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Transfer Pricing – Business Incentives, International Taxation and Corporate Law

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I. Introduction

Transfer Pricing, meaning the “setting, analysis, documentation, and adjustment of charges made between related parties for goods, services, or use of property (including intangible property)”, lies at the intersection of three fields of research and regulation: Business research focuses on the use of transfer prices to provide incentives for efficient resource allocation within a multi-divisional firm; taxation rules strive to control transfer prices between head office, subsidiaries and permanent establishments within a multinational enterprise in order to allocate profits and ensuing tax revenue among the countries where the firm operates; corporate law uses a panoply of strategies to monitor related-party transactions between corporate entities and their dominant shareholders as these might result in the diversion of the company’s assets to the detriment of minority shareholders or company creditors.

Currently the state of the debate can be organized as follows:

- In the field of business research, the seminal work by Schmalenbach and Hirshleifer on transfer pricing has been enriched over the years by economic research on incentives meant to mitigate the deficiencies frequently encountered within organizations (as opposed to contracts in the open market). The task of "incentive transfer pricing" is optimization. While the corporate headquarters intends to increase overall efficiency within the firm (and thereby the overall profit), managers of subdivisions are subject to the “usual” fallacies of principal-agent-relationships like information asymmetries, the non-observability of their effort, the existence of over- and underinvestment or of over- and underproduction as they endeavor to increase the part of the overall profit allocable to “their” subdivision. It is well established that the solution for this optimization problem depends on a lot of variables, such as the specificity of upfront investment, the existence of proprietary intangibles, the complementarity between the internal and the outside market and so on. In particular, there is no clear answer when to use marginal cost, average cost, historical cost, real or notional market prices etc. in order to promote efficient behavior.

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1 Wikipedia „Transfer Pricing“ (14th November 2010)
In the field of taxation of multinational enterprises, transfer pricing rules try to ensure that each involved country will be able to tax corporate income generated within its territory\(^7\). This is meant to further inter-jurisdictional equity between states while not distorting the competitive situation for independent companies on the one hand and companies belonging to an international group on the other hand. The starting point for transfer pricing analysis is the application of the “arm’s-length” price on intra-group transactions, i.e. the conditions of these transactions are examined as to their comparability with dealings between unrelated business entities (Art.9 OECD Model DTC). The allocation of profits to entities within a corporate group as different taxpayers pre-empts the allocation of profits to the jurisdiction of the territory where these entities are resident\(^8\). The theory underlying the arm’s length price suggests that transactions governed by arm’s length prices do not only indicate the “right” profit for the particular group company but also the “right” split of revenue for the involved countries.

In the field of corporate law the main thrust of the debate is focused on the protection of minority shareholders against exploitation of the corporate firm by controlling shareholders\(^9\). Against this background, the regulation and the research on related-party transactions is concentrated on listed corporations where portfolio shareholders face problems of asymmetric information and collective action while dominant shareholders are able to extract “private benefits of control”\(^10\) from their influence on the management of the firm. In recent years, several major studies\(^11\) have analyzed the different legal strategies for monitoring related-party transactions, comparing rules and standards on disclosure of such transactions, on approval for these transactions by shareholders or supervisory bodies and on ex-post sanctions like personal liability or criminal sanctions. For non-listed companies, the abuse of power by majority shareholders is relevant as well but not covered in similar detail by most corporate laws.

The relevance of transfer pricing for the purpose of creditor protection comes up when related-party transactions are used to transfer corporate assets to shareholders under the guise of third-party contracting. These “concealed distributions” can be rendered illegal both

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under the rules of corporate law such as rules on “legal capital”\textsuperscript{12} and under the rules of insolvency law as these transactions may involve “fraudulent trading”\textsuperscript{13}. The scope of application for these rules and standards governing the protection of creditors against the diversion of corporate assets is simultaneously wider and narrower when compared to the rules and standards governing the protection of minority shareholders. They are wider in scope because they also address the diversion of assets from wholly-owned subsidiaries where no minority shareholders exist (a case very common in a multinational corporate group) and they are narrower in scope because they exert their force only when a related-party transaction actually endangers the full satisfaction of creditors, e. g. when a company operates on the brink of insolvency or (when applicable) its legal capital is diminished by the transaction.

While these three aspects of transfer pricing are subject to intensive controversies within their respective disciplines, the mutual interaction has not gained much attention. The state of the art is the following:

- Tax law starts from the assumption that the application of the arm’s length standard will reduce the interference of tax effects with \textit{bona fide} business decisions taken by the corporate management\textsuperscript{14}. Insofar it presupposes that \textit{ceteris paribus}, in a non-tax world, managers of a corporate firm would basically enter into arm’s length transactions anyhow. Tax law seems to hypothecate a pre-stabilized harmony between standards of good management and international revenue allocation. Business research, on the other hand, has shown in recent years that transfer prices as applied by tax authorities to intra-group dealings diverge in many cases from the transfer prices meant to enhance efficient decisions in multi-divisional firms, thus leading to a mutual trade-off between tax benefits and business deficiencies and vice versa\textsuperscript{15}. The setting of a transfer price transforms into an optimization of the overall after-tax profit of the firm.

- Corporate law influences business decisions on transfer pricing in two respects: On the one hand, corporate law rules on the protection of minority shareholders and creditors provide a framework for intra-group transactions which the management is not allowed to transgress. Within this framework, the management is bound by law to pursue the goal of profit maximization, meaning on the one hand to increase to overall profit of the corporate group and on the other hand to reduce the overall tax burden of the corporate group. Insofar, the interaction of tax and business transfer pricing is governed by corporate law requirements. Manag-


\textsuperscript{14} OECD, Transfer Pricing Guidelines supra (note 7), para 1.8: “Because the arm’s length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm’s length principle promotes the growth of international trade and investment”.

\textsuperscript{15} See below at note x
ers will seek a balance between tax benefits and “tunneling” of profits to large shareholders\textsuperscript{16}.

- Tax law and corporate law interact in two other ways: Firstly, intra-group transactions which violate corporate law requirements are prone to non-recognition by tax authorities as well. This is particularly true when corporate law involves an outright prohibition of the transaction. While this assumption seems to put corporate law in the front row, the reality shows otherwise. In several jurisdictions, the application of transfer pricing discipline to corporate groups by tax authorities works as an enforcement device for protection of minority shareholders and company creditors: dominant shareholders and managers will refrain from extracting private benefits of control if tax authorities will sanction this behavior as tax avoidance or tax evasion\textsuperscript{17}.

II. The Duties of the Management

What does this mean for the duties of the management of the parent company in a multinational firm when it comes to the question of whether to enter into a contractual relationship with a subsidiary or to arrange contractual relationships between different subsidiaries at a lower level?

1. Profit Maximization within a Single Corporation

Corporate law requires the directors of a corporation to focus on the overall profitability of the firm. This is due to the agency relationship between directors and shareholders, which obliges the management to optimize the return on the investment for their principals, i.e. the shareholders of the company.

a) The Choice of Business Units and the Setting of Transfer Prices

The starting point for the analysis of profit maximization and transfer pricing is the single corporation which combines all business activities of the firm under the roof of one legal entity. The “business judgment rule” as applied in many jurisdictions renders the management to a large extent immune against claims that they have violated their “duty of care” when organizational matters are concerned\textsuperscript{18}. This is where corporate law meets business research. The corporate officers have to show that they informed themselves about current standards of good governance, that they established a risk management system and that they are aware of the existing state-of-the-art methods of how to lead a successful firm. But they are not bound by law to follow a specific organizational pattern.

This legal framework confers upon the management a wide leeway to organize the enterprise, setting up different business units (without separate legal personality) for different functions within the company. The shifting of resources between these different units, the employment of transfer prices


and the scope of discretion awarded to sub-divisional managers are hardly constrained by corporate law rules. The outer limitation to this organizational freedom is the company objective laid down in the corporate charter which circumscribes the main field of activity for the firm, in particular the nature of its business. Against this background, the management is also to a large extent at liberty whether to “make or buy” components of its main product as long as the control of the value chain and the nature of the final product are not in question.

This basic freedom does not only address the organizational structure of the firm, it is also extended to the steering of the different business units. As far as resource allocation for different business units are concerned, it is evident that no legal rules require the management to use internal transfer prices at all. In a highly centralized firm, the top management is free to allocate resources by fixed quantities/budgets top-down. If transfer prices are used in order to steer the sub-central units, business research leaves open whether it is preferred that these transfer prices are administered by the top management, calculated unilaterally by the producing or the receiving unit or freely negotiated between the involved business divisions. Last not least, transfer prices – whether set by one actor or negotiated freely – do not have to reflect outside market prices if there are good business reasons to choose otherwise. The market “within the firm” is driven by specific benefits for the involved actors (mutual trust and a common information base in a long-term relationship) and specific drawbacks (substantial upfront investment and a mutual dependence which lead to a bilateral monopoly). Given the existence of upfront investment, transfer pricing at marginal cost will often be preferable. This will particularly hold true if closing down a business unit is not a realistic option.

On the other hand, business practice seems to contradict the predictions made by theory: observed transfer prices often exceed marginal cost; it is unclear how far this is due to further-reaching strategic objectives like “signaling” vis-à-vis competitors.

The only clear message from corporate law to the directors organizing the firm is the following: the paramount aim of all organizational activities is to increase the overall profit of the firm. The introduction of a transfer pricing policy which is meant to favor one particular business unit within the firm (and consequentially the local managers with profit-contingent salaries) would violate the “duty of care” of the top management.

b) International Taxation and Transfer Prices

20 Top management administering transfer prices may either set the price as such or set rules according to which the price has to be calculated (cost-based approach, market-based approach etc.); see e.g. Igor Vaysman, „A model of cost-based transfer pricing“, 1 Review of Accounting Studies (1996) p.73 – 108.
22 This critique of „market prices” dates back to Schmalenbach supra (note 3), p.175 – 177.
aa) The Conceptual Difference between Business and Tax Transfer Prices

Besides business organization, transfer prices are of paramount importance in the field of international taxation. They determine the profit of each involved business unit of the firm; business units which qualify as “permanent establishments” under double taxation conventions will be taxed according to the tax statutes of the country where they are located. Leaving aside technical matters like cross-border loss compensation, transfer pricing gains particular relevance when tax rates in the involved jurisdictions differ. It has been established early enough that firms show a genuine interest in shifting profits by means of transfer pricing to low-tax countries. This has led governments to provide constraints under domestic and international tax law. The most common rule is that transfer prices have to be set following the “arm’s length” standard which requires a hypothetical analysis of how the involved business units would have negotiated assuming they are independent from each other. Transfer prices simply “set” by the top management or established under an administered framework are not accepted by the tax authorities unless they reflect the outcome of hypothetical negotiations. This leads to a conceptual deviation from transfer pricing as required by business-oriented governance:

- The business function of transfer prices requires the management to choose transfer prices which set incentives to maximize the overall profit of the firm; tax law requires business units to choose transfer prices which maximize their respective share of the overall business profit of the firm. Management science shows that free negotiation of transfer prices between sub-central business units is not universally applicable when it comes to efficiency-enhancing governance of the business. In many situations quantity-driven or cost-driven pricing will prevail from a management perspective even if one or some of the involved business units will lose when compared to freely negotiated prices.

- The business function of transfer prices requires the management to take into account the economic underpinnings of intra-firm trade in the first place. Within a firm, business units are meant to cater to other business units within the firm; this is reflected in upfront specific investment, in the creation of proprietary intangibles, in long-term contracting and so on26. This brings about “synergies” which contribute to the overall profit of the firm. It is doubtful to what extent these synergies have to be accounted for under the “arm’s length” standard.

- For an existing firm business research has established marginal cost as the regular starting point for optimal transfer pricing. While it is evident that there are exceptions from this rule, it is evident as well that international tax rules start from the opposing end, i.e. taking the market price of a good or service as the best estimate for intra-firm trade pricing (“comparable uncontrolled price”).

From these conceptual differences we can draw the conclusion that efficient business transfer prices and legally required taxation transfer prices will only in rare cases coincide. What does this mean for the choice of transfer prices by the top management of the firm?

bb) Choices for the Management in the Tax and in the Business Sphere

The management of the firm is obliged to maximize the overall profit of the firm. It has been laid out elsewhere, that also from a legal point of view this exercise has to focus on the after-tax profit as

dividends to shareholders are paid out of after-tax profits and as the value of the shares reflects the amount of existing and latent tax liabilities at the level of the corporate entity. The agency relationship between corporate managers and shareholders requires the former to take into account the corporate tax burden as it contributes to the overall outcome of the business activities.

(1) No Legal Conformity for Managerial and Tax Transfer Prices

The starting point for the analysis is the fact that the law does not require any conformity of transfer prices used as incentives and transfer prices used in the tax area. Against this background, there are studies which fully decouple both from each other. They take a fixed transfer price for tax purposes as given and focus on the management’s unrestricted choice of transfer prices for incentive matters. The notable result is that the transfer price chosen for management purposes does not simply duplicate the transfer price chosen in a tax-free world. The differential between low-tax and high-tax countries where the involved business units are located shows an indirect influence on the choice of the incentive transfer price as the incentive transfer price will determine the size of business activity in the involved jurisdictions which themselves are taxed according to the tax-only transfer price. Against this background it has been proposed that the optimal transfer price for business purposes will be “a weighted average of the pre-tax marginal cost and the most favorable arm’s length price” to compute a transfer price which minimizes the profit

Another influence of tax rules on transfer pricing on business decisions, which arises irrespective of the full decoupling of managerial and tax transfer prices concerns business decisions which influence the calculation of the tax-relevant transfer prices. If and so far as tax law requires the firm to include certain factors into the transfer price (e.g. investment cost), the management will see an incentive to reduce the relevant factor in the country where the tax rate is higher than in the other involved countries. Both for the “cost-plus” method and for the “resale method” the influence on the size of sales or the cost structure of a business unit has been shown. In this respect, transfer pricing for tax purposes determines the size of the taxable profit of a business unit, thus contributing to the effective tax burden of that specific unit.

(2) Limited Conformity for Managerial and Tax Transfer Prices

Contrary to what the law requires, many firms perceive a necessity to align transfer prices for managerial and tax purposes. This is traced back to a desire to avoid double book-keeping which involves substantial compliance costs and may support a critical stance taken by the tax authorities, as these will have the opportunity to use the “managerial books” as evidence in transfer pricing disputes. Any

deviation from tax transfer pricing might lead to adjustments and penalties to the detriment of the corporation and even to double taxation when the foreign state does not counter-adjust in full under Art.9 par.2 OECD Model. The management will have to evaluate the “legal risk” following from the choice of two different sets of transfer prices. When the management reaches the conclusion that full conformity should be envisaged, they have to select a transfer price within the “range” typically available for “arm’s length” prices. In this exercise, the management faces a well-researched trade-off between tax effects resulting from a choice of a particular transfer price and the incentive-effects of this transfer price\textsuperscript{31}. When the management reaches the conclusion that different sets should be employed, the penalty risk will gain influence on the choice of the two transfer prices as well\textsuperscript{32}.

\textbf{cc) Consequences for International Tax Policy}

It becomes clear from the afore-described interaction of tax and managerial goals for the choice of transfer prices that the existence of tax concepts like the “arm’s length” principle and in particular the high reputation of the “market price” as a starting point for tax-oriented transfer pricing analysis damage overall efficiency within business organizations. It is well known that this result – among other factors – has given rise to the claim that transfer pricing in the tax world should be scrapped altogether in order to replace it with a formula-based apportionment system of profits for multinational enterprises. This is not what this article is going to plead for. Rather it invites to consider a full alignment of tax and managerial transfer pricing – but delinking the outcome of the transfer pricing process from the assertion of tax jurisdiction over the overall corporate profit\textsuperscript{33}.

International tax law starts from the assumption that the allocation of income to a certain taxpayer pre-empts the allocation of the right to tax this income to the country where the taxpayer resides. For permanent establishments, this general rule is modified to the extent that profits which are attributable to a permanent establishment are taxed in the country of source. For this purpose, the permanent establishment is treated as a fictitious taxpayer and “dealings” between the permanent establishment and the head office are controlled under the “arm’s length” principle. The transfer price is established in general under the CUP method, the cost-plus method or the resale-minus method. Transfer pricing at marginal cost is generally not accepted by traditional transfer pricing tax rules.

The use of transfer prices for taxation purposes which deviate from those transfer prices which enhance efficiency from the perspective of managerial accounting is evidently linked to the intention of both involved countries to get a “fair share” of the overall outcome of the joint efforts by the business unit belonging to a single firm. If one tries to reconsider the underlying tension between tax and business goals, it becomes obvious that the “dividing line” should not be drawn between transfer prices in the tax and in the business world but between transfer prices set by private business on the one hand and taxing rights allocated to jurisdictions on the other hand.


\textsuperscript{33} The following outline builds on Schön supra (note 7), p.241 – 251.
This becomes clear when we decide to use managerial transfer prices for tax purposes as well. This will lead to an allocation of profits between the involved business divisions, which follows in full the line necessary to enhance the overall profit of the firm. This will make it possible for some business units to extract rents from the existence of other business units within the firm. These rents will have their economic foundation in specific investment effects by those other business units, by the use of proprietary intangibles, by long-term commitments and mutual trust and so on. From a tax point of view, these rents should not only be allocated to the country where the “winning” business unit is located. These rents are due to the fact that the “losing” business unit provides a specific business opportunity to the other divisions of the firm. In other words: the “winning” business unit should be taxed not only in its location country but also in the jurisdiction where the other unit resides. Insofar, the “source” of the revenue in the involved countries does not simply follow the delineations between the involved companies.

2. Profit Maximization in a Corporate Group

a) The Corporate Law Framework for Related-Party Transactions

The concept of transfer pricing gains a completely different character when we are not looking at divisions or dependent units within a single corporation but when these units are incorporated as separate legal entities. In this case we do not perceive notional dealings and notional prices which work as mere calculation devices; to the contrary, transfer prices become hard-wired “real” prices accompanying “real” contracts which affect the financial situation of the involved corporations, thus influencing the size of the corporate profit available for shareholders and the size of the corporate assets available for creditors. The view of corporate law on transfer pricing is therefore framed by the necessity to protect creditors and minority shareholders from self-interested treatment by dominant shareholders (colluding with the management).

The inherent conflict of interest is a constant source of concern. Nevertheless corporate law accepts related-party transactions in general. The instrument of dealings between a corporation and its dominant shareholder generates efficiency-enhancing synergies and may therefore provide a reward to the dominant shareholder who incurs monitoring cost. Therefore, no corporate law system in the world contains an outright prohibition of self-dealing.

The strategies adopted in different legal systems to establish a certain level of control when it comes to related-party transactions show a great variety. The most prominent examples are:

- Approval of related-party transactions by shareholders or disinterested directors (excluding the involved parties from voting); this instrument is used in particular in the United Kingdom.

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37 For the relevant comparative studies see supra (Note 11); a recent proposal to monitor self-dealing see: Maria Gutiérrez/Maria Isabel Saez, “A Carrot and Stick Approach to Discipline Self-Dealing by Controlling Shareholders”, ecgl Law Working Paper No.138/2010, January 2010, pleading for call options and put options for minority shareholders in order to secure ex post compensation for the outcome of the related-party transaction.
Disclosure of related-party transactions; both US-GAAP\textsuperscript{40} and IFRS\textsuperscript{41} provide that the existence of these transactions has to be reported to investors. Furthermore, the 4\textsuperscript{th} and 7\textsuperscript{th} Directive of the European Union in the field of corporate law require all companies (and groups) to disclose “transactions which have been entered into with related parties by the company, including the amount of such transactions, the nature of the related party relationship and other information about the transactions necessary for an understanding of the financial position of the company”\textsuperscript{42}. For self-dealing within a corporate group, these disclosure rules are particularly relevant when the individual accounts of the involved companies are drawn up while the consolidated accounts will not show intra-group dealings at all\textsuperscript{43}.

- Liability of shareholders and directors for “breach of loyalty” when self-dealing amounts to unfair treatment of minority shareholders. This standard-based approach (found both in the United States, Canada and in continental Europe) is founded on the agency relationship between directors and shareholders when it comes to the administration of the company’s assets and opportunities. Insofar, it is widely acknowledged that also the controlling shareholder who employs his power over the management to enter into a related-party transaction on favorable terms with the corporation is liable. In a famous German derivative shareholder suit case a U.S. parent company (“ITT”) had to pay damages to its German subsidiary for an “unfair” service fee\textsuperscript{44} levied from all group companies; in a recent Canadian case Ford U.S.A. was held liable for “oppression” of minority shareholders in this subsidiary as the long-term sales contract between Ford U. S. and one of its Canadian subsidiaries had led to enduring losses for the latter\textsuperscript{45}. Moreover, such self-dealings are not rendered immune against the courts’ scrutiny under the “business judgment rule”. In order to counter the extent conflict of interest the directors have to show the “intrinsic” or “entire” fairness of related-party transactions\textsuperscript{46}.

- Finally, disguised distributions are subject to creditor-protecting rules like insolvency law provisions on “fraudulent trading” and capital maintenance rules (the latter in jurisdictions where the concept of legal capital still prevails)\textsuperscript{47}. But these rules only bite when asset diversion either leads to insolvency of the company or when the assets of the company do not fully cover the subscribed capital\textsuperscript{48}.

\textsuperscript{38} Enriques et al. (note 9), p.162 – 169.
\textsuperscript{39} Paul Davies, Gower and Davies: Principles of Modern Company Law, 8\textsuperscript{th} Ed. (Thomson 2008) p.529 – 557.
\textsuperscript{40} SFAS No.57 (1982).
\textsuperscript{41} IAS 24 (2003).
\textsuperscript{43} See Art.34(7b) of Directive 83/549/EEC (supra note x); „The transactions, save for intra-group transactions, entered into by the parent undertaking, or by other undertakings included in the consolidation, with related parties ...”; SFAS /IFRS
\textsuperscript{44} Federal Court of Justice (Bundesgerichtshof), judgment of 5\textsuperscript{th} June 1975 (II ZR 23/74) Official Gazette (Entscheidungen des Bundesgerichtshofs in Zivilsachen - BGHZ) Vol.65, p.15 – 21.
\textsuperscript{47} Supra (note 12).
One point deserves to be mentioned: A third avenue of corporate law reasoning goes beyond shareholder and creditor protection and pleads for a full protection of the company “in itself” against unfavorable contracting with dominant shareholders. This view is particularly relevant in jurisdictions where a corporate entity is not merely regarded as an instrument to further “shareholder value” but as a self-standing organization which caters to different stakeholder groups. Against this background, the German law of stock corporations is applied in such a way as to prohibit any non-arm’s-length transaction between a wholly-owned stock corporation (public or not) and its shareholder irrespective of the existence of minority shareholders and the necessity to protect the creditors’ interest. From a comparative perspective, though, this approach seems to present a minority view which will not be pursued further in this article.

What does this mean for the leeway the managers of the parent company have when it comes to transfer-pricing policies within the firm. It means that there are two completely different categories of companies to be addressed: For wholly-owned subsidiaries where no creditors are in danger, corporate law hardly sets limits to the choice of transfer prices. But if there are outside shareholders or if the company is on the brink of insolvency, transfer prices have to be “fair” in order to avoid liability of the directors and of the dominant shareholder.

b) The “Arm’s-Length” Standard under Corporate Law

While it is evident that transfer prices in related-party transactions shall be “fair” in theory, it remains unclear what this means in practice, in particular, whether the “arm’s-length” standard shall be applied for intra-group dealings.

A contradictory starting point is offered by accounting rules and standards. In this respect, International Standards and European directives seem to have different viewpoints. US-GAAP starts from the assumption, that related-party transactions are not typically priced at “arm’s length” as they reflect the specific conditions for dealings within the firm. Against this background, neither IFRS nor US-GAAP mandate an outright “adjustment” of transfer prices under the arm’s-length standard; they simply provide for disclosure of the material substance of the dealing in order to let the recipient of the information form his own judgment on the economic effects of an arrangement. The European accounting directives, to the contrary, require disclosure of related-party transactions only “if such transactions are material and have not been concluded under normal market conditions.” The preamble of the most recent directive amending existing law purports that disclosure is necessary “only where such transactions are (...) not carried out at arm’s length. Disclosure of material transactions with related parties that are not carried out under normal market conditions can assist users of an-

50 SFAS No.57 para 3: „Transactions involving related parties cannot be presumed to be carried out on an arm’s-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm’s-length transactions unless such representations can be substantiated.
52 See the provisions quoted in Fn.42 and Fn. 43.
nual accounts to assess the financial position of the company as well as, when the company belongs to a group, the financial situation of the group as a whole\textsuperscript{53}.

The same distinction shows up when it comes to the requirement of \textit{ex ante} shareholder approval. UK law very rigidly demands disclosure and/or upfront approval by disinterested directors or shareholders for all related-party transactions as the UK tradition does not confer upon the courts the power to interfere with intra-company dealings under an unclear distinction between “fair” and “unfair”\textsuperscript{54}. French law – on the other hand - only provides for separate approval of dealings which deviate from “normal” conditions\textsuperscript{55}, thus hypothesizing the arm’s length standard as a carve-out for the control of related-party transactions.

While the \textit{ex ante} requirements on disclosure and shareholder/board approval can refrain from the distinction between fair and unfair transactions, the application of the “duty of loyalty” \textit{ex post} standard for directors and dominant shareholders has to commit itself to a material framework for intra-group transactions. In this respect, most corporate law systems seem to prefer the “arm’s length” standard in order to test the “fairness” of a related-party transaction. This is conceptually wise as minority shareholders only participate in the economic success of the company they belong to, not in the economic success of the parent company or other related parties. Therefore, the minority shareholders are entitled to a profit share which reflects the self-standing profitability of the company they have invested in. With respect to the allocation of the profit generated within this particular corporate entity, minority shareholders are entitled to “equal treatment”; dominant shareholders are not allowed to expropriate them by self-dealing. Against this background, the “arm’s-length” standard provides the right starting point for the analysis\textsuperscript{56}. According to court practice and literature, the U.S. test on the “entire fairness” of a related-party transaction seems to support the arm’s length standard\textsuperscript{57}. The same holds true for Germany, where the courts apply the notion of a “fictitious independent director” acting in the best interest of the subsidiary company only\textsuperscript{58}. In Canada, the arm’s length standard was explicitly transferred to corporate law in the above mentioned judgment in “Ford Canada” where the court held:

“Why would the management of a truly independent entity in Ford Canada’s position continue to tolerate an inter-corporate pricing agreement that leaves it with a staggering aggregation of losses carried forward and with the only reasonable expectation for the future being that of continuing mammoth losses”\textsuperscript{59}.

c) Arm’s Length Pricing and the Group Situation

The real problem lies elsewhere: how far does the “arm’s length” standard take into account the particular situation of a group company which – according to its corporate charter, its financial and human resources and its business model – specializes on intra-group transactions in order to con-

\textsuperscript{53} Preamble, Paragraph 6, Directive 2006/46/EEC supra (note 42); for a similar rule under French law see Art. L 225-40 Code de Commerce.
\textsuperscript{54} See Davies supra (note 39), p.529 – 533.
\textsuperscript{56} Contrary to this, in Italy, it is sufficient that no “harm” is done to the company, i.e. that the transfer price reflects the “reservation price” (Enriques et al. supra (note 9), p.173).
\textsuperscript{57} Enriques et al. supra (note 9), p.173.
\textsuperscript{58} Holger Fleischer in: Karsten Schmidt/Marcus Lutter (Ed.), Aktiengesetz Kommentar, 2nd Ed. (Cologne 2010), Vol.I, § 57 AktG para 12.
\textsuperscript{59} Supra (note 45), para 300.
tribute to the overall outcome of the group and to benefit from synergies existing within the group. Taking a closer look, there are three different topics to be discerned:

- Firstly, one has to ask, whether the “fairness” of intra-group dealings has to be judged on a separate basis for every transaction, or whether the treatment of a subsidiary by its parent company is viewed in its entirety. In this respect, German law, French law and Italian law have developed rules and principles granting some flexibility to the parent company. Under German law, the parent company is in the position to force the directors of the subsidiary to enter into disadvantageous dealings within the group if there is some financial compensation by the end of the year (§ 311 Stock Corporation Act). For this purpose, advantageous and disadvantageous measures taken during the year are mutually set-off. Under French law, the so-called Rozenblum doctrine renders legal any asset diversion by a corporate parent as long as three conditions are met: the structure of the group is stable, the parent is implementing a coherent group policy, and there is an overall equitable intra-group distribution of costs and revenues. Similarly, in Italy, parent companies are not held liable if there is no damage in the light of the overall results of the management and co-ordination activity. When these conditions are fulfilled, the individual transaction does not have to comply with the arm’s-length standard on a stand-alone basis.

- Secondly one has to ask whether the economics within the firm justify the decision of the management of a subsidiary to deliver goods or services to another group company at marginal cost or at a price between marginal cost and the outside market price. As intra-group dealings often build on specific investment, proprietary intangibles and long-term contracting, the directors of a group company will often find it in the best interest of the subsidiary to enter into such a contract in order to secure a long-term “customer base” within the group. There are hardly any corporate law precedents for this, but at least in Germany, the majority view seems to accept that “good business reasons” can justify the management’s decision to accept intra-group prices below market price on an arm’s length basis.

- Thirdly one has to find out whether the parent company might be obliged to share any “synergy rents” with the subsidiary or whether arm’s length pricing has to be judged on a stand-alone basis for the subsidiary, not regarding positive effects of the group situation for the parent company and other members of the corporate group. To put it differently: Are subsidiaries entitled to a “profit split” under corporate law? The OECD Transfer Pricing Guidelines seem to assume this as they regard the profit split as an “arm’s-length” solution chosen by independent companies as well. In corporate law, practice, there is no clear evidence for this when it comes to dealings between group companies. A similar question has arisen when in the course of a corporate takeover minority shareholders are “squeezed out” of a group, thus leaving the whole “synergy rent” to the controlling shareholder. While the law in the United States takes the view that minority shareholders deserve an extra pay-

62 Mémento Pratique Francis Lefebvre, Groupes des Sociétés 2007-08, para 2370 – 2378.
ment for leaving the control of the company to the dominant shareholder, German law sees no legal basis for such a concept.  

**d) The Interaction of Incentives, Tax and Corporate Law for Transfer Pricing**

Starting from the assumption that the directors of the parent company of a corporate group are obliged to further the profitability of the group as a whole (as reflected in profits and capital gains arising at the level of the parent company) they will have a threefold view on transfer prices:

- In the first place, transfer prices will be used to contribute to the overall efficiency of the firm. Insofar, transfer pricing is about increasing the size of the cake.

- In the second place, transfer prices will be used to slice the cake among tax jurisdictions. Insofar, transfer pricing is about decreasing the effective tax burden. It has been said before that in order to ensure efficient use of transfer prices, international tax should refrain from coupling incentive transfer pricing and tax rules on international tax allocation. International tax allocation should be built on two elements instead: transfer pricing will be the starting point for profit allocation to the involved companies but synergy rents drawn by a group company from dealings with another group company shall be taxed in the “source country” as well.

- In the third place, transfer prices have to be consistent with the framework set by corporate law. Insofar one has to verify to what extent corporate law sets limitations to free-wheeling incentive transfer pricing. In the light of the foregoing analysis the following conclusions can be drawn:

  - For dealings with (or between) subsidiaries which are wholly-owned by the parent company and where creditors’ claims are not put at risk, there is virtually no corporate law limitation for transfer pricing. These can be administered by the parent company, set by the servicing or receiving party or simply left to free negotiations between the involved group companies.

  - For dealings with (or between) subsidiaries where minority shareholders exist and/or creditors’ claims have to be protected, some countries apply the arm’s-length standard as a “fairness test”. This seems to pre-empt other modes of using transfer prices as business incentives. On the other hand, it has been shown that in corporate groups, there are different techniques to extend the leeway for the group management. They can

    - show that the internal economics of the firm justify the employment of specific non-arm’s length prices for the subsidiary on a stand-alone basis;

    - arrange a coherent group policy which evenly hands out benefits and disadvantages for group companies even if the arm’s length standard is not met for individual transactions.

    - use incentive transfer prices in the first place and “compensate” the subsidiary for ensuing losses ex post.

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Against this background, corporate law does not enforce strict discipline on transfer pricing. Transfer prices for related party transactions can be tailor-made to increase efficiency if some basic mechanisms to protect minority shareholders and company creditors are established.

3. Prioritizing the Incentive Function of Transfer Prices

Given the overall goal of business organization, corporate and tax law to foster welfare by increasing efficient allocation of resources, it makes sense to arrange tax law and corporate law in a way that does not interfere with efficient pricing from an business organization point of view. This involves the following:

- Transfer prices should not be the final measuring rod for allocation of taxing rights between countries. They are meant to allocate profits between business units but not to define the framework of territorial source taxation. Therefore, synergy rents drawn by members of a corporate group should be allocated to the country where the synergy is located (e.g. from the use of specific investment in a country) not to the country where the corporation receiving the rent resides.

- Corporate group law should be employed in a way that does fully compensate creditors and minority shareholders for losses from a group strategy which damages local profitability of a particular subsidiary in order to foster the overall profitability of the group. Transfer prices should not pre-empt creditor and shareholder protection if there are other modes of compensation available to the parent company.

III. Relevant Case Law

The foregoing position that the different goals for efficiency-oriented transfer pricing, allocation of governmental taxing rights and corporate law protection for shareholders and creditors plead for better “distinguishing” between these purposes and the instruments used to achieve them. In order to make this case clear one should have a look at the following cases which have been decided recently by courts in Canada, the United Kingdom and the United States.

1. DSG Retail Limited et al. vs. HMRC

In a case decided by Special Commissioners John F. Avery Jones and Charles Hellier a UK company selling goods to customers entertained an insurance contract for warranties with an affiliate company located in the Isle of Man. It was disputed whether the premiums paid to the captive insurance company were in line with the arm’s length principle. The Special Commissioners found that while the premiums passed the arm’s length test, it was evident that the parent company (and other group members) had offered to the captive insurance company a “business facility” which it would not have found outside the group. Therefore, taking into account the “bargaining power” of the parent company, the insurance premiums paid to the capital insurer had to be reduced by an offsetting consideration for the “business opportunity” as such.

From the point of view taken in this article, the case clearly shows the necessity to apply different concepts for different purposes. From an efficiency point of view it makes sense to employ the “mar-

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ket price” in order to fully show the risk exposure generated by the warranties. From a tax point of view, one has to notice that the captive insurance company used a business opportunity located in the United Kingdom which should give rise to source taxation in this country. From the corporate law point of view it makes sense to fully compensate the captive insurance company for the risk assumed in the course of its business without deducting a set-off for the business opportunity. Otherwise, minority shareholders or creditors of the insurance company might feel excess downside risk from the operation of the insurance company.

2. Glaxo SmithKline (Canada)

In the “Canadian” Glaxo case, a Canadian subsidiary of the British GlaxoSmithKline group produced pharmaceuticals in Canada under a far-reaching licensing agreement with a British group company. Part of the agreement was to purchase raw material from a Swiss group company at a price five times the market price. While the Tax Court held the purchase price to be far above arm’s length and therefore confirmed the transfer pricing adjustment effected by the tax authorities, the Federal Court of Appeals took the opposite view. They found that from the perspective of an independent company it was reasonable to accept the exaggerated purchase price as this was “part of the package” pre-arranged with the British parent company which gave access to the manufacturing and distribution of the high-value pharmaceutical product.

From an efficiency point of view it seems evident that the administered transfer price for the raw materials runs foul of good incentive policy. This arrangement will possibly reduce the Canadian subsidiary’s effort to increase the production up to the optimal point. On the other hand, if this pricing arrangement goes hand in hand with a compensatory reduction of the license fee payable to the British group companies, the incentive function might be restored.

From a corporate law view, the first question is whether the transaction with the Swiss company has to be examined irrespective of the overall contractual arrangement. Insofar it has been laid out that several national laws support a broad perspective which allows us to assess an individual transaction on the basis of the aggregate contractual framework. Therefore, corporate law might come to the result that the directors of the Canadian subsidiary acted in line with the duties of care and of loyalty.

From a tax law point of view, one cannot doubt that an inflated profit attribution to the Swiss company cannot hold – even if from the perspective of the Canadian subsidiary there is a balanced outcome in line with the arm’s length principle – shall not be allocated to Switzerland. This is outright profit shifting. Rather, the larger part of the profit made by the Swiss company has to be taxed in Canada or in the United Kingdom. Either one can argue that the Swiss company has exploited a monopolistic situation in Canada which was created by the pre-ordained contractual arrangements to the detriment of the Canadian company – then it makes sense to tax this monopoly rent in Canada. Or one can argue that the purchase price paid to the Swiss company has to be recharacterized as a “disguised license fee” which is generated by the business activity of the UK company and therefore taxable in Great Britain unless Canada is in the position to levy a withholding tax on the royalties.

order to come to this conclusion, tax law has to leave behind both the connection with corporate law and with efficiency-oriented incentives.

3. GE Capital (Canada)

In the GE Capital case, the Canadian subsidiary of GE Capital (U.S.) had to pay a fee to the U.S. parent for granting a guarantee covering the subsidiary’s debt issues. The tax authorities did not allow the deduction of this fee as the Canadian subsidiary would have benefited from the reputation of the parent company in any case. The Tax Court held that while part of the subsidiary’s AAA rating was simply due to an “implicit guarantee” stemming from its position as a group member of General Electric, another part of this rating was created by the explicit guarantee given by the parent company. An arm’s length fee – the Tax Court concluded – would cover the “explicit guarantee” but not the “implicit” portion.

This case gives rise to the question of whether subsidiaries can be forced to pay a consideration for a synergy benefit which stems from the accumulation of economic power within the corporate group as a whole. From an incentive point of view, it makes sense to pay a compensation for these involuntary “spillovers” in order to exert some discipline on financial behavior of subsidiaries. From a corporate law point of view, there is no clear evidence whether a consideration can be claimed for such a synergy effect.

Most interestingly, the allocation of a taxing right in such a situation should take into account the “location” of this rent. As both the “implicit” and the “explicit” guarantee provided to the Canadian subsidiary have their territorial point of reference in the United States where the parent company and its assets are located, the Canadian subsidiary benefits from an economic factor which is largely connected with the United States. Insofar, it makes sense to allocate the whole revenue from the fee to the U.S. tax authorities. This should not be dependent on the question of whether the subsidiary – guided by its own interest – would actually pay the full fee under the arm’s length principle. The allocation of profits under the arm’s-length principle does not give the final answer to the problem of where to allocate taxing rights for intra-group profits.

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