Abstract: Transfer pricing is the setting of prices for transfers within the multinational enterprise (MNE). While transfer prices may be set for purely internal reasons there are often strong external motivations to engage in transfer price manipulation (over/under invoicing). In this paper, we explore the ethics of transfer pricing, focusing on two different views: moral ethics and tax ethics. We draw insights from the tax fraud and fraud triangle literatures to develop the concept of abusive transfer pricing, and propose changes in accounting standards and global norms to reduce abusive transfer pricing.

Highlights:
- Transfer price manipulation (TPM) is an internalization benefit that enables MNEs to arbitrage economic and regulatory differences between countries.
- Government authorities and MNEs disagree as to the illegality and ethicality of TPM; we define abusive TPM using insights from the tax fraud literature and argue abusive TPM is both illegal and unethical.
- Insights from the fraud triangle (opportunity, pressure, rationalization) can explain why abusive TPM occurs and help design policy recommendations to reduce abusive TPM.

Keywords: transfer pricing, ethics, fraud, tax avoidance, fraud triangle, arm’s length standard

Word count: 13,053

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1 Not for citation or circulation without permission of authors. An early version of part of this paper was presented by one of the authors at a September 2009 World Bank conference in Washington, DC, on illicit flows from developing countries, and we thank the discussant Kimberly Clausing and conference participants for helpful comments. We also thank David Cooper and Tina Dacin for helpful comments on the previous version of this paper.
THE ETHICS OF TRANSFER PRICING

INTRODUCTION

Size matters and the size of multinational enterprises (MNEs) relative to the global economy is impressive. There are now more than 82,000 MNEs worldwide, each with an average of 10 foreign affiliates. In 2009, MNE value-added activities reached a “historic high of 11 per cent of world gross domestic product” (UNCTAD, 2010, p. 16). In 2010, 42 of the 100 largest economies in the world were MNEs, not countries. Total revenues of the five largest MNEs were larger than the combined gross domestic product of the world’s poorest 110 countries.\(^2\)

MNE are large in global trade also. Exports of goods and services by MNE foreign affiliates are now one-third of global exports (UNCTAD, 2010, p. 16). Statistics on intrafirm or related party trade (trade between MNE subunits) historically have only been available for the United States and Japan. OECD (2002, p. 164) estimates that 31\% of Japanese exports and 24\% of imports in 1999 were related party transactions; for the United States the comparable figures were 36\% and 39\% respectively. The US Department of Commerce (2010) estimates intrafirm trade is 48\% of US exports and 40\% of US imports. OECD (2010, p. 21) provides very preliminary estimates that intrafirm trade is between 7\% and 12\% of world trade in goods and services, and between 8\% and 15\% for all OECD countries.\(^3\)

That MNEs represent a very large share of world trade is particularly important because these firms have the ability to set their own prices for transactions within the MNE group. The price of an intrafirm transfer is called a transfer price, and the process by which the MNE determines the price for its intrafirm transactions is called transfer pricing.

Governments have long been worried about the potential harmful effects of transfer pricing, ...

\(^2\) Authors’ calculations using revenue data from Fortune’s 2010 “Global 100” Corporations and 2010 IMF Statistics data on country GDP. Summed GDP of the poorest 110 countries is $1.423 trillion; summed revenue of the five largest MNEs (Wal-Mart, Royal Dutch Shell, Exxon Mobil, BP and Toyota) is $1.428 trillion.

\(^3\) The OECD estimate for the US intrafirm trade share (between 9\% and 21\%) is low compared to US Department of Commerce estimate, suggesting that the OECD numbers may be low for other countries also.
particularly for developing countries (UNCTAD, 1978; OECD, 1979, 1984). Starting in 1979, the OECD began to issue guidelines for national tax authorities and MNEs on transfer pricing for corporate income tax calculations (Eden, 1998, 2009). Many governments responded by establishing a variety of bilateral and multilateral agreements to improve regulations over transfer pricing manipulation (Picciotto, 1992; Eden, 1998). Today, more than 50 governments now regulate transfer prices using some version of the OECD guidelines (Eden, 2009). The regulatory norm is the arm’s length standard, which requires that the transfer price be set equal to the price that two unrelated parties would negotiate at arm’s length for the same or similar product traded under the same or similar circumstances to related parties (Eden, 1998; Eden, Dan and Wan, 2001).

The primary reason why governments have developed the arm’s length standard is that they do not believe that MNEs set their transfer prices at arm’s length, but rather engage in widespread transfer price manipulation (TPM), that is, the over or under-invoicing of prices for intrafirm transactions. Transfer price manipulation, once an obscure area studied only by a few academics such as Hirshleifer (1956, 1957), Horst (1971) and Rugman and Eden (1985), has become front-page news due to multi-million dollar disputes such as the recent Xilinx and GlaxoSmithKline tax disputes with the US Internal Revenue Service (Leone, 2011; Linex Legal, 2011). Central to these disputes is whether transfer pricing was used to avoid or evade payment of corporate income tax and if so, whether the manipulation was overly aggressive. In other words, national governments are specifically concerned about situations where aggressive transfer pricing manipulation focused on tax or regulatory minimization moves “over the line” into abusive transfer pricing, which we define as illegal or fraudulent transfer pricing.

Moreover, governments are not the only actors concerned about transfer pricing. With the collapse of Enron, WorldCom and other MNEs in the early 2000s, non-governmental organizations have also started to pay attention to corporate fraud, focusing on abusive financial behaviors and transfer price manipulation (Tax Justice Network, 2008; Christian Aid, 2009). For example, the World Council of
Churches (2000) stated that “developing countries annually lose millions, perhaps billions, of dollars because of transfer pricing”. Christian Aid has published reports arguing that transfer pricing is “tax dodging”, “cooking the books”, “secret deals”, “scams”, that “rob the poor to keep the rich tax-free” stripping income from developing countries (Christian Aid, 2009).

While national tax authorities and non-governmental organizations view transfer pricing as suspicious at best and illegal and immoral at worst, transfer pricing is viewed by MNE executives and the tax planning industry as both legal and morally acceptable (Hand, 1934, 1947; Friedman, 1970; Duhaime.org, 2011; Money Blue Book, 2011). Since the goal of the firm is to maximize the returns of its shareholders and transfer pricing can raise the MNE’s after-tax profits on a worldwide basis, TPM is a valued activity for the MNE because it creates shareholder wealth. As one MNE executive in a LinkedIn exchange with one of the authors indicated, his instructions to his staff regarding transfer pricing were simple: minimize global tax exposure.

Clearly, the major actors in the global economy – governments, MNEs and non-governmental actors -- have fundamentally different views on the ethics of transfer pricing. Given the size of MNEs in the global economy and the importance of intrafirm trade in global trade, the ethics of transfer pricing merits deeper exploration. We argue that ethical issues arise only with respect to abusive transfer pricing, and not to transfer price manipulation, per se.

Our paper takes a three-step approach to analyzing the ethics of transfer pricing. First, we examine the benefits of transfer price manipulation for the MNE, looking at internal and external pressures to engage in TPM. We argue that TPM is one of the key benefits of internalization for the MNE. Second, we apply insights from the tax fraud literature to TPM. We find that, while the ethical issues are seen differently depending on “where one sits”, both MNEs and governments agree that one form of TPM is illegal and unethical: abusive transfer pricing. Third, we use the fraud triangle (pressure, opportunity, rationalization) to develop a transfer pricing fraud triangle. We argue that MNEs are more
likely to engage in abusive TPM when pressures and opportunities are high, and firms rationalize their actions as legitimate and beneficial for shareholders. Lastly, we use the transfer pricing fraud triangle to recommend some policy changes that should curtail abusive transfer pricing.

A BRIEF LITERATURE REVIEW

The ethics of transfer pricing can be seen as a subset of the literature on business ethics. Representative studies of business ethics are Schweiker (1993), Macintosh (1995), Macintosh et al. (2009) and Braithwaite (2005). In this literature, a corporation is an entity, just like an individual, which has ethical obligations. Schweiker (1993, p. 241) observes: “This otherness involved in personal identity is also present in corporations. It inheres in the fiduciary relation between a corporation as an economic force and the accountant as the one who renders an identity.” He goes on to state (p. 246): “The issue, then, is not if one [a corporation] is socially responsible, but how that responsibility is exercised or neglected by the corporation.”

Extensive research contributions by Macintosh and his coauthors have examined post-structuralist perspectives, especially regarding expansion of social theory to accounting issues. For example, Macintosh et al. (2009) give for consideration a financial statement preparer who may abide by accounting rules, but who has little interest in objectivity and correspondence to reality. Macintosh (1995) studies the manipulation of profit (aka earnings management) phenomenon in which corporate executives of large MNEs make self-beneficial choices of accounting methods in addition to activities that affect economic events that affect reported profits. This study considers recent research that examines the problem from an "ethics perspective" and concludes that such efforts are only quasi-ethics based; rather, they examine "socially-acceptable" behavior.

In his book, Markets in Vice, Markets in Virtue, Braithwaite (2005) concludes that effective regulation could actually flip markets in vice to markets of virtue. He provides guidance for those
involved with corporate policy, governance, and regulation. The book, which is an empirical study of tax avoidance and regulation, offers guidance for establishing equity in national tax systems, while suggesting ways that regulators might enhance markets in virtue and diminish markets in vice.

While numerous studies have addressed how ethics relates to the operations of an MNE in general, relatively little has been written specifically on the ethics of transfer pricing. Transfer pricing, per se, is simply the setting of transfer prices, which conveys no information about whether they are overpriced, underpriced or set at arm’s length according to any standard, set internally by the MNE or externally by a tax authority. The literature on this topic, unfortunately, is quite sparse. Moreover, what has been published on the ethics of transfer pricing is somewhat problematic in that most articles simply review the basics of transfer pricing without grappling with the ethical dilemmas facing MNEs (Dembinski, 2006; Bateman, 2007; Jeffers, Burgess and Hughes, 2008).

The few articles that do specifically focus on the ethics of transfer pricing typically start from the normative assumption that transfer pricing is morally wrong because it harms society (Mehafdi, 2000; Christian Aid, 2009; Sikka and Willmott, 2010). Mehafdi (2000), for example, provides detailed lists of the physical, economic and psychological harm to the MNE itself and to the host country that can be caused by transfer pricing. The host country potential negative impacts identified by Mehafdi (2000, p. 371, in addition to the loss of income tax and custom duties, include: depletion of natural resources, environmental damage, health hazards, increased national debt and poverty, psychological feelings of betrayal and loss of trust in MNEs, and economic colonialism. He argues that transfer pricing can “abuse the trust and hospitality of the host country”, “rob the local workforce”, “reinforce politics of greed” and “tarnish the TNC’s image” (p. 374). Sikka and Willmott (2010) extend Mehafdi’s argument by examining the ‘dark side’ of transfer pricing, which they see as a vehicle employed by corporations to avoid taxes and facilitate capital flight. Their article focuses on the politics of transfer pricing and provides multiple examples of abusive transfer pricing. The authors conclude that:
The use of transfer pricing to avoid taxes poses challenges to professional and corporate claims of acting as socially responsible corporations. It is difficult to reconcile claims of social responsibility with everyday corporate routines and processes that divert tax payments away from society to shareholders. .....Such practices may enrich a few people but also deprive millions of people of clean water, sanitation, education, healthcare, pensions, security, transport and public goods. (2010, pp. 353-354)

The set of even-handed articles on the ethics of transfer pricing is very small. Perhaps the best is Hanson, Crosser and Laufer (1992) who examine transfer pricing using the lens of tax (situational) ethics and moral ethics. The tax ethics view argues that MNEs must comply with tax law, but are not obliged to do any more. Since reducing taxes is sound business planning, as long as the methods are legal and disclosed to the tax authority, the MNE executive is not obligated to do any more. The moral ethics view, on the other hand, argues that merely complying with legal norms is not necessarily ethical. MNE executives should take into account the societal impacts of their actions, including the impacts of their transfer pricing policies. The authors argue that ethics requires more than technical compliance with the “rules of the game”. Even if tax minimization is legal and therefore meets the test of tax (situational) ethics, the authors argue that MNE executives must also be concerned with the broader implications of tax minimization in terms of societal well-being. We build on their work below in the section on TPM and tax fraud. However, first, we explore why MNEs engage in TPM. We argue that TPM is a key benefit that is only available when the firm internalizes transactions.

WHY DO FIRMS ENGAGE IN TRANSFER PRICE MANIPULATION?

The Benefits of Internalization

Being a multinational enterprise offers a variety of advantages compared to a domestic firm. Chief among the benefits is internalization (Buckley & Casson, 1976), the substitution of intrafirm or related party transactions (the internal market or hierarchy) for arm’s length transactions (the external market). There are at least three benefits to the MNE from internalization. First, internalization reduces transactions costs, such as the costs of search, negotiation, monitoring, and dispute settlement, which
hamper trade between unrelated firms. Second, MNEs can transfer tacit resources such as non-codifiable knowledge flows more effectively within the MNE than between arm’s length firms, simply because tacit flows are so difficult to transfer over distances; internalization therefore facilitates cross-border transfer of intangible assets (Kogut and Zander, 1993). Both of these motivations for internalization are efficiency enhancing and should improve global welfare.

Third, we live in a semi-globalized world where there are still large differences between countries (Ghemawat, 2001). Through internalization, MNEs can benefit from integration and arbitrage in ways that domestic firms cannot. Multinationals can integrate, taking advantage of economies of scale and scope on a regional or global basis. MNEs can arbitrage, taking advantage of differences in prices and endowments across countries, putting stages of the production chain such as processing, assembly and sales where they offer the greatest net value added for the MNE. This external motivation for internalization is also efficiency enhancing and should raise global welfare.

Semi-globalization also offers opportunities for regulatory arbitrage, where MNEs take advantage of differences in government regulations across countries by, for example, shifting activities and profits to less taxed or regulated locations (Rugman and Eden, 1985; Eden, 1998). The opportunity to raise global after-tax profits by using transfer pricing to engage in regulatory arbitrage between countries has been a major concern of national tax and other regulatory authorities for many decades, one that prompted the development of the arm’s length standard (Picciotto, 1992; Eden, 1998). TPM based on regulatory arbitrage may or may not be efficiency enhancing, for national and global welfare (see, for example, Rugman and Eden, 1985; Itagaki, 1991).

The reason why internalization creates benefits that are unavailable (or less available) to open market transactions is that the goals of the trading partners change; this change not only makes a big difference in firm behaviors, but also has different legal implications for MNEs and domestic firms. The goals of parties to an intrafirm transaction are cooperative – their purpose is to maximize joint MNE
profit – whereas the goals of arm’s length parties when they trade are conflictual – their purpose is to maximize individual profits. In effect, MNE subunits collude rather than compete in the market. Internalization creates opportunities for collusion among MNE subunits, allowing them to take advantage of differences between countries in ways that unrelated parties cannot. Moreover, when unrelated firms collude, they can face legal challenges as cartels, anti-competitive behavior and/or price fixing since competition laws in most countries outlaw collusive behavior between unrelated firms. Internalization therefore provides both economic and legal opportunities for value creation through intrafirm transactions that are not available in arm’s length transactions.

MNEs therefore have both internal and external motivations to replace arm’s length transactions in the open marketplace with internal transactions within the MNE hierarchy. Once transactions are moved inside the firm, the MNE must determine the optimal transfer price that takes into account both the internal and external motivations.

**Internal Motivations for Transfer Pricing**

There may be cases where the MNE has no internal reasons for setting a transfer price; transactions may be small in volume or difficult to value or occur with extraordinary rapidity. Conventional accounting practice, for example, generally defers valuation of intangible assets until there are arm’s length purchases or sales, creating the balance sheet item "goodwill", which measures the excess purchase price over fair value of the assets acquired. In such cases, we do not expect to see transfer prices.

However, in the typical case, the MNE has internal motivations for setting a transfer price such as performance evaluation of subsidiary managers, better tracking of intrafirm flows, and so on. In such cases, where no external market exists, the MNE should set the transfer price equal to the shadow price on intrafirm transactions; generally, this is the marginal cost of the exporting division. Efficient transfer prices for services and for private intangibles have similar rules; they should be based on the benefit-
cost principle; i.e. each division should pay a transfer price proportionate to the benefits it receives from the service or intangible (Eden, 1998). Where external market prices exist, they should be taken account in setting the transfer price; that is, divisions should be allowed to buy and sell in the external market. In each case, the purpose of the TP is efficient resource allocation within the MNE group.

Transfer pricing is designed for and ideally suited to internal management and accountability of corporate profit centers and cost centers, thereby contributing to better overall management of corporate operations. TPM can potentially distort this very useful activity, if the focus is solely on tax minimization, and does not consider the goal of better management and accountability.

**External Motivations for Transfer Pricing**

Economists have long studied tax-induced motivations to engage in TPM. For evidence that firms do manipulate transfer prices to raise their after-tax returns; see, for example, Bartelsman and Beetsma (2003), Clausing (2002), Eden (1998), Eden and Rodriguez (2006), Li and Balachandran (1996), Fisman and Wei (2001), Grubert and Mutti (1991), Swenson (2001) and Tomohara (2004). Overpricing inbound transfers and underpricing outbound transfers can be used to move profits out of a high-tax jurisdiction or from a country that does not allow capital remittances. Differences in corporate income tax rates between countries (which are exacerbated by tax havens and tax deferral) create profitable opportunities for MNEs to engage in TPM.

Trade taxes (tariffs, export taxes) provide a second external motivation for TPM. For evidence on tariff-induced motivations for TPM see Eden (1998), Vincent (2004), Goetzl (2005) and Eden and Rodriguez (2004). Another external motivation is foreign exchange restrictions. One example of evidence on foreign exchange rate motivations for TPM is Chan and Chow (1997); they found that foreign MNEs were engaged in TPM to shift profits out of China not because of CIT differentials (in fact, Chinese tax rates were lower than elsewhere) but to avoid foreign exchange risks and controls.

Another area susceptible to TPM is political risk, where capital flight can be accomplished

Transfer Pricing Strategy: Balancing External and Internal Motivations

The fact that MNE subunits can collude in setting the transfer price gives an MNE the ability – which unrelated firms do not legally have – to choose a price that jointly maximizes their profits, the so-called profit-maximizing transfer price. The determination of a profit-maximizing transfer price is a complex decision-making process. The MNE must take into account both internal motivations (costs and revenues of the individual affiliates) and external motivations (the existence of external market prices and government regulations such as taxes and tariffs) that can affect the optimal transfer price (Hirshleifer, 1956, 1957; Horst, 1971; Eden, 1998). The tax-saving benefits from TPM must be traded off against resource-allocation distortions within the firm caused by mispricing. The final transfer price that maximizes the MNE’s global after-tax profits is unlikely to look at all like the regulatory methods proposed in the OECD guidelines or the specific methods set in national tax regulations (Eden, 1998).

Given the wide variety of internal and external motivations for setting transfer prices, how do MNEs in practice actually determine their transfer pricing policies? Some research has been done in this area; see Borkowski (1992), Chan and Lo (2004), Colbert and Spicer (1995), Cravens (1997), Durst (2002), Elliot and Emmanuel (2000a,b), Tang (1993, 1997, 2002) and Cools (2003)). The survey evidence suggests that both internal and external motivations affect transfer-pricing decisions.

Cravens (1997) surveyed 82 US multinationals about their international transfer pricing objectives. The respondents (typically the controller, vice president of finance or chief financial officer) were asked to rank the top three objectives for their firm’s transfer pricing strategy. The highest ranked goal was managing the tax burden (28% of respondents ranked it in the top three), followed by
maintaining competitive position (17%). What is interesting is that motivations were almost equally split between internal (managerial and operational) and external (government, other external) objectives. Thirty-five percent of respondents ranked tax-related goals (managing the tax burden, complying with regulations) in the top three.

Tang (2002, p. 42), in his 1997-98 survey of 86 MNEs, found results similar to Cravens. Maximizing consolidated after-tax profits was listed by 42% of respondents as their most important transfer-pricing objective; second was determining the performance of domestic and foreign divisions at 24% followed by tax minimization at 11%. He concluded that government regulations and corporate profits were the “two overriding considerations” (2002, p. 155).

Cools, Emmanuel and Jorissen (2008) examine the effect of transfer pricing tax compliance on design and application of management control systems for one MNE that used the same transfer prices for tax compliance and internal management purposes. The study finds immediate effects of tax compliance on the design of organizing controls with subsequent effects on planning, evaluating and rewarding controls. The authors suggest that changes to management control systems are not understandable without appreciation of the MNEs’ fiscal transfer pricing compliance process.

The evidence from surveys of MNEs also shows that most firms delegate responsibility for transfer pricing decisions to the parent, which suggests that where there are multiple conflicting objectives the MNE moves decision making to the headquarters level. Tang (2002, p. 43), for example, found that in his 1997-98 survey, 69% of MNE respondents allocated the responsibility for setting transfer prices to top executives of the parent company; about one-third of these decisions were made without prior consultation with divisional executives. Only 18% of transfer prices were determined solely by divisional executives. These results were similar to those he found in earlier surveys.

Elliott and Emmanuel (2000b) provide justification for centralizing transfer pricing decision making. They found, in interviews with 12 UK multinationals, that: “It proved impossible for our
participants to describe a single intra-group transaction in isolation from the group’s operations as a whole. In virtually all instances, commercial reality required the inter-connectedness of the parts of the group to be recounted. (2000, p. 218). The authors attributed this inseparability to market forces (the market was global or displayed sequential interdependence as in 24-hour global trading) and/or vertical integration. As a result, transfer prices were centrally determined, as was the decision to buy or sell on external markets. Elliott and Emmanuel (2000b) noted that centrally determined transfer prices were sometimes adjusted for local market conditions (e.g., subsidiaries were in start-up situations or were smaller) or for fiscal reasons (e.g., to take advantage of tax holidays or unused foreign tax credits). Where exceptions were frequent, additional internal structures were added to “maintain subsidiary managerial commitment and motivation” (2000b, p. 219).

Lastly, Ernst & Young, in each of its biennial transfer pricing reports, has continued to argue that transfer pricing should be treated as a strategic decision for the MNE. Ernst & Young (2001, p. 8), for example, argues that “MNCs can realize significant financial and efficient benefits by integrating tax and operations at every step of the [value] chain”. The advantages included “the ability to enhance shareholder value by preemptively driving out unnecessary tax costs within the boundaries of the arm’s-length principle, via a close alignment of tax and business structures”. The 2001 survey, however, lamented that only 29% of parent firms and 35% of subsidiaries saw transfer pricing as part of strategic planning; 28% of parents and 20% of subsidiaries determined transfer prices after strategic decisions were made and an even larger percent (39% of parents and 38% of subsidiaries) treated transfer pricing as a tax compliance issue. The E&Y survey concluded that “the continued lack of alignment between tax and operations is discouraging” (2001, p. 7). More recent reports, however, argue that MNE executives now see transfer pricing not only as their top international tax concern, but also strategically important for the MNE as a whole. The responsibility for the transfer pricing function within the MNE is shifting

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4 That is, aggressive TPM should be used to minimize taxes, up to legal boundaries.
from tax to finance or audit, partly as a response to the increased transfer pricing-related financial statement risk related to FIN 48. Only 44% of MNE parent respondents to the 2007-2008 Ernst & Young survey report that the transfer pricing function is located in their tax department, down from 50% in 2005 (Ernst & Young, 2008, p. 11).

We therefore conclude that MNEs are now elevating transfer pricing from an international tax concern to a strategic concern for the firm. However, there is little to no evidence that MNE executives view transfer pricing – even abusive transfer pricing – as an ethical issue. To build an ethical theory of transfer pricing, we argue it is important to incorporate insights from two related literatures on illegal corporate behavior, tax fraud and the fraud triangle, to which we now turn.

TRANSFER PRICE MANIPULATION: INSIGHTS FROM TAX FRAUD

Tax Avoidance, Evasion and Fraud

We start with by first distinguishing among the various types of tax planning. *Tax planning* is the arranging of one’s affairs, either an individual or a firm, for a tax purpose. Tax planning is the arranging of one’s affairs for a tax purpose. The goal of most tax planning is to reduce one’s or one’s client’s taxes. The reasons for doing this are several. Some states and countries levy much heavier tax rates than others, creating an incentive for firms to shift profits from high-tax to low-tax locations. Second, arbitraging international tax burdens is an inherently “multinational” activity. MNEs, by definition of being multinationals, operate in multiple countries around the world. Profiting from arbitrage (taking advantage of differences) and integration (taking advantage of economies of scale and scope) are two core skills of MNEs in a semi-globalized world. For example, nothing would be inherently morally wrong with intentionally moving an MNE’s operations from one country to another for the benefit of cheaper raw materials, lower labor rates, or lower taxes.

Most international tax accountants and lawyers are in the tax planning industry. They see their
primary function as helping firms to minimize their tax burden (Sikka, 2008; Sikka and Hampton, 2005; Sikka and Wilmott, 1995). Sikka and Hampton (2005), for example, argue that the Big Four accounting firms gave shifted their focus from auditing to tax planning and the selling of tax avoidance products to MNEs and individuals.

There are three forms of tax planning: avoidance, evasion and fraud (McBarnet, 1991, 1992; Kramer, 2001). Tax avoidance is legitimate tax planning for the purpose of minimizing the firm’s tax burden; tax avoidance is legal. Judge Learned Hand made this point very clearly: “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.” (Hand, 1934, p. 809) Later he reaffirmed this position, “Over and over again courts have said there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.” (1947, pp. 850-851).

Tax avoidance is often tolerated; for example, firms are permitted to move from one state to another within a country to reduce their corporate income taxes (e.g. from California to Texas). Movements between countries, even where tolerated, however may have tax consequences (e.g. the levying of exit taxes). Many tax preferences identified in the OECD (1998)’s abusive tax havens initiative have actually been tolerated forms of tax avoidance. Governments may even encourage tax avoidance, for example, by establishing tax preferences that encourage certain activities such as R&D investments, or giving tax holidays for new investments.

Tax evasion is tax planning that is not tolerated by the government (McBarnet, 1992; Kramer, 2001). “Not tolerated” means that the method of saving taxes is not covered in tax law (a “loophole”) or there is an unfavorable provision that could be interpreted (depending on how one interprets the substance of the provision) as barring the activity. In such cases, tax evasion may be illegal, but – if there
were no deliberate intent to defraud – may not be punishable.

There are two types of tax evasion: substance over form and abusive or sham transactions (Kramer, 2001). In substance over form, the MNE may arrange its activities specifically so as to save tax, for example, by creating facts so as to take advantage of a favorable tax provision or to create facts so as to avoid the clear wording of an unfavorable tax position, thus, there is no economic substance behind the activity. In such cases, the tax authority may look through the transaction to the economic substance behind it, or look through the literal interpretation of the legal provision to assess the intention of the tax provision. As an example, the MNE might create arm’s length transactions, buying or selling with outside parties, specifically so as to create arm’s length prices. If these transactions are small or marginal trades, the tax authority may likely to discard these transactions and argue they are not comparables. Many tax authorities now explicitly keep the right to recharacterize transactions when the form and substance of the transaction differ significantly.

With abusive or sham transactions, the creation of facts must be purely tax motivated with no substance behind it. In this situation, the tax authority is likely to disregard the transaction. More generally, governments may have anti-abuse rules where, if the MNE attempted to circumvent the tax code by setting up fictitious arrangements so as to save tax, these are treated as an abuse of the tax code and penalties are levied in addition to the transactions being recharacterized.

*Tax fraud* involves tax planning where the relevant facts are disguised or nonexistent facts are feigned, or where tax evasion is covered by a criminal provision in national tax law (McBarnet, 1991, 1992; Kramer, 2001). Giving incorrect or incomplete information about tax-relevant facts to tax authorities, or not informing tax authorities of relevant facts, is tax fraud. In short, tax fraud is tax evasion combined with lying. Basically, if a firm either (a) conceals relevant facts that firms are under an obligation to disclose or (b) distorts relevant facts, this constitutes tax fraud.

One can imagine the three types of tax planning as arranged along a vertical line, where tax
avoidance is legal, tax evasion is not tolerated but not necessarily illegal, and tax fraud is definitely illegal. The “bright line” test is to distinguish when tax planning moves from legal to illegal; that is, determining where tax evasion with lying begins.

The first test involves distinguishing between tax avoidance and tax evasion, where in the “eye of the beholder” matters since what the MNE may see as tax avoidance, the tax authority is likely to see as tax evasion (McBarnet, 1991, 1992). For example, thin capitalization rules were created when tax authorities determined that MNEs’ manipulating their debt/equity ratios to reduce their overall tax burden (since interest costs are tax deductible but equity costs are not) was illegal (Brean, 1985). Other examples of “fiscal transfer pricing” remain in the legal category (see, for example, the methods discussed in Brean (1985) and McBarnet (1992)). McBarnet (1992, pp. 64-65) argues that the difference between avoidance and evasion is that, “it’s not what you do but the way you do it”. Both activities are motivated by the desire to escape tax; both have the same effects (private gain at the expense of public loss). The key difference, she argues, is the means used. Tax evasion abuses (breaks or ignores) the law; tax avoidance uses the law (its rules, loopholes or gray areas) to avoid tax. By using rather than abusing the law, the MNE is able to avoid risk of tax penalties or damaged reputation.

The second test, distinguishing between evasion and fraud, depends on providing deliberate intent (lying). A recent quote from the IRS Commissioner makes the challenge involved in determining deliberate intent very clearly, “One of our challenges at the Internal Revenue Service is to determine and distinguish between taxpayers who want to comply but cannot due to complexity or ambiguity of the tax law, and taxpayers who consciously choose not to comply” (Stiff, 2007, p. 4). McBarnet (1992, pp. 65-66) argues that firms engage activities to “get the form right”, providing themselves with fraud insurance against accusations of deceit; see also McBarnet (2006) on creative compliance.

**Transfer Price Manipulation: Links to Tax Fraud**

Hanson, Crosser and Laufer (1992) argue that the ethics of transfer pricing differs depending on
whether one takes a tax (situational) or moral ethics perspective. In the tax ethics view, MNEs must comply with the law but are not required to go further. The moral ethics view, however, sees compliance with legal norms as insufficient. Below, we apply insights from the tax fraud literature to analyze the ethics of transfer price manipulation, using these two views.

The Tax Ethics View

Friedman (1970) argued that the social responsibility of business was to use its resources and engage in activities designed to increase profits, as long as the firm stayed within the “rules of the game”. Staying within the rules means operating within the legal limits of the law, without deception or fraud. The only responsibility of a firm’s manager is therefore to focus on maximizing returns for its stockholders. The responsibility of society is to establish the framework of law within which firms interacted. As long as the firm stays within the rules, it is behaving ethically and in accordance with the social responsibility of business.

When one moves this argument to the international level, the social responsibility of business, building on Friedman (1970), is to maximize returns for the MNE’s stockholders on a global basis, within the legal limits of the law, without deception or fraud. The “law” now becomes more complicated, however, since there are at least two countries involved, the home country and one or more host countries; gaps between national laws provide profitable opportunities for MNE arbitrage.

We can visualize TPM as similar to the range between tax avoidance, evasion and fraud, depending on whether the TPM is within the law or not, and whether the intent was to deliberately withhold or manipulate information. If the purpose was to divert income, but the activity is legal, then no evasion or fraud has occurred. If the activity is illegal or there was no substance behind the transactions then TPM crosses the bright line test and becomes illegal.

We illustrate this in Figure 1 where the vertical axis measures the legality of the activity, ranging from clearly legal to highly illegal. As one moves up in the figure, we progress from tax avoidance
through evasion to tax fraud. The “bright line” in the middle represents the gray between legal and illegal activities. The horizontal axis measures the opportunities for regulatory arbitrage, which range from low to high. As opportunities for regulatory arbitrage increase, we argue MNEs are more likely to engage in aggressive TPM, skirting the bright line between legal and illegal activities. Some MNEs will go further and engage in abusive TPM, which we see as akin to illegal tax evasion with or without the presence of lying. Abusive transfer pricing becomes fraudulent when accompanied by lying.

[Figure 1 goes about here]

In the tax (situational) ethics view, as long as TPM complies with the “rules of the game” and is designed to achieve the social responsibility of business (maximizing returns for shareholders), TPM is ethical. Therefore, from a tax ethics perspective any activities that are not directly illegal (in the top quadrant of Figure 1) are morally acceptable.

**The Moral Ethics View**

The moral ethics view argues that the MNE is an organization that has responsibilities beyond its shareholders that encompass all of the firm’s stakeholders. Stakeholders are any group that can affect or is affected by the achievement of the MNE’s goals (Freeman, 1984), or more generally, any persons or groups with legitimate interests in procedural and/or substantive aspects of the firm’s activities (Donaldson and Preston, 1995). Stakeholder theory assumes that values are a necessary part of conducting business, and managers disclose their values, preferences and biases by engaging in corporate social activities (Evan and Freeman, 1988). Therefore the moral responsibility of business includes being socially responsible (Freeman, Wicks and Parmar, 2004).

This literature argues that firms also benefit from investing in socially responsible activities. The firm signals the values and preferences of its top management team, and derives benefits such as strong reputation (Brammer and Pavelin, 2006) and better performance (Orlitzky, Schmidt and Rynes, 2003). A positive corporate reputation is associated with a significant market value premium, superior financial
performance, and lower cost of capital (Smith et al., 2010; Blazovich and Smith, 2011). Moreover, organizational theory predicts that the organizational forms most likely to survive are those that focus on legitimacy as well as attempting to maximize shareholder returns (DiMaggio and Powell, 1983).

There is some literature that argues responsible tax practices can contribute to corporate social responsibility (McBarnet, 2006). If we apply the moral ethics view that MNEs should be good corporate citizens not only to CSR activities but also to transfer pricing, at the very least, transfer pricing should be designed to “do no harm” (Mehafdi, 2000). The definition of stakeholders expands to include both home and host country governments and residents. To maintain a positive corporate reputation, MNE executives would need to voluntarily apply OECD transfer pricing rules in a way that was determined to be correct and fair to affected parties, particularly in developing countries.  

A moral ethics view of transfer pricing suggests that the bright line dividing legal from illegal activities in Figure 1 does not coincide with the line determining ethical from unethical transfer pricing. Any TPM that causes social harm, in this perspective, is seen as unethical, and that would easily include activities in the bottom half of the figure.

Transfer Price Manipulation and Tax Fraud

Where TPM is patently illegal or there is no substance behind the intrafirm transactions, TPM is akin to tax evasion; when lying is attached, TPM is akin to tax fraud. Both the tax ethics and the moral ethics view of transfer price manipulation agree that the activity is clearly unethical. The two views differ in the “gray” area where TPM is aggressive but still within legal boundaries. In the tax ethics view, as long as TPM is legal and maximizes returns to shareholders – regardless of how aggressive the over/under-invoicing – the MNE is engaged in ethical behavior. In the moral ethics view, however, most TPM – whether aggressive or not --- imposes costs on society and should be discouraged. In this view,  

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5 MNE executives might well counter that the moral responsibility to pay “above and beyond” the taxes required by law requires a similar commitment from the tax authority, that is, the government spend the funds so received on socially responsible activities. Additional taxes paid that are siphoned off by corrupt dictators into secrecy havens create no social value.
ethical behavior requires more than simple compliance with the “rules of the game”; MNEs must also be concerned with the broader implications of TPM for societal well-being. We see these two views as irreconcilable, given their normative underpinnings.

TRANSFER PRICE MANIPULATION: INSIGHTS FROM THE FRAUD TRIANGLE

The Fraud Triangle

Criminal sociologist Dr. Donald Cressey argued that there are three conditions present when fraud occurs: opportunity, pressure and rationalization (Cressey, 1953). First, the individual must have the opportunity to commit fraud, for example, where controls are missing or weak. Second, the individual must have a financial need, pressure or incentive to commit fraud. Third, the individual must rationalize the fraudulent act, either ex ante or ex post, as consistent with his/her personal code of ethics. Fraudulent acts are more common when opportunities and pressures are high, and individuals are more predisposed to rationalize their actions.

Cressey’s three-fold characterization of fraud has been linked to financial statement fraud by numerous accounting researchers (e.g., Wells, 1997; Montgomery, Beasley, Menelaides and Palmrose, 2002; Coenen, 2007; Skousen et al., 2008). Financial statement fraud occurs when a firm deliberately issues materially misleading financial statements that injure investors and creditors (Elliott and Willingham, 1980, p. 4). Opportunity, the first corner of the fraud triangle, comes from positions of power, where individuals have greater control over decision-making and lower accountability to others for those decisions. Research indicates that organizational structure that allows individuals to dominate decision making, e.g. regarding senior management, there is a higher potential for fraud (Beasley, Carcello, Hermanson and Lapides, 2000; Abbott et al., 2000; Dunn, 2004; Skousen et al., 2008).

Lack of or weakness in internal and external monitoring also increases the likelihood of fraud (Nestor, 2004). To reduce this likelihood, firms should design an organizational structure that includes a
corporate code of ethics and internal controls that provide accountability for decisions. McBarnet (2006, p. 1105), for example, argues that firms should adopt company-wide Codes of Ethics and Compliance, where “evidence of code implementation and a culture of integrity” are required.

Pressures and incentives, the second corner of the fraud triangle, typically arise from failure, where firms are in debt, need funds and are worried about negative analyst forecasts. Success also, interestingly, can be a pressure for fraud. Mishina, Dykes, Block and Pollock (2010), for example, find that high performing firms are more likely to engage in illegal activities due to loss aversion and hubris. Desai and Dharmapala (2006) find that incentive compensation for managers is also an important determinant of tax avoidance; higher incentive compensation discourages rent diversion by managers and encourages aggressive use of tax shelters.

Rationalization, the third corner, is also important. Financial statement fraud can be rationalized by an unethical ‘tone at the top,’ that is senior management’s ethical perspective that making money at all costs is acceptable. While the negative consequences of unethical behavior are well documented, its occurrence persists as human beings are often short-term focused and make irrational decisions that jeopardize personal and organizational reputation, even where their acts can lead to both civil and criminal penalties (Blazovich and Smith, 2011; Smith et al., 2010; Murphy and Dacin, forthcoming).

The fraud triangle was incorporated into auditing standards by the American Institute of Certified Accountants (AICPA) in its Statement on Auditing Standards No. (SAS) 99: Consideration of Fraud in a Financial Statement Audit (AICPA 2002). SAS 99 defines fraud as an intentional act that results in a material misstatement in a firm’s financial statements. The fraud must be intentional; misstatements that are not intentional are not fraud. SAS 99 breaks fraud into two types: misstatements arising from (1) fraudulent financial reporting such as deliberate falsification of accounting records such that they do not comply with GAAP, and (2) misappropriation of assets by methods such as theft or the creation of false documents. SAS 99 argues that the three fraud triangle
conditions are usually present when fraud occurs: motivation (reason to commit fraud), opportunity (absence of controls to prevent or detect fraud) and attitude (ability to rationalize fraud). SAS 99 includes a detailed appendix identifying risk factors associated with greater likelihood of an organization’s committing fraud.

**The Transfer Pricing Fraud Triangle**

We argue there are clear linkages among the three types of illegal corporate behavior that we have discussed in this paper: transfer price manipulation, tax fraud, and financial statement fraud. When TPM becomes aggressive and moves over into the abusive category, it can potentially lead to tax fraud or financial statement fraud or both. We illustrate the overlap in Figure 2.

[Figure 2 goes about here]

We also argue that the fraud triangle can be applied to transfer pricing fraud (see Figure 3). Opportunity in the fraud triangle comes from positions of power and the absence of controls or monitoring. The opportunity for abusive transfer pricing exists due to the semi-globalized environment in which MNEs operate, that is, multiple nations with different tax rates and transfer pricing rules. TPM is an arbitrage activity. Global after-tax profits can be increased by exploiting gaps and loopholes, both real and financial, between countries. The opportunities for abusive TPM are ever present. Moreover, governments have difficulty monitoring or controlling TPM because of the absence of global rules, and the lack of coordination and harmonization of national regulations. MNEs can play a “cat and mouse” game with national governments, taking advantages of weaknesses in the global regulatory framework.

The pressures and incentives for transfer pricing fraud are similar to those for tax and financial statements fraud: the additional global after-tax profits and managerial bonuses that come from TPM and higher analysts’ forecasts and stock market valuations. MNEs rationalize aggressive TPM using the tax ethics view that shareholders benefit and “everyone is doing it” (Braithwaite and Braithwaite, 2006).

[Figure 3 goes about here]
POLICY IMPLICATIONS

If abusive transfer pricing is illegal and unethical, how can governments reduce MNE incentives to engage in such behaviors? We argue that the transfer pricing fraud triangle in Figure 3 provides useful insights. Key to reducing abusive TPM is lessening the (1) opportunity, (2) pressures/incentives, and (3) rationalization for MNEs to engage in abusive transfer pricing. Reducing opportunity requires more coordination and harmonization of national regulatory systems so as to eliminate arbitrage opportunities for TPM. Greater regulatory and monitoring control (e.g., simultaneous coordinated audits, exchange of information, multilateral advance pricing agreements) will also reduce opportunities for transfer pricing fraud. Reducing pressures for abusive TP can best be accomplished through national and international accounting standards. Changing rationalization of abusive TP is perhaps the most difficult of the three and may require the development of new norms. Because so much has been written on tax policy changes to reduce opportunities for TPM (e.g., Eden, 1998, 2009), we confine our remarks to accounting and other regulatory changes.

Changing Rules: Accounting Standards

Financial reporting requirements are already placing new burdens on MNEs, and on the accounting, legal, economic and consulting firms that provide them with financial advice. Over half of respondents and 66% of US respondents to Ernst & Young’s 2008 survey reported that new financial reporting requirements have increased their costs of transfer pricing compliance. Eighty-seven percent of parent respondents believe that transfer pricing is now a financial statement risk for their firm, with 21% seeing it as the largest risk issue (Ernst & Young 2008, pp. 22-23). The more complex the transfer pricing issues in the industry, the greater the perceived financial risk. Industries where transfer pricing is now seen as posing the largest financial statement risk are telecommunications (53%), pharmaceuticals (48%) and biotechnology (45%). Strengthening (or clarifying) SAS 99 as applying to abusive transfer
pricing would help reduce the pressure or motivation for transfer pricing fraud.

Our first policy option is to build on the changes in accounting standards that are already bringing transfer pricing under the SEC umbrella through the 2002 Sarbanes-Oxley Act. SAS 99 includes an appendix identifying risk factors associated with greater likelihood of an organization’s committing fraud. Several of the “opportunity” factors are closely related to transfer pricing and the linkages to TPM could be made more explicit. (See Box 1.)

[Box 1 goes about here]

The 2002 Sarbanes-Oxley (SOX) Act requires that firms certify they have established internal controls to ensure accurate financial reporting, and that the firm’s external auditors attest they have assessed these controls. Section 302 of Sarbanes-Oxley requires that the principal executive and financial officers review the financial reports and attest that they present fairly all material information, including the valuation of intrafirm transfers. This means that the chief executive officers of all MNEs must now state that their firm’s transfer pricing policies accurately reflect all material information that could affect the firm’s financial statements. Section 404 requires the firm to include in annual report filings a report on these internal controls over financial reporting, together with an independent auditor’s assessment of the firm’s internal controls. The implication is probably greater central control of transfer pricing, and a closer synchronization between finance and tax departments of large MNEs.

Since January 2007, all firms using US GAAP rules, including non-US firms registered with the SEC, must comply with Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48). FIN 48 mandates a framework for the recognition, measurement, and disclosure in US GAAP financial statements of the impact of uncertain tax positions taken or to be taken in a company’s tax returns. FIN 48 requires firms to determine whether a tax position they have taken will be more or less likely to be sustained upon examination by a tax authority, including foreign tax authorities if the company files tax returns outside the US. Tax positions must be identified, documented, subject to a recognition test and
measured. Timing issues (e.g. with respect to depreciation of assets) must also be taken into account. The required documentation and analyses under FIN 48 are also subject to the internal control standards required by the Sarbanes-Oxley Act. Since transfer pricing policies are an important component in the MNE’s tax positions, FIN 48 is widely expected to have major impacts on MNE compliance burdens (Spencer and Miesel, 2009).

These initiatives force the executives of MNEs and their advisors and auditors to pay more attention to fraudulent activities inside the corporation. Intrafirm transactions, because they allow units of the MNE to collude with one another, provide opportunities not only to avoid taxes but also to engage in tax evasion and tax fraud. Thus, clarifying that egregious TPM is also corporate fraud, and requiring tax auditors to be whistle blowers, should reduce fraudulent transfer pricing.

Corporate management of MNEs should establish transfer pricing policies that lead to appropriate price, where possible independent, arms-length prices. Regarding opportunity for transfer pricing fraud, firms should strive to establish transfer pricing practices such that individuals involved will have accountability and will have as little opportunity as possible to use abusive transfer prices. Financial performance should not be communicated as the firm’s ultimate goal, but “doing what’s right” always trumps doing what makes the highest profit. Pressure should be to adhere to the highest standards of ethics, which should be communicated from top management. By presenting the importance of ethical transfer pricing, by communicating the importance of doing what’s right, firms can ensure that transfer pricing practices will not lead to transfer pricing fraud (McBarnet, 2006).

**Changing Norms: Abusive Transfer Pricing**

Including ethical training with respect transfer price manipulation as part of the tax planning community’s professional recertification activities would help strengthen the rationalization corner of the transfer pricing fraud triangle. Such training could focus on comparing tax and moral ethics, determining the “bright line” where a TPM action becomes unethical, and taxation in the context of
corporate social responsibility. The ethics of TPM could also be included in business school classes, particularly in accounting and MBA courses.

A much deeper policy change would be to attempt to change the underlying norms and rules of the game. A hypernorm is a “principle seen as so fundamental to human existence that they should guide evaluating lower level moral norms” (Donaldson and Dunfee, 1994, p. 265). Examples of hypernorms include universal injunctions against murder as well as business hypernorms informing employees of health hazards in their workplace and employee rights to physical security in their workplace (Spicer, Dunfee and Bailey, 2004).

The moral ethics approach to TPM suggests that MNE executives need to focus more on stakeholders and see the payment of taxes as not only a legal question but also an ethical and moral one. Could governments encourage the development of a transfer pricing hypernorm whereby abusive transfer pricing would be seen as corporate fraud and socially irresponsible? We suggest two ways that might lead to the development of a transfer pricing hypernorm.

First, the UN Global Compact offers a set of hypernorms for firms in areas of human rights, labor standards, environment protection and corruption. The UN Global Compact, according to its executive director (Kell, 2005, p. 78), is designed to define and formalize a “standard of what constitutes global corporate citizenship”. The Global Compact “asks companies to embrace, support and enact, within their sphere of influence, a set of core principles in the areas of human rights, labor standards, the environment and anti-corruption” (UNGC, 2007). Box 2 outlines these norms. Of the Global Compact hypernorms, the one most closely related to TPM is the anti-corruption norm. This norm focuses on corrupt governments and firms’ efforts to avoid paying bribes. The norm is not about corrupt firms and their effects to engage in TPM to evade government regulations or engage in fraudulent activities. However, one could conceptualize of this norm being broadened to include corrupt behaviors of firms in the form of evasive and fraudulent TPM; we add this change in Box 2.
A second route to creating a global hypernorm would be to extend the work being done by the Financial Action Task Force (FATF). The FATF’s 2006 report on trade-based money laundering distinguishes between (1) tax avoidance and evasion, (2) capital flight and (3) trade-based money laundering. Trade-based money laundering is defined in the report (FATF, 2006: Executive Summary) as:

*the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origins. In practice, this can be achieved through the misrepresentation of the price, quantity or quality of imports or exports. Moreover, trade-based money laundering techniques vary in complexity and are frequently used in combination with other money laundering techniques to further obscure the money trail.*

The Wolfsberg Group (2009) has built on FATF (2006) to develop a series of trade finance principles to guide the banks involved in providing trade finance. The Wolfsberg Principles outline seven types of mispricing that can facilitate money laundering: over/underinvoicing, multiple invoicing, short shipping, over shipping, deliberate obfuscation of the type of goods and phantom shipping. While the purpose of these norms is only to deter money laundering activities through trade mispricing, one could imagine something similar to the FATF and Wolfram Principles being used to create a set of more general norms for transfer pricing. See Box 3.

**CONCLUSIONS**

The purpose of this paper was to develop a theoretical framework for understanding the ethics of transfer pricing. We argued that the ability to manipulate transfer prices is one of the key benefits of internalization for the MNE; through TPM, multinationals can take advantage of arbitrage opportunities in a semi-globalized world. Problems arise when MNEs use transfer pricing as a form of regulatory arbitrage because TPM now creates distributional and ethical conflicts between the MNE and its stakeholders in home and host countries.

We argued that the tax fraud literature provides a useful lens for understanding transfer pricing
ethics. We compared tax and moral ethics, and linking moral ethics to the literature on stakeholders and corporate social responsibility. We concluded that the ethical issues of transfer pricing were not clear cut, and partly normative in nature. While transfer pricing is not only legal but legitimate and needed for efficient resource allocation, transfer price manipulation may be either legal or illegal, moral or immoral, depending not only on “where one sits” but also on the degree of TPM. For the MNE and the tax planning community, and also perhaps for many governments, the ethical question is setting “bright line” tests for determining what is legal versus illegal. For others, the ethical issues are more complex and closer in nature to corporate social responsibility concerns, not only shareholders but stakeholders matter and these stakeholders are not only in the home country but everywhere the MNE operates.

We then used the fraud triangle as a lens for understanding transfer price manipulation. Reducing MNE incentives for abusive TPM requires a focus on the three components of the transfer pricing fraud triangle: opportunity, pressure and rationalization. We outlined changes in national and international accounting standards that could be helpful in reducing abusive transfer pricing. We also argued that developing a global hypernorm could clarify the bright line test of ethical transfer pricing.

We see our paper as a modest response to the call by Arnold (2009) for bridging the gap between accounting research and the world of accounting practice in one of the “most socially important aspects of accounting practice”: the ethics of transfer pricing. We hope our paper encourages others to investigate this contentious and difficult area.

Arguably, some of the most socially important aspects of accounting practice are those where the difficulty of obtaining data has, with few exceptions, produced a lacuna in academic research. These include issues such as tax evasion, money laundering, transfer pricing, off-balance sheet financial activities, and the politics of accounting standard setting, to name but a few. The task of bridging the gap between accounting research and this world of accounting practice is extremely difficult, but nonetheless essential. (Arnold, 2009, p. 804)
Figure 1: Transfer Price Manipulation: Insights from Tax Fraud

![Diagram](image-url)
Figure 2: When Transfer Price Manipulation Becomes Fraudulent

Transfer price manipulation, if aggressive, can lead to (1) tax fraud, (2) financial statement fraud, or (3) both.
Figure 3: The Transfer Pricing Fraud Triangle

The opportunity for TP fraud is often present, given a multinational enterprise's operations in multiple nationalities with different tax rates and transfer pricing rules.

The pressure, or motivation, for TP fraud essentially comes from incentives to lower taxes and thereby increase profitability.

The rationalization, or attitude, for TP fraud is derived from the ethics perspective taken by the firm at the highest level, i.e., the ethics 'tone at the top.' In practice, it is the ethics perspective of individuals carrying out firm policy in operations that will commit or not commit TP fraud. Of course, it is senior management who must set the proper tone at the top and who are ultimately responsible for actions of the firm.
Box 1: SAS 99 Opportunity Risk Factors Linked to Transfer Pricing

SAS 99 includes an appendix identifying risk factors associated with greater likelihood of an organization’s committing fraud. Several of the “opportunity” factors are closely related to transfer pricing, suggesting that transfer price manipulation can be an opportunity risk factor.

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult “substance over form” questions
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
- Significant bank accounts or subsidiary or branch operations in tax haven jurisdictions for which there appears to be no clear business justification

Source: SAS 99.
Box 2: Principles of the UN Global Compact (Adjusted for Abusive Transfer Pricing)

The UN Global Compact’s ten principles in the areas of human rights, labour, the environment and anti-corruption enjoy universal consensus and are derived from:

- The Universal Declaration of Human Rights
- The International Labour Organization’s Declaration on Fundamental Principles and Rights at Work
- The Rio Declaration on Environment and Development
- The United Nations Convention Against Corruption

The Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labour standards, the environment, and anti-corruption:

**Human Rights**
- **Principle 1**: Businesses should support and respect the protection of internationally proclaimed human rights; and
- **Principle 2**: make sure that they are not complicit in human rights abuses.

**Labour Standards**
- **Principle 3**: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
- **Principle 4**: the elimination of all forms of forced and compulsory labour;
- **Principle 5**: the effective abolition of child labour; and
- **Principle 6**: the elimination of discrimination in respect of employment and occupation.

**Environment**
- **Principle 7**: Businesses should support a precautionary approach to environmental challenges;
- **Principle 8**: undertake initiatives to promote greater environmental responsibility; and
- **Principle 9**: encourage the development and diffusion of environmentally friendly technologies.

**Anti-Corruption**
- **Principle 10**: Businesses should work against corruption in all its forms, including extortion, bribery, and abusive transfer pricing.

Box 3: The Wolfsberg Trade Finance Principles

Trade-finance money laundering is the use of trade finance to obscure the illegal movement of funds includes methods to misrepresent the price, quality or quantity of goods. Generally these techniques rely upon collusion between the seller and buyer since the intended outcome from the arrangements is obtaining value in excess of what would be expected from an arm’s length transaction. The collusion may well arise because both parties are controlled by the same persons. The transfer of value in this way may be accomplished in a variety of ways which are described briefly below:

- **Over Invoicing**: by misrepresenting the price of the goods in the invoice and other documentation (stating it at above the true value) the seller gains excess value as a result of the payment.

- **Under invoicing**: by misrepresenting the price of the goods in the invoice and other documentation (stating it at below the true value) the buyer gains excess value when the payment is made.

- **Multiple invoicing**: by issuing more than one invoice for the same goods a seller can justify the receipt of multiple payments. This will be harder to detect if the colluding parties use more than one FI to facilitate the payments/transactions.

- **Short shipping**: the seller ships less than the invoiced quantity or quality of goods thereby misrepresenting the true value of goods in the documents. The effect is similar to over invoicing.

- **Over shipping**: the seller ships more than the invoiced quantity or quality of goods thereby misrepresenting the true value of goods in the documents. The effect is similar to under invoicing.

- **Deliberate obfuscation of the type of goods**: parties may structure a transaction in a way to avoid alerting any suspicion to FIs or to other third parties which become involved. This may simply involve omitting information from the relevant documentation or deliberately disguising or falsifying it. This activity may or may not involve a degree of collusion between the parties involved and may be for a variety of reasons or purposes.

- **Phantom Shipping**: no goods are shipped and all documentation is completely falsified.

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