INTERNATIONAL TRANSFER PRICING STRATEGIES FOR MINIMIZING GLOBAL INCOME TAXES

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RESUMO: A sobrevivência a longo prazo de estratégias financeiras ótimas, em mercados internacionais competitivos, é crítica. Estratégias financeiras concernentes a preços de transferência se tornam cada vez mais importantes à medida que os fiscais de impostos de rendas procuram receitas adicionais através de um controle crescente das práticas empresariais. Neste artigo, as estratégias ótimas de impostos são apresentadas depois de serem revisados o conceito de preços de transferência e as suas bases lógicas subjacentes ao crescente interesse dos governos. Num próximo artigo, nós analisaremos os efeitos das restrições governamentais nas estratégias de preços ótimos.

ABSTRACT: *Optimal financial strategies are critical for long term survival in competitive international markets. Financial strategies pertaining to transfer pricing have become increasingly important as income tax authorities seek additional revenues through increased monitoring of company practices. In this first of two articles, optimal tax strategies are presented after reviewing the transfer pricing concept and the rationale underlying governments' increased focus on transfer pricing. In the second forthcoming article, we analyze the effect of government restrictions on optimal pricing strategies.*

PALAVRAS-CHAVE: estratégias financeiras, transações internacionais, impostos, preços de transferência.

KEY WORDS: *financial strategies, international business, tax, transfer pricing.*

With a stabilized currency, opening economy and increased privatizations, internationalization of Brazil's market has accelerated dramatically in recent years. At the same time, as with governments throughout the world, federal authorities in Brazil remain ever vigilant for revenue sources. The confluence of internationalization and revenue needs has motivated significant changes in how Brazilian income tax authorities view multinational transactions. These changes signal Brazil's emergence as a global economy and they have substantial implications for how business is conducted by Brazilian multinationals and foreign enterprises with Brazilian interests. A fundamental implication pertains to transfer pricing among multinational affiliates. In this two article study we address tax minimizing corporate transfer pricing strategies (this article) and the effect of government restrictions on these strategies (forthcoming article).

More specifically, in this first article, the concept of transfer pricing is presented including its historical background and conceptual features. Then, the extent of and reasons for governments' preoccupation with transfer pricing are explored. With this orientation, the next section addresses the article's main focus which is an analysis of optimal company strategies for minimizing income taxes using transfer pricing. We conclude by observing that company incentives to manipulate transfer prices have prompted governments to institute or consider rules that restrict companies' transfer pricing strategies.

THE TRANSFER PRICING CONCEPT

A transfer price is the amount charged by one company for a product or service supplied to a related company, such as a transfer between a parent corporation and its subsidiary.[1] A government is threatened by related company pricing when the pricing is manipulated to minimize the taxable income in its jurisdiction. Because of this threat, many countries, especially in North America and Europe, have enacted provisions that attempt to prevent the manipulation of intercompany transfer pricing. After studying the issue over the last year, Brazil adopted much stronger restrictions effective in 1997.[2]

Background

International transfer pricing norms derive largely from restrictions specified under the domestic tax laws of the United States of America (US). Because reports by the Organization for Economic Co-Operation and Development (OECD) have typically been issued in response to US transfer pricing regulations, it is with good reason that many features of recent OECD transfer pricing guidelines[3] are similar to the US Regulations. The US and OECD models for transfer pricing reflect contemporary international thinking on the subject. Hence, they are primary source documents used by many governments, such as Brazil, in formulating their own transfer pricing rules.

A transfer price is an amount charged by one company for a product or service supplied to a related company, such as a transfer between a parent corporation and its subsidiary.

The history underlying current transfer pricing principles dates back to 1921 when the US perceived a potential for abusive income shifting between related taxpayers and enacted the predecessor to the current transfer pricing rules. Regulations were issued in 1935 adopting a standard for dealings among related taxpayers. The primary use of these Regulations by the US was in the domestic context until the early 1960s when attention was drawn to the shifting of income to foreign affiliates. New Regulations were promulgated in 1968 and, with only a few changes, governed US transfer pricing until 1986.

In 1986, the US Congress began to change these rules. At the same time, it requested the US tax authority to reexamine the theory and administration of transfer pricing. In response a report, or so-called white paper, was issued by US tax authorities in 1988.[4] Long-awaited transfer pricing Proposed Regulations issued in 1992 rejected many of the white paper's more controversial proposals, and introduced new ones. Faced with overwhelming criticism, the tax authority quickly withdrew and replaced the Proposed Regulations. In January 1993, transfer pricing Temporary Regulations were issued followed by Final Regulations in July 1994. It is these Final Regulations that form the basis for the July 1995 OECD transfer pricing guidelines.

1. US GENERAL ACCOUNTING OFFICE, Report to Congressional Requesters. *International taxation: Transfer Pricing and Information on Nonpayment of Tax*, Background. GAO/GGD-95-101, April 1995.

2. Law 9430 (December 27, 1996).

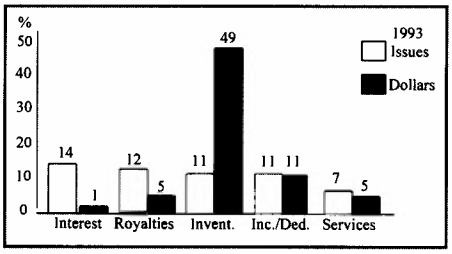
3. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD publication service, July 1995.

4. US DEPARTMENT OF TREASURY. *A Study of Intercompany Pricing*. US printing office, October 1988.

Concept features

At least two initial observations about the transfer pricing concept are noteworthy. First, transfer pricing is frequently associated with transfers of inventory. However, the concept is equally applicable to intercompany prices for noninventory transactions, such as interest charged on intercompany loans, intercompany royalties paid for intangibles, payments for intercompany leases, and fees for intercompany services as, for example, administrative services and the like. However, despite the concept's broad scope, evidence suggests that, at least in the US, inventory represents the highest dollar value of transfer pricing issues as illustrated for 1993 in Exhibit 1.

Exhibit 1
The value and number of 1993 US proposed Transfer Pricing Issues as a percentage of all 1993 proposed Transfer Pricing Issues



Source: US GENERAL ACCOUNTING OFFICE, Report to Congressional Requesters. *International taxation: Transfer pricing and information on nonpayment of tax.* GAO/GGD-95-101, April 1995, Figure 1, p. 5.

As Exhibit 1 indicates, of the 369 corporations for which the US proposed transfer pricing adjustments in 1993, 49 percent of the dollar amount pertained to inventory even though it represented only 11 percent of the issues. The next closest dollar contender was the nonspecific category of income allocations and deductions (Inc./Ded.) which represented only 11 percent of US proposed adjustments, as well as 11 percent of the issues.

Second, transfer prices are only of concern to governments if they are between related companies. Under the US Regulations, companies are related if they are owned or controlled, directly or indirectly, by the same interests. Control is not limited to an objective test, such as 50 percent ownership in stock. Similarly, the July 1995 OECD guidelines on transfer pricing define related companies (or associated enterprises) by reference to the OECD Model Tax Convention on Income and Capital (hereafter OECD Model Tax Convention). According to the OECD, companies are related if one company participates directly or indirectly in the management, control or capital of a company in another country, or if the same persons participate directly or indirectly in the management, control or capital of two companies.[5] Recent Brazilian provisions capture the control concept by defining various forms of ownership[6] and go a step farther by imposing transfer pricing restrictions on transactions between a Brazilian company and *un*related entities in tax havens.[7] Therefore, while in spirit the related company concept captures the notion of control and potential manipulation, control may be defined in a number of subjective and/or objective ways.

GOVERNMENT FOCUS ON TRANSFER PRICING

There are numerous incentives to manipulate transfer prices. For example, cash flows naturally follow transfer prices between related entities across jurisdictions. Therefore, transfer prices provide a mechanism for avoiding exchange restrictions and withholding taxes to which cross boarder dividends, and other passive cash flows, might be subject. In addition to cash management, transfer prices might be instrumental in financing. For example, Brazil's Adiantamento de Contrato de Câmbio (ACC) provides favorable short term borrowing interest rates against the prices specified on export contracts. Hence, greater access to ACC funds is facilitated by higher transfer prices in contracts with foreign affiliates. Compensation based on measures of profit also provide nontax incentives to manipulate transfer prices. A unit manager would favor transfer prices that increase profits to the extent they have an impact on his or her remuneration. Moreover, marketing strategies may impact transfer pricing. For example, low transfer prices with an affiliated foreign supplier might follow from a foreign market penetration strategy based on under pricing. Finally, while this study focuses on income tax, import taxes, such as Brazil's Imposto de Importação, might influence preferred transfer prices with an affiliated foreign supplier.

Despite these and other potentially conflicting incentives for companies to manipulate transfer prices, federal authorities have increasingly focused on the income tax implications. Brazil's recent transfer pricing provisions reflect this preoccupation. To-date Brazilian expenditures to enforce its transfer

5. US DEPARTMENT OF TREASURY. *A Study of Intercompany Pricing.* US printing office, October 1988. Glossary. And the OECD COMMITTEE ON FISCAL AFFAIRS. *Model Tax Convention on Income and Capital.* Article 9(1). OECD publication service, March 1994.

6. Law 9430 (December 27, 1996) defines related parties as those with a parent-subsidiary relationship (which requires direct or indirect voting rights of greater than 50 percent), companies with direct ownership of 10 percent or more, companies with 10 percent or more ownership held by a common owner, those with partnership relationships, an individual and a company which has among its directors or controlling shareholders a relative, spouse or close friend of the individual, and those between which there is an exclusive agent, distribution or concession contract.

7. Law 9430 (December 27, 1996) defines a tax haven as a country with a maximum income tax rate below 20 percent.

pricing rules have been negligible. At the other extreme, the US consumed approximately 186 staff years in closed transfer pricing cases in 1993, and about 227 staff years on similar cases in 1992.[8] This sizable investment reflects the efforts of US examiners, economists, and appeals staff. Fluctuations occur between years because large cases cover several years and have a significant impact in the year in which they close. Total US proposed adjustments, for cases with proposed adjustments of US$20 million or more, are shown in Exhibit 2.

Exhibit 2
Proposed US Transfer Pricing adjustments for cases with US$20 million or more of proposed adjustments

Year	Amount (US$ billions)
1989	4.8
1990	6.0
1991	2.3
1992	4.1
1993	1.8
1994	3.5

Source: US GENERAL ACCOUNTING OFFICE, Report to Congressional Requesters. *International taxation: Transfer pricing and information on nonpayment of tax.* GAO/GGD-95-101, April 1995, Table II.1, p. 19.

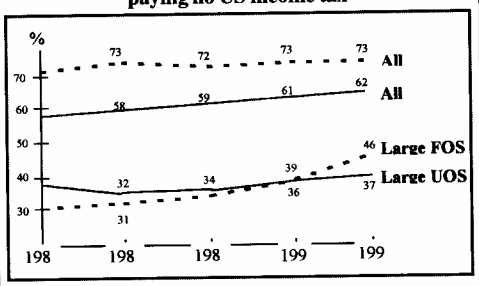
This exhibit indicates substantial proposed adjustments. Moreover, the adjustments shown in the exhibit are just for large cases. For example, Exhibit 2 includes only 51 and 64 companies in 1993 and 1994, respectively. If all the 369 US challenges for 1993 are considered, proposed adjustments increase to US$2.2 billion. Because of lost data, the US General Accounting Office reports that all 392 US challenges for 1994 resulted in the same amount (US$3.5 billion) of proposed adjustments shown in Exhibit 2.[9]

Of course, not all proposed adjustments are sustained. For example, for the cases shown in Exhibit 2, 27 percent and 21 percent of the proposed adjustments were sustained in 1993 and 1994, respectively. Even sustained adjustments might not result in additional taxes to the extent taxpayers have offsetting adjustments from current or prior years, such as used operating losses. Despite these qualifications, unanticipated tax costs arising from sustained adjustments can be significant for any given company, and merely fighting a proposed adjustment can be extremely costly.

Why have governments such as Brazil recently developed transfer pricing rules, and other governments such as the US so aggressively pursuing transfer pricing adjustments? Clearly, Brazil sees an opportune source of revenues in the face of increased globalization. Moreover, to the extent one government aggressively pursues adjustments within its jurisdiction, other governments tend to reciprocate in an effort to create symmetry in both policy and company accounts.

On the international landscape, the US has been the aggressor prompting heightened transfer pricing activity by other governments. US efforts have been motivated by evidence, albeit inconclusive, that there are more foreign owned US subsidiaries (FOSs) paying zero US tax than US owned US subsidiaries (UOSs) as shown in Exhibit 3.

Exhibit 3
Percentage (%) of foreign owned US subsidiaries (FOS) and US owned US subsidiaries (UOS) paying no US income tax



Source: US GENERAL ACCOUNTING OFFICE, Report to Congressional Requesters. *International taxation: Transfer pricing and information on nonpayment of tax.* GAO/GGD-95-101, April 1995, Figure 2, p. 8 and Appendix V, Table V.1, p. 39.

The two top lines in Exhibit 3 indicate that for all controlled corporations, between 11 and 15 percent[10] more FOSs than UOSs paid no US income tax from 1987 through 1991. One explanation for these significant differences is systematic differences in FOS and UOS transfer pricing policies.

The bottom two lines in Exhibit 3 reflect a less convincing pattern of transfer pricing abuse for large FOSs and UOSs defined as those with assets of US$100 million or more. For these firms, only during 1990 and 1991 were more FOSs than UOSs paying no US income tax. On the other hand, while not shown in Exhibit 3, large FOSs that did pay US income tax in 1991, paid less (as a percentage of gross receipts) than large UOSs.[11] Additional

8. UNITED STATES GENERAL ACCOUNTING OFFICE. , Report to Congressional Requesters. *International taxation: Transfer Pricing and Information on Nonpayment of Tax.* GAO/GGD-95-101, April 1995, p. 6.

9. Lost data during the implementation of a new tax authority management information system likely caused the understatement of 1994, as well as 1993, proposed adjustment amounts. UNITED STATES GENERAL ACCOUNTING OFFICE. Report to Congressional Requesters. *International taxation: Transfer Pricing and Information on Nonpayment of Tax.* GAO/GGD-95-101, April 1995, Appendix II, p. 20.

10. The 11 and 15 percent difference in FOS and UOS nontaxpayers occurred in 1991 and 1988, respectively. The number of companies represented in Exhibit 3 range from: All FOSs 29,632 (1987) to 34,423 (1991); All UOSs 1,330,988 (1987) to 1,261,559 (1991); Large FOSs 297 (1987) to 715 (1991); Large UOSs 2,483 (1987) to 3,713 (1991). US GENERAL ACCOUNTING OFFICE. Report to Congressional Requesters. *International taxation: Transfer Pricing and Information on Nonpayment of Tax.* GAO/GGD-95-101, April 1995, Appendix V, Table V.2, p. 40.

11. US GENERAL ACCOUNTING OFFICE. Report to Congressional Requesters. *International taxation: Transfer Pricing and Information on Nonpayment of Tax.* GAO/GGD-95-101, April 1995, Appendix V, Table V.4, p. 42.

evidence that transfer pricing might be responsible for the 1991 large firm difference is supported by the analyses of cost of goods sold (CGS) to receipts, and purchases to receipts shown in Exhibit 4.

Exhibit 4
1991 ratios for large FOSs and UOSs paying no US income tax

	Large FOSs	Large UOSs
Cost of Goods Sold/Receipts	65.7%	43.0%
Purchases/ Receipts	47.7%	25.7%

Source: US GENERAL ACCOUNTING OFFICE, Report to Congressional Requesters. *International taxation: Transfer pricing and information on nonpayment of tax.* GAO/GGD-95-101, April 1995, Appendix V, Table V.5, p. 43.

Large FOSs had substantially higher CGS and purchase costs (relative to receipts) than large UOSs. To the extent their goods sold and purchases made are similar and acquired from parent companies, manipulated transfer pricing provides at least one explanation of FOS and UOS differences. The similarity of inventory purchased and sold by FOSs and UOSs is some what dispelled by the industry analysis shown in Exhibit 5.

Transfer prices provide a mechanism for avoiding exchange restrictions and withholding taxes to which cross boarder dividends, and other passive cash flows, might be subject.

As this exhibit indicates, there are substantial differences in FOS and UOS industry representation. Therefore, this and not transfer pricing may explain the CGS and purchase ratio differences in Exhibit 4. Grubert *et al* report that about half of the difference in rates of return between FOSs and UOSs can be explained by exchange rate fluctuations and the "newness" of the investment, while the other half may be explained by transfer prices or other reasons.[12] In a study by Collins *et al*, evidence is provided that nonpayment of taxes by FOSs

Exhibit 5
1991 industry breakdown of large corporations paying no US income tax

	Large FOSs	Large UOSs
Mining	3.5%	1.2%
Construction	2.1	0.5
Manufacturing	29.9	10.3
Transportation and public utilities	2.0	3.3
Wholesale Trade	16.9	3.8
Finance, insurance and real estate	34.5	77.7
Services	11.2	3.2
Total	100.0%	100.0%

Source: US GENERAL ACCOUNTING OFFICE, Report to Congressional Requesters. *International taxation: Transfer pricing and information on nonpayment of tax.* GAO/GGD-95-101, April 1995, Appendix V, Table V.6, p. 44.

in the wholesale trade industry is linked to manipulation of inventory transfer prices.[13] In addition, Harris *et alii* provide evidence that suggests US manufacturing companies with subsidiaries in foreign jurisdictions manipulate transfer prices.[14] Considering all the evidence, transfer pricing is suspected, but not conclusively linked, by US authorities to FOS and UOS tax paying differences. Apparently, this suspicion is sufficient to justify substantial investment in transfer pricing monitoring by US authorities and other governments in turn.

TAX MINIMIZING TRANSFER PRICING STRATEGIES

Sophisticated income tax strategies are an important component of long term success for companies competing in world markets. A company's transfer pricing policy is among the most relevant features of a competitive strategy. Unfortunately, there is no simple heuristic for implementing an optimal tax saving transfer price. A company's preferred transfer price with a foreign affiliate depends on (1) foreign tax rates and (2) the company's foreign tax credit (FTC).

12. GRUBERT, H., GOODSPEED, T. and SWENSON, D. Explaining the low taxable income of foreign-controlled companies in the United States. *Studies in International Taxation.* University of Chicago Press, p. 237-270, 1993.

13. COLLINS, J.H., KEMSLEY, D. and SHACKELFORD, D.A. Zero taxable income of foreign-controlled domestic corporations: Transfer pricing manipulation or low profitability? Working paper (University of North Carolina), May 2, 1994.

14. HARRIS, D., MORCK R., SLEMROD, J. and YEUNG, B. Income shifting in U.S. multinational corporations. *Studies in International Taxation.* University of Chicago Press, p. 277-302, 1993.

The FTC concept

Before elaborating on items (1) and (2) above, we describe the FTC concept. In general, the FTC is a system that home countries implement to mitigate double taxation on their domestically based businesses with international activities. The threat of double taxation arises because most countries, including Brazil since 1996, tax the domestic *and* foreign source income of their home companies. Because typically the foreign (host) country also taxes income earned within its territory, foreign source income is at risk of being taxed in *both* the host and home country.

Sophisticated income tax strategies are an important component of long term success for companies competing in world markets.

While the mechanics of a FTC can be complicated and vary from country to country, in concept it allows a company to use foreign taxes paid to offset home country tax caused by foreign source income. For example, assume a Brazilian corporation subject to a 25 percent income tax rate, repatriates $100 of income (gross of tax) earned by its Costa Rican subsidiary which is subject to a 20 percent income tax rate.[15] Absent the FTC, all or some of the $100 earned is at risk of being taxed in both Costa Rica and Brazil. To mitigate this inequity and facilitate trade, Brazil allows the $25 of Brazilian tax to be offset by the $20 of Costa Rican tax, resulting in a net tax in Brazil of only $5. The worldwide tax rate on the $100 is still the maximum country rate of 25 percent, but $20 is paid to Costa Rica and $5 is paid to Brazil.

If the host country has a higher tax rate than the home rate, the FTC is limited. For example, assume that $100 is earned by a Germany subsidiary which is subject to a 45 percent local income tax rate. Upon repatriation, Brazil allows a local income tax credit limited to $25, not a credit in the full $45 amount paid in Germany. Hence, Germany will collect $45 of tax and Brazil will collect zero tax. Once again the income is being taxed at the maximum country rate. The $20[16] tax paid in Germany for which no benefit was received in Brazil is referred to as an *excess credit*. It represents a tax attribute which, if properly managed by multinational companies, can save additional taxes.

While the above examples capture the concept underlying the FTC and its limit, the actual mechanics and implementation may be fraught with complications and judgment. Complications might arise from the formula used to implement the concept, a requirement to measure foreign taxable income using home country rules, the definition of credible foreign income taxes paid, and the allocation of income and deductions between foreign and domestic sources as required by most FTC formulas. However, to understand tax minimizing transfer pricing strategies, the FTC concept as illustrated above is sufficient.

Case examples - basic facts

With this understanding of the FTC, we now revisit our observation that the preferred transfer price with a foreign affiliate depends on (1) foreign tax rates and (2) the company's FTC. Items (1) and (2) are analyzed using two cases (A and B). The basic facts underlying all these cases are similar to the FTC example above and delineated in Exhibit 6.

Exhibit 6
Basic facts for cases A and B

Income tax rates:	
BrazCo (a Brazilian parent corporation)	25%
CRCo (a BrazCo Costa Rican subsidiary)	20%
GerCo (a BrazCo German subsidiary)	45%
Product transfer:	
BrazCo's production costs	$ 0
Retail sales price by BrazCo subsidiaries	$100

As Exhibit 6 indicates, in the cases that follow a Brazilian corporation, BrazCo, is subject to a 25 percent local income tax rate. BrazCo has subsidiaries in Costa Rica, CRCo (subject to a 20 percent local income tax rate), and/or German, GerCo (subject to a 45% local income tax rate). BrazCo is a supplier and its intercompany transfer price corresponds to cost of goods sold (CGS) for a purchasing subsidiary. For simplicity, we assume BrazCo's subsidiaries sell the product locally for $100 and BrazCo's production costs are negligible ($0). Hence, $100 of net profits are available to the affiliated group from product sales. Moreover, we assume there are no transfer pricing restrictions. This latter assumption helps illustrate the point that optimal transfer prices vary depending on foreign tax rates. However, governments are increasingly restricting transfer prices in ways detailed in our second article that will appear in the next issue of

15. Foreign earned income is not subject to Brazil's social contribution (or social welfare) tax which, for domestic earnings, is calculated based on taxable income.

16. $20 = $45 tax paid in Germany - $25 FTC in Brazil.

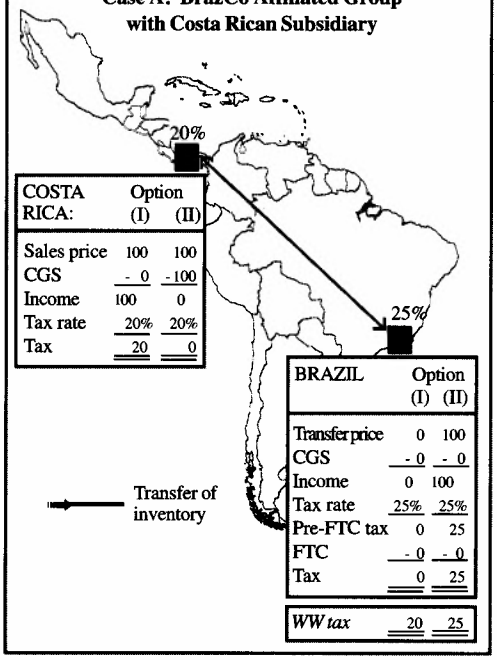
this journal. Therefore, less extreme transfer prices than identified below are likely in actual markets. Consistent with items (1) and (2) above, the relevant transfer pricing issues are how do foreign tax rates affect tax minimizing transfer prices and how are transfer prices affected by the FTC?

The effect of foreign tax rates and FTCs on transfer pricing

Case A (Exhibit 7) and Case B (Exhibit 8) illustrate the impact of foreign tax rates and the FTC on tax minimizing transfer prices. In these two cases, we assume BrazCo has only one subsidiary and it sells the product to its subsidiary which distributes the product locally.

- *Case A.* This case assumes that BrazCo's only subsidiary is CRCo. BrazCo's worldwide tax burden will be minimized if, in the extreme, the transfer price to CRCo is zero as shown in Exhibit 7.

Exhibit 7
Case A: BrazCo Affiliated Group with Costa Rican Subsidiary



COSTA RICA:	Option (I)	(II)
Sales price	100	100
CGS	- 0	- 100
Income	100	0
Tax rate	20%	20%
Tax	20	0

BRAZIL	Option (I)	(II)
Transfer price	0	100
CGS	- 0	- 0
Income	0	100
Tax rate	25%	25%
Pre-FTC tax	0	25
FTC	- 0	- 0
Tax	0	25
WW tax	20	25

If the transfer price is zero as under Option I, no income is recognized in Brazil, the high tax jurisdiction, and all the income is recognized in Costa Rica, the low tax jurisdiction. The other extreme is shown in Option II where the transfer price is $100, thus all the income is recognized in Brazil resulting in a pre-FTC tax of $25. Because none of this income is earned and taxed in Costa Rica, the FTC offset equals zero resulting in a final Brazilian tax of $25. BrazCo's worldwide (WW) tax burden under Option I is $20[17] compared to an Option II WW tax of $25.[18] Therefore, in this case the optimal tax strategy is to shift as much income as possible to Costa Rica, the low tax jurisdiction (Option I). Under this strategy, Brazil does not tax CRCo earnings as long as they are not repatriated to Brazil. While not shown in Exhibit 7, if BrazCo repatriates CRCo's $100 of income (gross of Costa Rican tax), Brazil will impose a tax of $25 offset by a $20 FTC. This results in a net $5 Brazilian tax in addition to the $20 Costa Rican tax, or the same WW tax of $25 as under Option II.

Tax minimizing strategies provide clear incentives for companies to manage their transfer prices.

Case B. This case assumes that BrazCo's only subsidiary is GerCo. Contrary to Case A, BrazCo's worldwide tax burden will be minimized if, in the extreme, the transfer price to GerCo is $100 as shown in Exhibit 8.

With a transfer price of zero (Option I), all the income is recognized in Germany, the high tax jurisdiction, and a $45 WW tax results. While not shown in Exhibit 8, the WW tax is still $45 if GerCo repatriates its $100 of earnings (gross of tax) because all the Brazilian tax will be offset by BrazCo's FTC. With a transfer price of $100 (Option II), all the income is recognized and taxed in Brazil, the low tax jurisdiction, resulting in a $25 tax. Because under this strategy all the income is in Brazil, repatriation is not an issue. The general rule suggested by Cases A and B is to shift income to the lowest tax jurisdiction and hold it there. As these basic cases illustrate, transfer pricing preferences may be radically different depending on the foreign tax rate and considering the FTC.

Optimal tax planning

International tax rules, especially those dealing with transfer pricing, are subject to a high degree of professional judgment and interpretation. This is true in countries with longstanding transfer pricing laws, such as the US, and especially true for countries with new transfer pricing regimes, such as Brazil. Moreover, there are a wide variety of ways in which international transactions can be structured. Reasonable interpretations and structural alternatives present legally sound tax planning strategies of substantial benefit to taxpayers.

17. $20 = $20 tax paid in Costa Rica + $0 tax paid in Brazil.

18. $25 = $0 tax paid in Costa Rica + $25 tax paid in Brazil.

For example, in some countries with established international tax rules, such as the US, highly effective tax planning strategies derive from the way in which FTCs can be used and income can be characterized (as foreign or domestic income). These strategies may enable a parent company to use excess FTCs from one foreign affiliate to offset the domestic taxes generated on income from another foreign affiliate in a technique referred to as cross crediting. Under such strategies, optimal transfer prices may fall somewhere between the extremes illustrated in Cases A and B above.

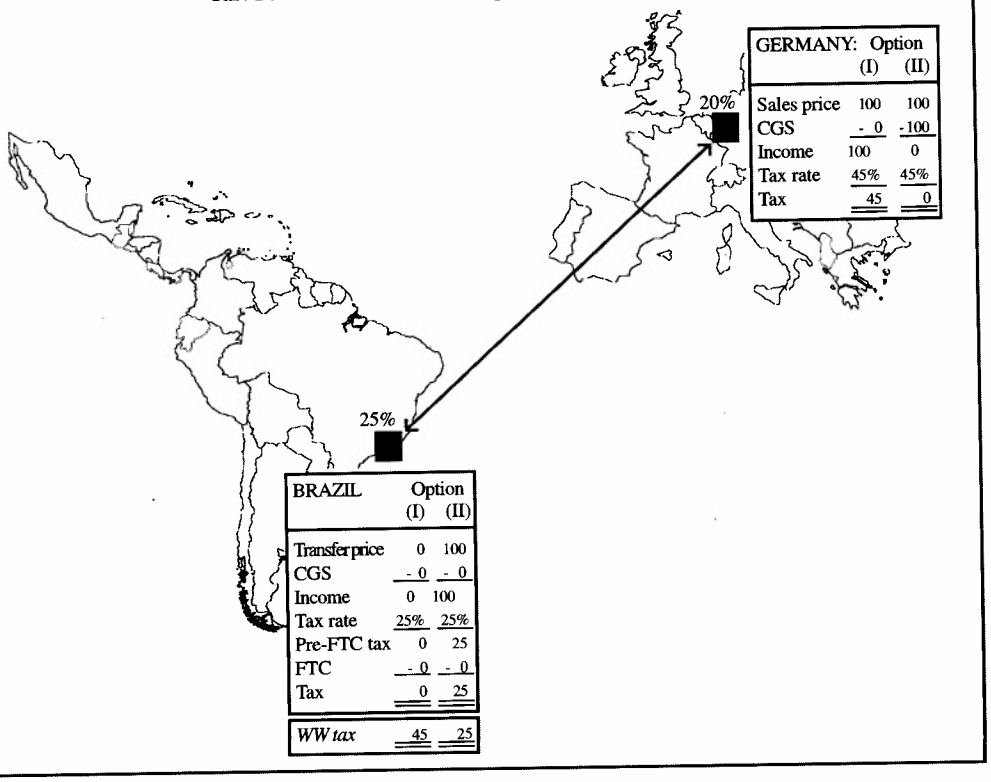
Because more recent transfer pricing regimes, such as Brazil's, have been subject to less interpretation, the opportunities to exercise reasonable professional judgment is less restricted. As a result, more tax minimizing transfer pricing strategies are potentially available. Moreover, the experiences of professionals and multinational companies in countries with longstanding transfer pricing laws provide useful models for interpreting the less developed laws in Brazil and other countries with recently enacted regimes. It may be of significant advantage for taxpayers to drawing from this wealth of experience in complying with recently enacted regimes.

CONCLUSION

Tax minimizing strategies provide clear incentives for companies to manage their transfer prices. Optimal strategies may require extreme prices as illustrated in Cases A and B, as well as other tax motivated prices depending on the planning opportunities available to multinational companies. Accordingly, governments have increasingly scrutinized the transfer pricing practices of international entities. Brazilian companies must face this scrutiny in other countries as they continue to expand their global operations. Moreover, the Brazilian government has just adopted more rigid transfer pricing restrictions, hence creating an even greater incentive for Brazilian companies to understand this pervasive issue.

Considering companies strategic incentives and quasi-evidence that transfer pricing strategies are undertaken, governments have developed anti-abuse restrictions that generally conform to tractable principles. As will be discussed in a forthcoming article, these restrictions impose subjective constraints on optimal transfer pricing strategies and suggest the need for companies to develop a consistent transfer pricing policy. ❑

Exhibit 8
Case B: BrazCo Affiliated Group with German Subsidiary



GERMANY:	Option (I)	(II)
Sales price	100	100
CGS	- 0	-100
Income	100	0
Tax rate	45%	45%
Tax	45	0

BRAZIL	Option (I)	(II)
Transfer price	0	100
CGS	- 0	- 0
Income	0	100
Tax rate	25%	25%
Pre-FTC tax	0	25
FTC	- 0	- 0
Tax	0	25
WW tax	45	25