

Vik-Giger Corporation

Multinational transfer pricing and taxation.

Vik-Giger Corporation, headquartered in the U.S., manufactures state-of-the-art milling machines. It has two marketing subsidiaries, one in Brazil and one in Switzerland, that sell its products. Vik-Giger is considering building one new machine, at a cost of \$500,000. There is no market for the equipment in the United States. The equipment can be sold in Brazil for \$1,000,000, but the Brazilian subsidiary would incur transportation and modification costs of \$200,000. Alternatively, the equipment can be sold in Switzerland for \$950,000, but the Swiss subsidiary would incur transportation and modification costs of \$250,000. The U.S. company can sell the equipment either to its Brazilian subsidiary or to its Swiss subsidiary but not to both. Vik-Giger Corporation and its subsidiaries operate in a very decentralized manner. Managers in each company have considerable autonomy, with each division manager interested in maximizing his or her own division's income.

Questions:

1. From the viewpoint of Vik-Giger and its subsidiaries taken together, should Vik-Giger Corporation manufacture the equipment?
 - (a) If it does, where should it sell the equipment to maximize corporate operating income?
 - (b) What would the operating income for Vik-Giger and its subsidiaries be from the sale? Ignore any income tax effects.
2. What range of transfer prices will result in achieving the actions determined to be optimal in requirement 1? Explain your answer.
3. The effective income tax rates for this transaction follow: 40% in the United States, 60% in Brazil, and 15% in Switzerland. The tax authorities in the three countries are uncertain about the cost of the intermediate product and will allow any transfer price between \$500,000 and \$700,000. If Vik-Giger and its subsidiaries want to maximize after-tax operating income:
 - (a) should the equipment be manufactured and
 - (b) where and at what price should it be transferred?
4. Now suppose each manager acts autonomously to maximize his or her own subsidiary's after-tax operating income. The tax authorities will allow transfer prices only between \$500,000 and \$700,000. Which subsidiary will get the product and at what price? Is your answer the same as your answer in 3? Explain why or why not.