TRANSFER PRICING AND PROFITABILITY OF MULTINATIONAL ENTERPRISES: A CONCEPTUAL DISCOURSE

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ABSTRACT

Transfer pricing is a technique used by multinational enterprises (MNEs) to shift profits out of the countries of their operation into tax havens. Shifting of profits by MNEs to their home countries through transfer pricing is common. Therefore, this study adopts a conceptual perspective in the examination of the issue of transfer pricing of the profit of multinational enterprises (MNEs) in Nigeria. It examines the issues in transfer pricing and the institutional set-up that has encouraged this as well as the factors affecting transfer pricing in MNEs. The paper progresses to present a review of theory and some pertinent studies on the issue of transfer pricing of MNEs. Finally, it highlights the challenges of transfer pricing and the strategies of overcoming it. The study concludes that sustainable development and effective implementation of policies to mitigate transfer pricing depend on a concrete understanding of the entire policy environment. Therefore, policy coherence is needed in this regard, particularly with respect to a robust policy on transfer pricing and taxes. The study recommends that institutional capacity be strengthened, particularly the legal framework as well as strong government effectiveness and capacity to curtail the humongous outflow of resources, as well as the implementation of reforms in the fiscal environment to make Nigeria benefit maximally from MNEs.
Keywords: Transfer pricing, Profit-sharing, MNEs, Tax avoidance, tax evasion and Tax penalty.

JEL Classification: F21, F23, H26, K34

1.0 INTRODUCTION

International cooperation in business trade and investment has created vast opportunities for exchange and transactions across countries involving financial flows and international capital movements. Transfer pricing refers to the value attached to the goods or services transferred between related parties or countries in the course of international trade, business, investment, and other financial engagements. Transfer pricing is a "technique used by multinational enterprises (MNEs) to shift profits out of the countries of their operation into tax havens. The approach involves a multinational firm selling itself goods and services at an artificially high price. By using its subsidiary in a tax haven to alter and inflate costs from its subsidiary in

another" country. For example, by buying steel from the tax haven-based subsidiary for a certain amount for steel, the multinational corporation 'moves' its profits out of the country where it genuinely does business into a tax haven, where it has to pay very little or no tax on profit (Tax Justice Network, 2004).

International transfer pricing, therefore, involves the prices at which a company undertakes cross-border transactions with associated enterprises. By so doing, international transfer pricing determines how the income of a multinational enterprise is shared among countries (host country and country of origin) for income tax purposes as a result of transactions within the firm. According to Seth et al. (2024) transfer pricing allows for the establishment of prices for the goods and services exchanged between subsidiaries, affiliates or commonly controlled companies that constitute part of the same larger enterprises. Transfer pricing is a tax-saving means for MNEs, although such claims might be contested by tax authorities (Seth et al., 2024). Transfer pricing, in general, is a component of corporate tax avoidance. Several factors influence multinational transfer pricing. They include; Transfer pricing as a tool to minimize worldwide taxes, duties and tariffs; Avoidance of financial restrictions on profit repatriation imposed by the government; Avoidance of divisional conflicts; General goal congruence, and Inflation (Criste & Nguyen, 2016).

In the case of domestic transfer pricing, the three main objectives of a domestic transfer pricing system are the attainment of congruence, the facilitation of divisional performance evaluation, and the promotion of divisional autonomy (Vally, 1997). While several studies in the developed and emerging economies have examined transfer pricing and profitability of MNEs, there are however scanty of papers on the subject matter in Nigeria. It is the recognition of this gap that warranted this conceptual study.

Aside from the introduction, section 2, contains a conceptual definition of transfer pricing and a review of theory and evidence connected with transfer pricing of profit of MNEs. Section 3, dwells on the impact and considerations of transfer pricing of MNEs on Nigeria's development. Section 4, dwells on the challenges of transfer pricing. Section 5, hinges on the strategies of overcoming transfer pricing challenges while Section 6, presents the conclusion, policy implications, and recommendations.

2.0 TRANSFER PRICING OF MNES: CONCEPT, THEORY AND EVIDENCE

2.1. Concept of Transfer Pricing

In general, while economists and international organizations have analyzed and discussed transfer pricing for a long time, interest in transfer pricing is more recent and growing exponentially. The term transfer pricing flow is seen by some as being vague and imprecise and the content controversial. The term is characterized by lack of 'precise and uniform definition as there is yet no firm agreement on conceptual and definitional issues related to transfer pricing. Thus, definitions of transfer pricing have evolved over the years. With the growing wave of globalization and external transactions and the ease of transferring money across borders (electronic transfers), transfer pricing has continued to grow rapidly. The definitions of transfer pricing generally involve the following practices –tax shifting, profit repatriation, manipulations and income obscurity (Ogbaisi et al., 2024).

Barker and Brickman (2017) described transfer pricing as the price at which entities within a group trade. MNCs are birthed when an entity moves beyond its border and acquire another company to create a competitive edge. Market advantage is attained by reducing cost of production, and efficiency in management and operations (Barker & Brickman, 2017). Transfer pricing is not restricted to taxation but when used in the perspective of international tax, it signifies the artificial maneuvering of internal prices within a multinational group to create a tax advantage (Ogidiaka et al., 2022). On the other hand, Osho et al. (2020) affirm that transfer pricing is not illegal, what is abusive is transfer mispricing. TP is important to all the parties involved (the taxpayers and tax authorities) because it affects the income and expenses as well as the taxable profits in the different tax areas in which the entity operates. It is often used to boost the overall profit of the head office which is at a disadvantage to the associate companies which operate in other countries with different tax jurisdictions.

Transfer pricing is a technique used by multinational enterprises (MNEs) to move profits from parent companies to subsidiaries and affiliates to ensure funds are evenly distributed. Nonetheless, many multinational corporations use it as a tactic to lower their tax burdens. Through transfer price manipulations operated MNEs, a part of the profits of MNEs are shifted from high-tax to low tax jurisdictions (Cristea & Nguyen, 2016). Transfer pricing is the setting of prices for the transfer of goods, services, and intellectual property between associated parties. In Nigeria, associated parties include entities within a multinational enterprise group, such as subsidiary companies and branches (Investopedia, 2024). According to Afifah et al. (2019) there are several motivations to do transfer pricing, and one of them is the motivation of tax avoidance. Tax is a mandatory contribution to a country that is owed by an individual or an entity based on the Law, by not getting compensation directly and used for state purposes

for the greatest prosperity of the people. The greater tax burden causes companies to transfer pricing in the hope of minimizing the burden. The decision to do transfer pricing will result in lower global tax payments in general. Another factor that allows companies to make decisions about transfer pricing is tunneling. Tunneling is the transfer of resources from within the company to the controlling shareholder. The transfer of resources can be done in various ways, one of them being through transfer pricing (Noviastika et al., 2016).

According to IMF (2015), transfer pricing refers to the setting of prices at which transactions take place involving the transfer of property or services between associated enterprises constituting part of an MNE group. Thus, if in one country an MNEs transfer prices are adjusted, resulting in greater taxable income, the associated enterprise in other countries should in principle, receive a "corresponding adjustment.'', reducing its taxable income. Where no corresponding adjustment is made, the MNE will suffer double taxation (IMF, 2015). Therefore, a coherent approach to transfer pricing needs to encompass, the deficiencies in the legislative, enforcement, and policy framework which allow them to take place, and the measures which can be applied to fight them. Inefficient or inaccurate transfer pricing policy implementation can lead to outflows of real cash transfer on account of year-end adjustments, tax fines, and penalties.

2.2. Theoretical Framework

This study is anchored on the arms-length principle and the expediency theory

Arm's Length Principle.

An important theory that relates to external dealings of MNEs as regards transfer pricing is the arm's length principle. The principle, in broad terms, states that entities that are related by means of management, control, or capital in their controlled transactions should agree on the equal terms and conditions that would have been agreed between non-related entities for comparable uncontrolled transactions (Vally, 1997). Thus, parties of a transactions are independent and on equal footing. According to the arm's length principle, MNEs are required to charge the same price for an internal transfer as they would have charged when exporting to an independent principle. In lack of better alternatives, tax authorities sometimes adopt a MNEs export prices to independent parties to proxy the arm's length prices of internal transfers of the same MNE. Thus, the MNE may have an incentive to adjust an arm's length price to the target transfer price to conceal its profit-shifting activities. Thus, the MNE accepts to forego some

revenue by adjusting prices to an independent party if the tax gains of the profit-shifting operations are high (Criste & Nguyen, 2016).

Expediency Theory

The expediency theory was developed by Wagner Adolph in the year 1956. Bhartia (2009) opined that every tax ought to justify the need for it and it is only on that basis and consideration that the government should choose a tax policy to implement them. The theory of expediency is in conformity with the hypothesized ideas of the canon of taxation which proposed that every tax must have qualities of being basic features of effectiveness, economy, and collection efficiency. The theory emphasizes that taxation provides a powerful set of policies and collection tools to the authorities and should be effectively used for bettering the economic and social needs of the citizens, it should be used to solve social ills, provide security, social amenities and provide a veritable tool in fighting income inequality, regional disparity, and unemployment and make a good living standard for the inhabitants (Afuberon & Okoye, 2014). In support of expediency theory, Kiabel (2009) posited that the economic and social decision of the government is to create an atmosphere conducive to an effective tax generation system that will be suitable to promote economic development and breed economic growth. Kiabel (2009) further stated that the truth and essence of an effective tax system is easy to collect and optimal utilization for the benefit of the taxpayer and the society at large. Since there would always be pressure from the political, economic, social, and political groups, every group tries to protect and promote their welfare, interest, and standard of living.

2.2.3 Empirical Review

De Mooij and Liu (2020) investigate how transfer pricing regulations (TPRs) affect real investment by multinational enterprises (MNCs). They conclude that the unilateral adoption of TPRs may harm MNCs' ability to invest effectively and underline the necessity for coordinated global efforts to stop MNCs from shifting profits for tax reasons. In their study of the OECD/G20 Base Erosion and Profit Shifting process, Buttner and Thiemann (2017) contend that gradual changes to transfer pricing principles add to the standards' complexity and incoherence, leading to an increase in conflicting assessments and ambiguity. Illicit financial flows (IFFs) and the challenges associated with characterizing and quantifying them are examined. According to the study, combining legal and illegal behavior under a single description leads to a loss of clarity and the possibility of confusion. The research also looks at

trade mis invoicing numbers and makes the case that they only sometimes point to illegal money movements. Specifically, the study by Caesan and Nguyen (2016) presents new evidence using difference-in-difference analysis to examine transfer pricing by multinational firms based on foreign firm ownership. The findings show that Danish MNEs reduce the unit values of their exports to this jurisdiction by 5.7-9.1%, on average. These manipulations, according to the authors lead to a report of 141 USD of export revenues of MNEs in Denmark. The result is associated with a loss of tax income equivalent to 3.2% of the tax returns on companies examined the issue of abusive transfer pricing and economic activity.

The revenue-shifting incentives of multinational U.S. firms using tax havens are studied by Richardson and Taylor (2015). The study discovers that employing tax havens positively correlates with multinationalism, aggressive transfer pricing, thin capitalization, and intangible assets. These findings greatly impact how tax authorities and lawmakers create efficient tax laws to stop income shifting. Using French firm-level data, Davies et al. (2017) examined how intra-firm prices differed from arm's-length prices. Their findings demonstrate that tax evasion and pricing to market are the driving forces behind transfer pricing. Muhammadi et al. (2016) examined Indonesian tax auditors' difficulties while auditing transfer pricing cases involving intangible property rights. They concluded that tax auditors and lawmakers should learn more about transfer pricing regulations to overcome these issues.

Akash and Munshi (2023) examined transfer pricing practices in MNCs and their effects on developing countries' tax revenue. The study sheds light on the top researchers, approaches, conclusions, theoretical and empirical gaps, and upcoming issues of transfer pricing research over the previous of nine years through a methodical analysis of 29 research publications from the Scopus database (2014–2022). The study looked at five significant areas of tax avoidance and transfer pricing research. Some of these issues include determining the impact of transfer pricing regulations on various types of multinational corporations, assessing the effectiveness of transfer pricing regulations in preventing tax evasion, examining various policy options and determining the impact of transfer pricing on other economic outcomes using a systematic literature review. The findings of this review demonstrate the need for transfer pricing research to look more closely at transfer pricing as a tool for business in addition to compliance and tax management.

Ogunoye et al. (2023) examine the effect of transfer pricing manipulation on economic growth in Nigeria. The auto-regressive distributed lag (ARDL) approach was applied to data from Nigeria between 1986 and 2019. The findings revealed an insignificant relationship between

economic growth and explanatory variables such as transfer pricing manipulation, unemployment rate, government revenue and trade openness. The result also shows a significant negative relationship between the exchange rate and economic growth. The study recommends that the government should implement proper monitoring of multinational companies to check their day-to-day transaction activities. This may help the government to generate more revenue and serve as an avenue to create more employment opportunities.

Ogosi et al. (2023) examine some transfer pricing variables and their strategic effects on the economic development in Nigeria. Secondary data sourced from the United Nations and the World Bank databases were utilized in the study using the ex post facto research design. Transfer pricing was proxied by trade misinvoicing and trade openness, economic development was represented by the human development index while regression analysis was employed in the study. The results showed that transfer pricing strategies have significant effect on the economic development in Nigeria. This indicates that trade misinvoicing and trade openness can jointly aid economic development if the illegal practices of tax avoidance can be nipped in the bud by the government, but they cannot remove structural constraints and weaknesses of the economy. It was recommended that the Nigerian government develop a policy of meaningful trade liberalization, encourage an automated flagging system that tests for deviations in the pricing of related and unrelated transactions by businesses, and take punitive action against defaulting MNCs and firms.

Bunje et al. (2022) aimed to enhance how trade openness is measured by including facets of nations' global trade integration to generate four distinct measures: exports plus imports to GDP ratio, the ratio of exports to GDP, the ratio of imports to GDP, and their combined effect index. They used the pooled ordinary least square, fixed effects, and the system generalized methods of moment estimation approaches to analyze balanced panel data from 52 African nations from 2000 to 2018. The results showed an intriguing mixed pattern between trade openness and GDP per capita: 1) POLS show trade openness has a mixed influence on economic growth. Similarly, when subdividing Africa into sub-regions, trade openness demonstrated a non-linear relationship with GDP, but the result in Northern Africa is sturdy in terms of economic growth. 2) Trade openness has a negative and statistical effect on GDP per capita, as per the fixed-effects model.

Adegboyega, Ogbebor and Lawal (2024) examined the effect of multinational corporations transfer pricing policies, corruption and economic growth in Nigeria from 1986 to 2022. The study adopts an ex-post factor research design, utilizing an autoregressive distributed lag

modelling and bound testing cointegration as the estimation techniques. The inferences were made at 5% significant level. The inferences were made at 5% significant level. The findings revealed that domestic non-oil revenue shows a significant and positive effect on Gross Domestic Product, suggesting a potential positive association between domestic non-oil revenue and Gross Domestic Product over the long term. In the short run lagged differences in Gross Domestic Product exhibit a positive and marginally significant coefficient, suggesting a persistence effect. In conclusion, in the examination of transfer pricing policy on Gross Domestic Product, the long-run estimates reveal a significant effect of transfer pricing on Gross Domestic Product (Adj. $R2= 0.229$, $F (4,37) = 30.94$, $p< 0.05$)), The study concluded that transfer pricing contributes valuable insights to the on economic growth in Nigeria.

A large attention in the tax literature focuses on “the ambiguity between a tolerant tax avoidance behaviour and tax evasion. The ambiguity is particularly relevant on the analysis of profit-shifting strategies, wherein MNEs carry out intra-firm transactions (exchange) between connected parties from different jurisdictions, in order to adjust the transfer prices in a bid to reallocate taxable profits from high-tax to low –tax jurisdictions. The rules of anti-shifting demand that the transfer prices follow the so-called arm’s length principle (OECD, 2017), which states that intra-firm prices must be consistent with the ones that would have been established with independent unrelated parties. Where the arm’s length condition is not fulfilled, tax authorities require the payment of taxes over the shifted profits and a tax penalty usually applies.

In other pertinent studies on transfer pricing of MNEs, prevailing studies provide pertinent evidence of profit shifting through direct transfer pricing adjustments (Swenson, 2001; Clausing, 2003; Bartyelsman and Beetsma, 2003; Bernard et al, 2006; Overesch, 2006; Criste & Nguyen, 2016; Davies et al., 2018; Rathke, 2019). Eden (2001), for instance, examined the links among taxes, transfer pricing and multinational enterprise. Swenson (2001) explored the connection between tax reforms and evidence of transfer pricing. The study further investigated the connection between tax reforms and transfer pricing. Clausing (2003) examined tax-motivated transfer pricing and US intra-firm trade policies. Bartyelsman and Beetsma (2003) examined corporate tax avoidance through transfer pricing in OECD countries. Bernard et al. (2006) examined transfer pricing by US-based multinational firms investigated international transfer pricing and multinational corporations. The study by Overesch (2006) evaluated transfer pricing of intra-firm sales as a profit shifting channel, drawing evidence from German firm. Other studies in this direction are Alm (2012), Levaggi and Menonncin (2013) which

focused on optimal dynamic tax evasion, Holtzman et al. (2014), Nielsen et al. (2014), Caesan and Nguyen (2016), Becker et al. (2017) and Rathke (2019). Other studies which examined the issue of tax havens in relation to multinational firms and transfer pricing include OECD (2017), Davies et al. (2018) and Rathke (2019).

Studies connected to transfer pricing (UNCTA/Ndikunma, 2016; World Bank, 2016a; Okojie, 2018) have also shown that countries that are heavily dependent on the external sector and FDI like Nigeria are susceptible to transfer pricing. In particular, many multinational corporations with the connivance of state officials in charge of managing the economy, who are bent on serving their interests, tend to help these MNEs to carry out shoddy and manipulative activities that involve illicit transfers. For instance, government officials in charge of important function and economic management wield lot of discretionary power which encourages rent-seeking behaviour. Given that there is usually a low level of competition (a few large companies), the possibility for checks and balances and institutional and regulatory control in the sector tends to be weak/low. According to Okojie (2018) the multinational companies that operate in the sector tend to wield considerable financial and market power that gives them the undue leverage to exert pressure on host governments and, thus circumvent regulations. Several MNEs have branches in several countries that facilitate export through inter-company trade and profit-shifting by means of transfer pricing (Okojie, 2018).

3.0 TRANSFER PRICING: IMPACTS AND CONSIDERATIONS

The impact of transfer pricing on the economy as well as measures to combat it are complex and multi-dimensional impinging on international and national economic, development, security, and rule of law policy issues. Transfer pricing is affected by many wider policy objectives, and involves many disparate actors across a variety of governmental and non-governmental policy disciplines. There is, therefore, a high risk that policies regarding transfer pricing may be incoherent or badly-coordinated and that their effectiveness will suffer as a result.

On "account of its multidisciplinary nature, complex international normative framework and deterministic relationship to equity, growth, sustainable development, security, governance and the rule of law; lack of coherence in the implementation of transfer pricing policy is likely to result in lack of sustainability, unintended consequences, and competing priorities – for example with missed opportunities to be more effective, or unintended negative consequences for other objectives. Because of this risk, illicit financial flows have been identified as a priority

area for policy coherence for sustainable" development. Transfer pricing has vast implications on growth, revenue generation, governance, security, and rule of law outcomes and, as such, should be considered a significant disabler of sustainable development. It is significantly connected with other determinants of governments' efforts to effectively use and mobilize their own revenues and resources for sustainable development (OECD, 2017).

- Manipulations go hand-in-hand with corruption and wider governance failures such as weak or ineffective law enforcement or justice sector, which undermine the rule of law.
- Corruption – Corruption can be fuelled by inappropriate transfer pricing. Corruption "undermines the effectiveness and legitimacy of governments, compromising their ability to support sustainable development. It broadens income inequality and reinforces countries' vulnerability to crime and social instability. Corruption also distorts competition and diverts resources away from productive investment - including by discouraging legitimate investment" in corrupt countries.
- Weak domestic resource mobilization – Transfer pricing is a key form of tax avoidance and weakens tax receipts in both developing countries and advanced economies. Tax avoidance, in certain circumstances accentuates the problem of income distortion and manipulation by MNEs
- Poor governance and weak institutions –Transfer pricing is clearly a symptom of weak institutions and poor regulatory frameworks. Excessive tax avoidance measures using manipulative strategies flourish under weak institutions, lack of transparency, and weak regulatory framework.
- Uncontrolled profit repatriation – Excessive transfer pricing can aggravate profit repatriation at the expense of the host country where the MNEs are located
- Inequality and exploitative elites – Transfer pricing fuels the problem of exploitation due to unnecessary tax avoidance measures. This act tends to conceal their ownership of assets, and thereby frustrate efforts to redistribute wealth and reduce governments' capacity to mobilise resources for inclusive growth. They therefore have a role in sustaining inequality and rent-seeking behaviour, which are key obstacles to achieving the sustainable development goals. The impact of transfer pricing on the ability of countries to use their own revenues and resources for financing sustainable development is enormous (OECD, 2017).

- Estimates of global losses from tax avoidance measures are considerably large, according to global statistics. A World Bank study estimates losses through tax at 7.5-15% of GDP.

4.0 CHALLENGES OF TRANSFER PRICING

Florence (2016) posits that transfer pricing is bound to shape the tax base of the countries involved in the cross-border transaction, involving the MNEs and tax authorities. Transfer pricing is usually conducted and manipulated through moving the deductible expenses to the high taxes jurisdiction and shifting the revenues to the tax haven countries. Hence, without any consistent rules and administration, MNEs might be provided with an incentive to evade taxation through transfer pricing manipulation, which is an over or under-invoicing of related party transactions in order to avoid government regulations, the world of international tax is left to deal with the upcoming legal challenges and loopholes, mainly concerning jurisdictional matters, custom valuation, allocation and double taxation (Florence, 2016).

5.0 STRATEGIES FOR OVERCOMING CHALLENGES OF TRANSFER PRICING

One of the critical solutions to the transfer pricing problem is advance pricing agreements. Advance pricing agreements offer a practical means of mitigating transfer pricing disputes. They are formal contracts between a company and one or more tax authorities, establishing the approach to the determination of transfer pricing for transactions over a fixed period. Other ways of combating transfer pricing are

(i) By aligning one's transfer pricing policy with the business strategy
(ii) By following the arm's length principle and documentation of transactions
(iii) By seeking advance pricing agreements or intelligent mutual agreement procedures
(iv) Monitoring changes in tax laws and regulations
(v) Seeking professional international business or investment advice and guidance.

6.0 CONCLUSION, POLICY IMPLICATIONS AND RECOMMENDATIONS

The paper examines and analyzes the issue of transfer pricing of MNEs. Transfer pricing has enormous implication on the economy of developing economies, particularly Nigeria by providing a lot of economic and financial benefits ranging from business, trade, and investment to the ECOWAS sub-region. Apart from creating tax avoidance opportunities for MNEs, it

tends to reduce the revenue capacity of the host country's economy. Combating transfer pricing problems requires a complex and multi-dimensional approach that involves policy coherence, "different actors, many of which have similar or overlapping mandates and responsibilities. It also potentially presents many areas where compromises are needed between the goal of transfer pricing and other domestic or international" policy objectives.

Sustainable development and effective implementation of policies to mitigate transfer pricing depend on a concrete understanding of the entire policy environment. Policy coherence is needed in this regard, particularly concerning a robust policy on transfer pricing and taxes. Building and "implementing coherent policies on a subject that involves so many different elements of government policy and so many different actors is challenging. Governments need to clearly articulate transfer pricing priorities and imperatives. Dealing with transfer pricing requires bringing together experts and officials who not only have different expertise and objectives but also different backgrounds and working cultures; different legal authorities and administrative" procedures. For example, law enforcement officers, financial supervisors, tax inspectors, administrators, and civil servants have very different backgrounds and knowledge and likely work in different organizational cultures.

Measures to combat transfer pricing can be complex and procedural. They must also be responsive to an international and ever-changing environment, with respect to business and tax reforms. It is not effective or coherent for each country to pursue these measures in isolation. Countries are more effective when they share information about the changing risk environment; when they pool their resources to identify and disseminate best practices in the implementation of policy measures; and when they exert concerted pressure on jurisdictions that do not play by the rules and may generate conflicts and spillovers internationally. The paper recommends that institutional capacity be strengthened, particularly the legal framework as well as strong government effectiveness and capacity to curtail the humongous outflow of resources, as well as the implementation of reforms in the fiscal environment to make Nigeria benefit maximally form MNEs. The implication of this recommendation is that by implementing good transfer pricing policies, consistent tax reforms, and institutional strengthening, optimal tax avoidance through transfer pricing can be attained that will be beneficial to both parties.

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