growth of around 9% per annum is fuelled by foreign direct investment (FDI) interacting with cheap labour and indigenous technology to achieve an export led boom. The Chinese government is still developing sophisticated property rights, land and foreign investment protection laws (e.g. relating to bankruptcy, patents, trade marks) and has sought to attract foreign direct investment by offering a variety of tax incentives and concessions to foreign corporations (Moser, 1999; Sun 1999; Ho and Lau, 2002). These include a two-year tax holiday starting with the first profit-making year and a 50% tax reduction for the following three years. Foreign corporations investing in high technology industries and low profit industries, such as agriculture and forestry, qualify for tax holidays for two further years. Foreign corporations investing in special economic zones are subjected to considerably lower tax rates i.e. their profits are taxed at a reduced rate of 15% compared to the normal rate of 33%. Some provinces and cities also offer a variety of tax inducements and subsidies e.g. lower land using fees. To help domestic economy, the government has restricted foreign companies’ access to some domestic markets and has also retained some foreign exchange controls and a withholding tax on profit repatriation. In addition, China’s currency is not fully floated on the foreign exchanges and its value is primarily fixed by the government rather than the markets. Whilst the tax incentives

¹² For example, the OECD guidelines privilege the arm’s length principle i.e. a transfer price should be the same as if the two companies involved were indeed two independent organisations. The OECD Model Tax Convention is considered to be the framework for bilateral treaties between OECD countries, and is also adopted by many non-OECD governments.

and new profit-making opportunities make China an attractive place of business for multinational corporations, various restraints may persuade companies to improve their returns through transfer pricing strategies.

The Chinese economic boom and tax incentives have created profitable business opportunities and the 1980 inwards FDI of only US\$57 million reached US\$35.8 billion in 1995 (UNCTAD, 2003). By the late 1990s, some 140,000 foreign investment enterprises were operating in China. Around 54%, 63% and 70% of the foreign investment enterprises reported operating losses of US\$7.1 billion to the tax authorities for the years 1993, 1994 and 1995 respectively (Ho and Lau, 2002). The reported losses should have persuaded multinational corporations to exit China but by the year 2000 inward FDI reached US\$40.7 billion, rising to a record US\$53.5 billion in 2003. By August 2004 the number of foreign investment enterprises operating in China rose to 490,000, but for the period 1996 to 2000, between 60%-65% of the companies with foreign investment reported negative profits and paid no taxes (Baker, 2005, p. 145). Major reason for this is the creative use of transfer prices, especially the adjustment of import and export prices to shift profits to more desirable locations.

For the automotive industry, it is estimated that by “quoting a higher-than-market price on equipment parts and raw materials, foreign firms may be able to bypass the various regulations on the repatriation of profits, and finally may understate the level of domestic earnings (Wang, 2001, p.6). In addition, since joint ventures rely on purchase of components and technologies from parent companies, “foreign investors intend to prolong the purchase period to maximise the profits generated from transfer pricing” (Wang, 2001, p. 11). One study estimates that Chinese exports by multinational corporations are underpriced by an average of 17% whilst imports are overpriced by an average of 9% (Sun, 1999). The Chinese tax authorities claim that tax evasion by multinational companies is costing them more than 30 billion Yuan (US\$3.6 billion) in lost tax revenues annually and that “.. almost 90 per cent of the foreign enterprises are making money under the table. most commonly, they use transfer pricing to dodge tax payments ...” (China Daily¹³, 25 November 2004). Despite strict currency controls China is estimated to be deprived of around US\$100

¹³ http://www.chinadaily.com.cn/english/doc/2004-11/25/content_394744.htm; accessed 30 November 2004.

billion of capital each year, primarily through mispricing of imports and exports (Gunter, 2004).

Russia, another emerging economy, also provides some evidence of the impact of transfer pricing practices. Following the collapse of communism, the Russian economy suffered considerable decline as evidenced by a decline in its GDP of -14.%, -8.7%, -12.7%, -4.2% and -3.6% respectively for the years 1992, 1993, 1994, 1995 and 1996, representing a drop of around 42% in the country's output (Bush, 2003). The level of Foreign Direct Investment (FDI) has been comparatively low. For example, the cumulative FDI for the years 1991 to 2003 was only US\$19.6 billion compared to US\$350 billion for China for the same period. Out of a global total of US\$1270 billion in 2000, Russia received FDI of only \$4.4 billion. Instead, the Russian government sought to revive the economy through market liberalisation, decentralisation of economic planning, devaluation of currency, privatisation of state owned assets and joint ventures with foreign owned multinational corporations (Vasilyev, 2000;). Russia's 89 regions were given considerable autonomy to offer tax incentives and subsidies (for an indication see Weinthal and Luong, 2001). To stimulate investment and attract jobs to the regions, a series of low/no tax zones or "closed autonomous territorial formations" within the Russian Federation (known by their Russian acronym, "ZATOs"), were also created either by federal law or by the autonomous regions (for example, Mordovia, Kalmykia and Evenkia). However, Russian businesses and ordinary citizens could not open accounts in foreign banks without the permission of the banking authorities though banks could move large amounts of foreign currency when supported by a commercial contract or one authorised by the Central bank.

Transfer pricing issues have been given visibility by the trade in oil, a major contributor to the Russian economy¹⁴ (Ahrend, 2004). In early 2004, a World Bank report stated that the country's oil and gas exports accounted for a quarter of the country's GDP rather than 9% reported in the official data (Financial Times, 19 February 2004). The major reason for the discrepancy is the transfer pricing policies deployed by companies operating in Russia. World Bank officials state that "many large Russian firms benefit from transfer pricing by employing trading companies to

¹⁴ Russia is the world's second largest exporter of oil, after Saudi Arabia.

avoid taxation. Companies sell their products to trading subsidiaries at below-market prices; these trading subsidiaries then sell the product to the end customer at market prices and pocket the difference typically shell companies are registered in remote regions [some] simply disappear soon after they have concluded as many transactions with end customer as possible". (Ruehl and Schaffer, 2004). For example, Russian oil priced for sale internally at US\$10 a metric ton was instead sold to the exporter's foreign subsidiary at \$10 a metric ton and then resold to foreign buyers at the market price of US\$120 a metric ton, with the profits being booked and retained at external companies (Baker, 2005, p. 152). Russian gas company Gazprom created Itera, an affiliated company based in Jacksonville, USA. It has been claimed that gas with a Russian domestic price of \$2 to \$4 per thousand cubic meters has been sold at that price to the US which then resold it to Russian republics at between US\$30 to US\$90 per thousand cubic meters, with the profits being retained in the US (Baker, 2005, p. 156; Browder, 2002). One study estimated that between 1995 and 1999, exports of just twenty-five items from Russia to the US may have been under-invoiced by US\$7.24 billion whilst imports may have been over-priced by US\$1.68 billion, resulting in a possible capital flight of US\$8.92 billion which when taxed at 25% would have yielded considerable tax revenues for investment in social infrastructure (de Boyrie et al., 2005). Whilst the full extent of the flight of capital from Russia is open to conjecture, Goskomstat (now known as Federal Statistics Service) estimated that between 1990 and 1995 up to US\$400 billion of capital may have been taken out of Russia to the US, UK, Cyprus, Switzerland, the Netherlands and Denmark (Tikhomirov, 1997).

The loss of tax revenues and the accompanying flight of capital eventually persuaded the Russian government to prosecute its biggest privatised energy company Yukos (owned by Group Menatep, registered at a Gibraltar post office box) whose annual audited accounts complied with the US GAAP. In a 120 page document, the Russian government set out its case against Yukos and a number of shell companies in Russia, as well as Switzerland, Gibraltar, Panama, and the Isle of Man to devise transfer prices (Kommisar, 2005; Clateman, 2004, 2005). The transfer pricing schemes, allegedly, enabled Yukos and its affiliates to reduce its revenue for the year 2000 by RUR210 billion and the government sued the company for US\$28 billion for back taxes and penalties. The Russian government claimed that a Yukos production

subsidiary sold crude oil at below-market prices to a shell company (i.e., a company with virtually no assets, employees or operations of its own) allegedly affiliated with Yukos and established in a low/no tax region. The shell company resold the oil to domestic and foreign buyers at market prices. Yukos controlled the entire operations and finances of the shell company via placement of directors, powers of attorney and also an agreement with the shell company under which Yukos organized the purchase, sale, transport, processing and shipment of oil. Most of the shell company's transactions were with other Yukos affiliates. Yukos received nominal commission for these services (0.01-0.5%); and the shell companies received the bulk of the profit resulting from the entire chain of production and sale of the oil. The transfer pricing policies enabled Yukos to save taxes because the shell companies enjoyed concessions on profits tax as well as a host of revenue taxes (such as road use tax, housing stock and social benefits tax and property tax). Yukos founder and former chief executive Mikhael Khodorkovsky was alleged to be "doing an enormous amount of asset stripping and transfer pricing" (The Observer, 26 March 2006) and was found guilty of tax evasion and fraud and jailed for nine years (New York Times, 31 May 2005). The company has been broken-up and is facing bankruptcy, leaving some dissatisfied creditors and shareholders (The Guardian, 29 March 2006).

'Transfer pricing' practices continue to pose challenges to developing countries keen to attract investment from multinational corporations (UNCTAD, 1999a, 199b), and may be responsible for a capital flight of some US\$200 billion each year from developing countries (Tandon, 2000). According to a former member of the UN North-South Commission, "the pharmaceutical TNCs make internal sales to their Latin American subsidiaries at prices between 33% and 314% above world market levels. Other examples are: rubber industry, 40%; chemicals, 26%; electronics, 1,100%" (cited in Tandon, 2000). Cuddington (1986) estimated that for the years 1977 to 1983, exports to richer nations from Argentina, Brazil, Chile, Mexico and Uruguay were underpriced by an average of 19.6%, 12.7%, 12.8%, 33.6% and 27.8% respectively. Zdanowicz et al., (1999) estimate that during 1995, imports and export prices from US to Brazil were mispriced by 15.23% and 11.3% resulting in capital flight from Brazil to US of between \$2 billion and \$4 billion. Since the mid-1990s, India has become a hub for the service industry. Many IT, pharmaceutical and financial services multinational companies have located research and labour intensive

operation in India to take advantage of cheap labour and local technology. Such activities are controlled from external locations and multinationals also provide global advice and infrastructure in return for service agreements and royalty charges. After scrutinising the transfer pricing practices of over 1,000 companies, tax authorities have demanded additional taxes from 250 companies, including Bank of America, Citibank, Coke, Standard Chartered Bank, American Express Bank, Hero Honda, Johnson & Johnson, H Lever, Microsoft, Samsung and Sony (India Times, 22 June 2005). Due to transfer pricing practices of multinational companies Papua New Guinea is estimated to have lost tax revenues of between K26 and K52 million (3Kina approximately equals 1US\$) in 1999 on its forestry business alone (Hunt, 2002, p.vi). Many African states are also concerned about “the indiscriminate relocation of profits, which if taxed would assist greatly in advancing the economy of the African countries. Various methods are now being implemented to stop this outflow of funds, and transfer pricing in various shapes and forms has been earmarked as a way to make a “quick buck”. The result is the unprecedented implementation of legislation with a smell of transfer pricing¹⁵”. Due to transfer pricing practices,

Developed and Advanced Economies

The corporate strategies to maximise global profits, has increased the attention that western governments pay to ‘transfer pricing’ issues (US Government Accountability Office, 2004). By examining the US customs data and filings of the actual import and export prices used by corporations, Pak and Zdanowicz (2002) provide some interesting examples. The import prices include plastic buckets from the Czech Republic at \$972.98 each, fence posts from Canada at \$1,853.50 each, a kilo of toilet paper from China for \$4,121.81, a litre of apple juice from Israel for \$2,052, a ballpoint pen from Trinidad for \$8,500, and a pair of tweezers from Japan at \$4,896 each. Examples of export prices include a toilet (with bowl and tank) to Hong Kong for \$1.75, prefabricated buildings to Trinidad at \$1.20 each, bulldozers to Venezuela at \$387.83 each, and missile and rocket launchers to Israel for just \$52.03 each. For the year 2001 alone, such practices may have deprived the US government of US\$53.1 billion of tax revenues (Pak and Zdanowicz, 2002).

¹⁵<http://allafrica.com/stories/200412150137.html>; accessed 15 December 2004.

The prevalence of unusual transfer prices is not known but according to Wall Street economist Professor Michael Hudson (a former Arthur Andersen and Chase Manhattan Bank employee) “Businesses--and especially the financial sector--establish dummy companies and adjust their transfer pricing (*e.g.* on sales of raw materials to refineries, and of refined or semi-manufactured products to their final distributors in the industrial nations) so as to take all their profits in these tax-free [tax havens] enclaves Esso and other oil majors were able to “game” the world’s tax systems by selling their crude oil at so low a price to their tanker companies as to leave little income for Saudi Arabia, Venezuela or other oil producing countries” (cited in Schaefer, 2004). A former Senior Fellow of the Brookings Institution stated, “I have never known a multinational, multibillion-dollar, multiproduct corporation that did not use fictitious transfer pricing in some part of its business to shift money between some of its entities. In years past, chemical companies were a common example of falsified transfer pricing, taking advantage of proprietary products to move revenues and relocate profits. The pharmaceutical companies widely known for the same practice, invoicing as much as 10 times or more for the same product sold to one subsidiary out of which profits were drawn as compared to another subsidiary where profits were permitted to remain” and that “transfer pricing is used by virtually every multinational corporation to shift profits at will around the globe” (Baker, 2005, p. 170 and 30).

Western companies have developed a variety of transfer pricing strategies to shift income to low/no tax jurisdictions. With advice from Arthur Andersen, Deloitte & Touche, Chase Manhattan, Deutsche Bank, Bankers Trust and major law firms, US energy giant Enron created 3,500 domestic and foreign subsidiaries and affiliates, including places such as Turks and Caicos, Bermuda and Mauritius. Some 441 were registered in the Cayman Islands, which does not levy any taxes on corporate profits (US Senate Joint Committee on Taxation, 2003). Enron’s interests in various foreign infrastructure development projects (*e.g.* power stations) were typically controlled through Cayman Island (which does not tax corporate profits) holding companies. Enron generally charged the projects specific entities a fee reflecting the cost of providing some management services. By designing appropriate transfer pricing policies that shifted income to tax havens, Enron’s profits of US\$1.785 billion for the

years 1996 to 2000 attracted no taxes. It also avoided taxes in developing countries such as India and Hungary.

WorldCom, a US based company, made an interesting use for transfer pricing for a variety of trademarks, trade names, trade secrets, brands, service marks and intellectual property. Accountancy firm KPMG¹⁶ advised the company to increase its post-tax earnings by adopting an intangible asset transfer pricing program. Under this, the company created “management foresight¹⁷”, a previously unheard of intangible asset (United States Bankruptcy Court Southern District of New York, 2004). The parent company registered this in low tax jurisdiction and licensed it to its subsidiaries in exchange for annual royalty payments, an arrangement which anticipated tax savings of US\$25 million in the first year and US\$170 million over five years (United States Bankruptcy Court Southern District of New York, 2004, p. 27). WorldCom’s insolvency examiner found that in some cases the royalties charged actually exceeded the company’s consolidated net income in each of the years 1998-2001 and in other cases represented 80 to 90 percent of a subsidiary’s net income. Over a four year period covering 1998-2001, more than US\$20 billion was accrued in royalty fees for use of the company’s intangible assets and most of the fees resulted from the licensing of “management foresight”. The paying subsidiaries treated royalty charge as an expense that qualified for tax relief whilst the income in the hands of the receiving company attracted tax at a low rate. Such a transfer pricing arrangement may have saved the company between US\$100 million and US\$350 million in taxes.

Transfer prices of SmithKline came under scrutiny by the Canadian tax authorities (Turner, 1996; McMechan, 2004). For the years 1980 to 1989, the authorities challenged the company’s pricing practices for cimetidine, an active ingredient used in the manufacture of the drug Tagamet. SmithKline formulated, packaged and distributed the drug and earned considerable profits in Canada. However, under an

¹⁶ The firm received US\$9.2 million in fees (United States Bankruptcy Court Southern District of New York, 2004, p. 13)

¹⁷ “Management Foresight” is management’s “strategy to provide customers “end to end bundled services over a global network nothing more than management’s vision to create a horizontally and vertically integrated corporate structure to provide a full range of Telecom services to its customers” (United States Bankruptcy Court Southern District of New York, 2004, p. 12).

agreement formulated in 1977, the company purchased key ingredient (which was under patent protection) at \$400 per kilogram from its offshore affiliates located in low tax jurisdictions, the Bahamas and Ireland. In the early 1980s, generic forms of ingredient became available at prices ranging from \$50 to \$250 per kilogram and this reduced the market price of the drug. However, SmithKline continued to purchase the ingredients under the pre-existing agreement at \$400 per kilogram, resulting in the reporting of lower profits and even losses in Canada. The tax authorities argued that the profits in Canada had been artificially deflated by the company's transfer prices which ignored the open market prices. Following protracted litigation, a judge concluded that "If this company . . . had been paying the international market price for supplies of this drug rather than a higher price to a related corporation [at a non-negotiated price], its operating profits then would have been almost three times as much. . . . One could readily speculate that the company would still have been in a profitable position had it decided not to purchase the more expensive drug from its sister subsidiary" (cited in McMechan, 2004). After a further wrangling of eight years, the tax authorities eventually disallowed \$51.5 million of deductions and the company also paid the Crown \$3.2 million in legal costs.

Consider the case of Microsoft, world's biggest computer software company. In 2001, it established a subsidiary, Round Island One Limited, operating from the offices of a Dublin law firm. Operations in Irish Republic¹⁸ are attractive because corporate profits are taxed at 12.5%, nearly a third of the rate in the US, and government offers tax incentives to research and development companies. By 2004, Round Island controlled US\$16 billion of Microsoft's assets and gross profits of nearly US\$9 billion, approximately 22% of the company's global profits (Wall Street Journal, 7 November 2005, p. A2). Much of Round Island's income came from royalties and licensing fees for copyrighted software code that originated in the U.S. Through another company, Flat Island Co., Round Island licenses rights to Microsoft software throughout Europe, the Middle East and Africa. Round Island has absorbed other Microsoft units, from Israel to India, moving much of their intellectual property to

¹⁸ According to an economic think-tank, "many multinational companies are booking as much profit as possible in Ireland, where corporation tax stands at just 12.5%. This is done mainly through transfer pricing" (The Herald, 16 March 2006)

Ireland¹⁹. As a result of the licensing and royalty arrangements, Microsoft's world-wide tax rate declined, enabling the company to shave at least US\$500 million off its tax bill (Sunday Times, 12 February 2006). US tax authorities are said to be looking at Microsoft's transfer pricing practices. The same scrutiny is also being applied to a number of other companies, such as Dell, Pfizer, Oracle, Lucent Technologies, Apple and Hewlett-Packard, that have also relocated their intellectual property to Ireland (Wall Street Journal, 7 November 2005, p. A2).

It is not unusual for multinational corporations to purchase or create and hold intellectual property in low tax jurisdictions and then charge other group members royalties for using the same (Pritchard, 2001). The advantage is that subsidiaries and affiliates can claim tax relief on cost whilst the recipient pays little or no tax on the income. Nestle, a multinational food company, conducts manufacturing operations through 285 plants located in 55 countries. Its trading utilises trade marks for well-known products as Nescafe and Taster's Choice (coffee), Nestea (instant tea), Quik and Nescoa (agglomerated cocoa products), Cailler, Frigor, Toll House, Nestle Crunch and Gala (chocolate products), Chambourcy (refrigerated milk products), NIDO (instant milk products), Findus (frozen foods), Maggi and Crosse & Blackwell (culinary products and food ingredients), Ce relac (baby food), and Beringer (wine). However, its trademarks are held by companies registered in Switzerland, a low tax jurisdiction. Upon acquisition of companies in Australia, it transferred a variety of trademarks to a Swiss company. In return, the Swiss company made royalty charges for the use of trademarks resulting in transfer of revenues from diverse locations to Switzerland. In the seven years to 2000, Australian companies made payments of A\$311 million to the Swiss companies. Since the assets in question are very specific, an independent arm's length price is not easily ascertainable and on a number of occasions, the Australian tax authorities have contested Nestle's tax liabilities. (Pritchard, 2001). The US tax authorities have also looked at the transfer pricing policies of Nestle. In this case, Nestle had established a subsidiary, Westreco, in the

¹⁹ Following critical press comments on its Irish subsidiaries, in March 2006 Microsoft registered its Round Island One and Flat Island Company subsidiaries as companies with unlimited liability. Under Irish law, unlimited companies have no obligation to file their accounts publicly (http://www.finfacts.com/irelandbusinessnews/publish/article_10005150.shtml; accessed 10 March 2006).

US to provide research and development services. In accordance with a contract, the Swiss parent company reimbursed Westreco for all salaries, rent, consulting fees, raw materials, equipment, and administrative expenses, but not taxes, plus a percentage mark-up. The US tax authorities argued that the mark-up was too low and effectively enabled the US subsidiary to shift income and avoid US taxes. However, the court (*Westreco, Inc. v. Commissioner, 1992*²⁰) sided with Nestle.

Companies do not necessarily have to transact internationally to develop suitable transfer pricing policies for the use of intellectual property. For example, the federal structure of the US has permitted places such as Delaware and Nevada to either offer lower tax rates or special provisions for income from intangible assets. Forsberg (2003) explains that in accordance with well established legal procedures a parent company transfers its trade names or trademarks to another subsidiary in Delaware and then pays a fee to the Delaware company in return for use of the name or mark. Often the subsidiary companies do not produce anything tangible and have little or no staffing. Such activity reduces the parent company's income and tax in the place of its business, because the fee is a deductible business expense²¹. Geoffrey Inc. is incorporated in Delaware and is a wholly owned subsidiary of Toys "R" Us, a global company incorporated in the US state of New Jersey. Geoffrey Inc. owns several trademarks -- including Geoffrey, the Toys "R" Us giraffe -- and trade names (including Toys "R" Us). Toys "R" Us pays royalties to Delaware-based Geoffrey Inc. to use the trademark and trade name. The tax impact of this is to reduce Toys "R" Us's taxable income in places where royalty payments are tax deductible, and shift it to Delaware, which does not tax royalty income. In recent years, US tax authorities have targeted the transfer pricing and royalty payments by some of the largest corporations, such as Toys "R" Us, Home Depot, Limited Brands Inc., Kmart Corp., Gap Inc.,

²⁰http://www.mayerbrownrowe.com/taxcontroversy/pdf/westreco_memoopinion.PDF

²¹ The Delaware company may then loan the money back to the parent company or send it back in the form of dividends to achieve more tax advantages for the parent. The interest that the parent pays on the loan is an expense that can be deducted from net income, thus reducing taxes further. The dividends that the parent receives back from the Delaware corporation do not have to be recognized by the parent as taxable income. In either case, the parent corporation has successfully transferred operating income earned in one jurisdiction into tax-free income that it can use without restriction.

Sherwin-Williams Inc., Tyson Foods Inc., Circuit City Stores Inc., Stanley Works, Staples Inc., and Burger King Corp (Wall Street Journal, 9 August 2002, p. A1).

The 'transfer pricing' policies of car manufacturers Nissan, Honda and Toyota have attracted the attention of the UK tax authorities. The authorities claim that due to the pricing of imported vehicles and parts, Nissan alone understated its UK profits by £400 million and added that "Transfer pricing has all the tax authorities worried. When you have a global organisation moving products and components across borders there is the obvious suspicion that they are attempting to avoid tax rather than simply trying to improve efficiency" (Daily Telegraph, 12 November 2004). Australian tax authorities have questioned the transfer pricing policies of Japanese car manufacturer Toyota, the biggest of the four Australian car makers by revenue. For the years 1998 to 2003, it claimed to have made profits of A\$75 million on turnover of \$4.7 billion. The tax authorities have challenged the prices assigned to imported vehicles and spare parts and are claiming back-taxes of between A\$400 million and A\$1 billion (The Age, 10 March 2004; 13 April 2004).

The US authorities have sued oil companies such as Shell, Mobil Oil, Oxy USA, Chevron, Conoco, BP Amoco, Texaco, Pennzoil, UPRC, Sun Oil Company, Kerr-McGee, and Exxon for allegedly underpriced energy sales at below-market posted prices and thus recording low royalties, eventually securing a settlement of \$400 million²². Similarly, the UK government has also questioned the transfer pricing policies and related royalty payments by IBM, a global information technology corporation. The investigation centred on the claim that the UK part of the company had increased its royalty payments from 8% to 12% of its income derived from the sale of products and services to IBM Corp, its loss-making American parent company (The Register, 12 August 1999²³). IBM is alleged to have paid £700 million to the UK tax authorities to settle the case (The Observer, 22 June 2003). Transfer pricing policies of GlaxoSmithKline, a global pharmaceutical company, are also under scrutiny by the US government. The tax authorities claim that the rate the company charged for marketing services supplied by its U.S. affiliate from 1989 to 1996 was

²² <http://www.usdoj.gov/opa/pr/2001/January/041civ.htm>

²³ http://www.theregister.co.uk/1999/08/06/inland_revenue_probes_ibm/

far too low, and thus understated Glaxo's US income and avoided around \$5.2 billion of US taxes (Daily Telegraph, 8 January 2004).

Summary and Discussion

This paper has sought to contribute to the emerging literature on the role of accounting in social conflict by focusing upon the role of transfer pricing in tax avoidance and flight of capital. 'Transfer pricing' policies are central to transfers of income, wealth and risks. Such issues are neglected in management accounting textbooks which primarily continue to regard 'transfer pricing' as an issue of a search for an optimal technique and pay little attention to its role in social conflict (Sikka et al, forthcoming). 'Transfer pricing' is at the heart of a conflict involving corporations, stock markets, company executives, business advisers and the state. It matters because it affects competing claims on economic surpluses in the shape of corporate earnings, rates of return, dividends, executive rewards, taxes, and ability of the state to provide public goods. The reported company profits also influence wage bargaining in companies.

"Transfer pricing' practices fulfil a function in allocating costs and revenues to various divisions, subsidiaries, affiliates and joint ventures. However, the picture is complicated by the tendency of the state to stimulate economic investment through tax incentives and subsidies. Corporations seem to respond by developing a variety of transfer pricing strategies both domestically and internationally, including underpricing exports, overpricing imports, booking transactions in shell companies in low/no tax jurisdictions, creation of specialised intangible assets and royalty programmes for intellectual property. Instead of receiving royalties from their foreign subsidiaries, many American parent companies are also commonly set up licensing deals, with smaller up-front payments, to reduce their domestic tax exposure (Sunday Times, 12 February 2006). Such practices may not be illegal but they shift tax burdens and deprive many developing countries of resources for economic development. In principle, 'transfer prices' should be based on an "arm's length" or comparable and independent market prices, but due to increasing concentration of economic activities within transnational corporations such prices cannot easily be ascertained. Many of the assets are organisation specific (e.g. trade marks, logos) and a suitable market or

an independent comparable price cannot easily be found. Notions of ‘costs’ and ‘revenues’ form the backbone of ‘transfer prices’ but such concepts are contestable and offer corporations considerable flexibility in devising suitable transfer prices.

Nation states have sought to check indiscriminate relocation of profits through transfer pricing and hence erosion of the national tax base through a variety of bilateral and multilateral agreements (for example, European Commission, 2004). However, whilst co-operating to check the tendency of capital to escape national regulations, states also seek to attract capital by offering low taxes, subsidies and incentives. This competition gives corporations greater possibilities of devising more creative transfer pricing policies to locate profits in more favourable locations. At the same time, because of low or no taxes on corporate profits a number of states (e.g. Cayman Islands) have no interest in scrutinising corporate transfer pricing practices.

Corporations are increasingly managed on regional or global basis, rather than national basis, and with the aid of global networks and advisers they have created complex corporate structures to advance novel transfer pricing practices and increase their earnings by avoiding taxes. With emphasis on global management of corporations, it is difficult to know where exactly the profits are generated or how real they are, since a few paper transactions and carefully designed ‘transfer pricing’ policies can shift and increase post-tax earnings. Whereas dedicated governments and even private organisations (e.g. banks) may be mobilised to focus upon money laundering, equivalent attention on profit laundering through ‘transfer pricing’ is less prevalent. ‘Transfer prices’ are internal to companies and rarely leave a visible trail external to the organisation. Private organisations cannot easily be called upon to check novel transfer pricing policies because they frequently compete with the state to devise novel schemes and thereby report higher profits. The tax authorities may occasionally challenge the ‘transfer prices’ used by some companies, but generally (especially in many developing countries) they do not sufficient resources to scrutinise all the prices charged on intercompany transfers.

In recent years, despite record profits in western countries, corporate taxes as a percentage of the GDP have been declining (Mitchell and Sikka, 2005; *The Economist*, 29 January 2004) and tax burdens have been shifted to consumption and

labour. The use of 'transfer pricing' policies appear to be one explanation for the decline in effective rates of corporate taxes. Developing countries seem to be particularly hard hit²⁴ and in many cases do not have adequate social infrastructure or tax administration to challenge the practices of global corporations whose turnover frequently exceeds their own GDP. It may be argued that many developing countries (e.g. China, Russia, India, African countries) lack suitable governance structures, property rights, bankruptcy laws and proven political stability and thus represent high risk investment for multinational companies. Therefore, corporations rely upon 'transfer pricing' policies to repatriate profits and bypass foreign currency controls. Such a view glosses over the tendency of capital to advance its private interests. It owes no allegiance to any people, products, nations and societies. Its objective of maximising return on capital necessarily brings it into conflict with variety of stakeholders and its policies deprive local population of the much needed resources for economic development and investment in local social infrastructure. However, the evidence cited in this paper is that corporations also devise 'transfer pricing' policies to avoid taxes and shift capital from economically advanced western nations, which have a long history of safeguarding corporate property rights and providing an environment conducive to smooth accumulation of business profits. Indeed, business interests are frequently central to domestic and foreign policies of countries, such as UK, US, Canada and Australia. However, this has not persuaded capital to be loyal to those nations and societies. Instead, companies are constantly devising new schemes and seeking out tax havens, which offer secrecy, low/no tax and social obligations to improve return on capital.

The burgeoning corporate social responsibility literature pays little attention to the role of transfer pricing in tax avoidance and flight of capital. Increasingly, the nation states have become concerned about the malleability of 'transfer prices' and their role in avoiding taxes and degradation of the economic environment. Faced with a squeeze on budgets and concerns about social legitimacy, some states have challenged corporate transfer pricing practices in courts. In the case of Yukos, the Russian

²⁴ Cobham (2005) estimates that developing countries from the African continent may be losing some \$385 billion each year due to organised tax avoidance and tax evasion, of which around \$50 billion is estimated to be related to corporate profit shifting. Transfer pricing is considered to be a major vehicle for this.

government also sold-off corporate assets to secure payment of back taxes. In the western world, a number of companies are facing lawsuits from the tax authorities and have been persuaded to make financial settlements. Some of the litigation may last for years²⁵ and thereby create considerable risk and uncertainty for investors and other stakeholders. Major companies acknowledge that “the likelihood of being challenged by tax authorities on their transfer pricing [practices] was increasing” (Henderson Global Investors, 2005a, p. 4). Such developments pose challenges to the quality of corporate financial reporting, which arguably is meant to enable investors and creditors to make assessment of risks to future earnings and cash flows. However, only a tiny number of companies make any reference to transfer pricing practices in their annual financial reports and rarely provide any meaningful information (Tang and Zhao, 2001). Increasingly, non-governmental organisations (NGOs) are making a direct link between transfer pricing practices, tax avoidance and poverty and are demanding disclosures of ‘transfer pricing’ policies (Global Witness, 2005). Despite reluctance from companies, some institutional investors are keen for companies to publish information about transfer pricing policies (Henderson Global Investors, 2005a, 2005b). However, corporate interest dominated standard setters (UK Accounting Standards Board, 1995; International Accounting Standards Board, 2003) do not require companies to provide information about ‘transfer pricing’ schemes and their consequences. The UK government has also refused to introduce legislation requiring companies to publish details of their transfer pricing policies (Hansard, House of Commons Debates, 14 February 2006, col. 1862) or tax calculations (Hansard, House of Commons Debates, 15 February 2006, col. 2083).

The use of ‘transfer prices’ to shift capital and avoid taxes poses some fundamental questions about the quality of national economic statistics. Most governments seek to steer the economy by using data on imports, exports, national income, balance of payments and terms of trade. However, the objectivity of such data is problematised by corporate ‘transfer pricing’ policies. By routing paper transactions through tax havens or no/low tax jurisdictions companies are not necessarily engaging in any new production of goods or services, but such practices significantly change the economic statistics being used by governments to manage local economies. The use of shell

²⁵ For example, Glaxo (now part of GlaxoSmithKline) have been in dispute with the UK and US tax authorities since 1989.

companies and the processing of trade through tax havens enable some jurisdictions to report higher Gross National Income (GNI) but the profits do not necessarily remain there or are necessarily used for the benefit of the local population. In the light of global transfer pricing schemes, the quality of economic statistics is worthy of further investigation.

Transfer pricing' practices are inevitably connected with a tax payment minimisation strategies developed by companies. As long as governments levy taxes on corporate profits or offer tax incentives to stimulate economy, companies will have reasons to develop transfer pricing policies to avoid taxes. Such practices exert pressure upon the state to shift taxes to labour, consumption and less mobile capital and pose fundamental questions about the nature and future of state. Faced with the above challenges and the malleability of 'costs', 'prices' and the power of the 'rule avoidance industry', some have advocated alternative models for allocation of 'costs' and 'profits' of multinational corporations. These include suggestions that tax authorities develop a 'formula allocation' model and allocate profits and costs with reference to economic activity rather than 'transfer pricing' influenced 'costs' (Picciotto, 1992a). Whilst major states can apply such a model to their domestic companies, its global development remains problematical as states seek to secure competitive advantages for capital sponsored by them.

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