VOLUME 14 NUMBER 2 AUGUST 2005

TRANSNATIONAL CORPORATIONS

United Nations
New York and Geneva, 2005
United Nations Conference on Trade and Development
Division on Investment, Technology and Enterprise Development

Editorial statement

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ISBN 92-1-112690-8
ISSN 1014-9562

Printed in Switzerland

Professor Sanjaya Lall, a member of the Board of Advisers of *Transnational Corporations*, died on 18 June 2005 at his home in Oxford. It is a great loss not only to his family, but also to our common work devoted to promoting development. Professor Lall was a renowned authority and made a great contribution to our knowledge of investment, industrialization, trade, technology and development.

Transnational Corporations

Volume 14, Number 2, August 2005

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Went for cost, priced at cost? An economic approach to the transfer pricing of offshored business services

Lorraine Eden *

What are the implications of the rapid growth in offshored business services for transfer pricing, the pricing of products traded between affiliated firms? I explore these implications through a case study of transnational corporations in the teleservices industry. Teleservices firms own foreign affiliates that provide inbound and outbound call services to third party clients. Economic analysis, applied to the facts and circumstances of the industry, is used to develop pricing rules for offshored call centres, including the implications for location savings. Even though the catchphrase "Went for cost, stayed for quality" does apply to teleservices as it does in other offshored business services, I conclude that "Went for cost, priced at cost" is the appropriate transfer-pricing maxim for tax authorities and firms to follow.

Key words: offshoring, outsourcing, transfer pricing, business services, teleservices, international taxation

1. Introduction

International trade and foreign direct investment (FDI) patterns are increasingly shifting from manufacturing to services (UNCTAD, 2004). The reasons for the rapid growth in services trade and FDI are straightforward. First, transnational corporations (TNCs) in service industries such as airlines, banking, accounting and consulting are rapidly becoming

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transnationalized. The privatization of State-owned enterprises in service industries such as telecommunications, electricity and postal services has encouraged inward FDI, particularly in Latin America and Central and Eastern Europe. Second, TNCs in the manufacturing sector are setting up foreign affiliates to provide support functions for the corporate group; financial, trading and marketing affiliates are common examples. Information technology enabled services (ITES), providing back office and support functions (payroll, order fulfillment) and front office functions (customer care), are being relocated to developing countries such as India and the Philippines. Information technology has enabled the disassembly of service processes into a number of relatively separable activities; codifiable interfaces between these activities enable them to allocated to legally independent organizations and placed in physically distant locations. While the original move offshore for most TNCs was caused by the availability of low-cost labour, both quality and cost are now key drivers of services FDI, as reflected in the maxim: “Went for cost, stayed for quality” (Dossani and Kenney, 2003, 2004).

The research question I address in this article is: what are the implications for transfer pricing of the rapid growth of FDI in business services? *Transfer pricing* is the pricing of products traded among affiliated units of a TNC. Because the prices are set in-house, there are opportunities for TNCs to manipulate them and avoid or evade Government regulations such as customs duties and corporate income taxes. In order to curtail these opportunities, most Governments have adopted transfer-pricing regulations based on the OECD guidelines (OECD, 1995). These guidelines require TNCs to follow the arm’s length principle, i.e. firms must price each intracompany transaction as if it had occurred between two unrelated parties negotiating