FACTORS AFFECTING TRANSFER PRICING AND INCOME SHIFTING(?) BETWEEN CANADIAN AND UNITED STATES TRANSNATIONAL CORPORATIONS

Transnational corporations (TNCs) create subsidiaries to lower manufacturing costs on a global basis by strategically exploiting technological advantages, reputation, trademarks, brand names, and economies of scale (Rome 1992). Cross-border subsidiaries

> increase the stock of investment and capital (in the host country), provide employment opportunities and tax revenues, increase national output and raise welfare. They also transfer technology by the simple process of establishing factories to produce goods using new technology. (Rugman 1985, 179)

Transfer pricing is one technique used by TNCs to optimize these strategies. However, transfer pricing manipulations are constrained by tax regulations which theoretically prevent income shifting among subsidiaries to minimize and/or avoid taxes on income.

An underlying assumption of most tax authorities is that TNCs are able to shift income to and from subsidiaries to reduce and/or avoid host/home country income taxes. Non-U.S.-based TNCs may understate their U.S. taxes by $11 billion annually, part of which is attributable to transfer pricing practices (Ernst & Young 1993). TNCs in Japan, the United Kingdom and Canada consistently reflect the highest Internal Revenue Service (IRS) adjustments to their reported taxable income.

At issue is why TNCs choose a particular transfer pricing method. Do organizational and environmental factors influence a TNC's choice, or are methods chosen primarily to facilitate income shifting? Are financial factors of any consequence in the decision? Perhaps tax regulations override all factors, and the extent of income-shifting is exaggerated. However, if income shifting is the