International Transfer Pricing

International transfer pricing refers to the pricing of transfers of goods, services and technology between related subsidiaries in different countries. The advent of multinational corporations and their continued growth has added a more complicated dimension to transfer pricing. This is because international transfer pricing must meet not only the objectives of profit maximisation and performance evaluation but also a wide variety of other objectives.

Objectives of international transfer pricing

The two basic objectives of transfer pricing are: (a) profit maximisation through goal congruence, and (b) performance evaluation. But international transfer pricing must meet a wide variety of other objectives also. These other objectives are sometimes so important that the basic objectives may be considered secondary or unachievable. Hence, it is necessary to understand the other considerations/factors involved in international transfer pricing and their impact on transfer pricing. The key objectives of international transfer pricing are:

1. *Moving funds internationally*
   a) By charging high transfer prices to an affiliate located in a country, the MNC can transfer funds out of that country.
   b) By charging low transfer prices to an affiliate and/ or purchasing from an affiliate at a high transfer price, the MNC can finance an affiliate.
   c) By charging low transfer prices to an affiliate and/ or purchasing from an affiliate at a high transfer price, the MNC can depict the position of the affiliate better than it actually is and improve an affiliate's credit rating thus enabling it to borrow funds locally.
   d) When host governments try to regulate corporate profits through regulatory techniques, MNCs try to disguise the true profitability of the affiliates by using transfer prices.
   e) MNCs can check trade union demands for higher wages by showing lower profit of the affiliate by manipulating transfer prices.

2. *Minimising taxes*

The objective of overall tax minimisation is fulfilled by shifting profit from a country with a high tax burden to a country with a low tax burden. This can be done by charging low transfer prices for goods and services bought in and high transfer prices for goods and services sold by an affiliate in a low tax country. The reverse procedure is to be applied for an affiliate operating in a high tax country.

3. *Minimising tariffs/ import duties*

Charging low transfer price to a high tariff country can help to minimise the impact of tariffs. However, the impact of taxation and tariffs should be considered together. Since, the burden of tax is usually more than the burden of tariffs, charging low transfer price to a high tariff but low tax country usually does not help.

4. *Avoiding exchange controls and quotas*

Transfer prices may be used to cancel the volume effects of foreign exchange quotas. Low transfer prices may be used to increase the quantity/ volume of imports where government imposes restrictions on the amount of foreign exchange that can be used to import a particular type of good. Similarly, where the government exercises control on the repatriation of dividends to the parent, this rule can be bypassed by the parent charging high transfer prices on goods sold to the subsidiary in that country.

5. *Minimising foreign exchange risks*

It is often argued that in international transfers, foreign exchange loss to one subsidiary situated in one country is compensated by foreign exchange gain to another subsidiary operating in another country and from the parent's point of view this should have no impact on the overall position of the parent. This argument does not hold good in reality because of difference in treatment of exchange gains and losses, in tax laws and competitive factors in the industry.) For example economic exposure may make a subsidiary less competitive and the parent may think in terms of buying from a non-related home-country to avoid the exposure. In such a case use of a low transfer price may help the subsidiary tide over such difficulties.

6. *Increasing share of profits from joint ventures*

A company may use transfer price as a technique to maximise its share of profits from a joint venture. It may transfer goods from a subsidiary to the joint venture at a higher price or transfer goods from the joint venture to a subsidiary at a lower price and thereby increase its own share of profits from the joint venture.

7. *Optimising managerial incentives and performance evaluation*

Transfer prices based on the arm's length principle are useful for optimising managerial incentives through proper evaluation of corporate performance. But if somewhat arbitrary transfer prices are established by the headquarters for fulfilling the other objectives of business, managerial disincentives arise and performance evaluation becomes difficult.

Indian Scene – The Finance Act 2001 introduced the detailed Transfer Pricing Regulations (T.P.R.) in India w.e.f. 1stApril 2001 corresponding to the assessment year 2002-2003. The sections and rules under the Income Tax Act, which deal with Transfer Pricing Regulations are sections 92 to 92F and rules 10A to 10E and sections 271(1)(c), 271AA, 271BA and 271G.

Definition

The term "arm's length price" is defined to mean a price applied in uncontrolled conditions. In other words it refers to the market value of a particular transaction ignoring the impact on pricing due to existence of special relationship between associated enterprises. The term "enterprise" is widely defined to include any person carrying out commercial activities of various types specified in the relevant section.

Choosing the transfer Price

Five criteria for an efficient international transfer pricing system

1. Provide an adequate profit measurement for performance evaluation.
2. Provide adequate information to top management for managerial decision making.
3. Facilitation profit maximisation.
4. Motivate managers of affiliates.
5. Minimise international transaction costs of the MNC by minimising border and income tax liabilities, foreign exchange risks, etc. and conflict with host governments' policies.

Methods for Determining Arm's Length Price

Comparable Uncontrolled Price Method (CUP)

The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction) in comparable circumstances. CUP method is the most direct and reliable way to apply the arm's length principle and hence the same is preferable over all other methods wherever it is possible to locate comparable uncontrolled transactions. Adjustments may be made for differences in quality, quantity, terms, transportation costs and other factors. This method is however very difficult to apply in practice. Commodity-type products ordinarily use this method for internal transaction.

Resale Price Method (RPM)

The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. For example, company A has sold a product to an associated company B at Rs.1000. Company B has resold the same to an unrelated party X at a price of Rs.2000. In order to arrive at arm's length price between A and B the price charged by B to X would be scrutinized. If reasonable profits in the hands of B are presumed at Rs.400 and expenses incurred by B amount to Rs.200, arm's length price between A and B will be Rs.1400 i.e., (2000-600). There may be further adjustments due to customs duty, etc. While resale price method may require less product comparability, it is a fact that closer comparability of products will produce better results.

The factors to be considered in this method are level of costs, value addition at each stage, time-frame of resale, computation of gross margin, etc.

Cost plus Method (CPM)

In Cost plus Method, first the cost incurred by the supplier of goods or services is determined. An appropriate cost plus mark-up is then added to the cost, to arrive at an appropriate profit in the light of the functions performed and market conditions. The resultant figure is the arm's length price. So essentially, CPM involves comparability of gross margins earned by suppliers in uncontrolled transactions. This method is useful for sale of semi-finished goods, rendering of services, etc.

Comparable Profits Method (CPM)

This method was introduced in the USA by revised transfer pricing regulations. The underlying assumption is that similarly situated taxpayers should earn similar returns over reasonable time periods. This method relies on comparability in factor or capital markets rather than strict equivalency in functional or product content. Reasonable similarity in functions and product markets are desirable. One important variation of this method is the *return on capital employed* (ROCE). In this variant, the ratio of operating income to average capital employed of the comparable is compared with the ROCE of the company in question.

Under this method adjustments have to be made for any differences between the comparables for factors such as differences in sales conditions, differences in cost of capital, foreign exchange risk, differences in accounting measurement practices, etc.

Profit Split Method (PSM)

This method is applicable where transactions are so inter-related that they cannot be evaluated separately for the purpose of determining arm's length price of any one transaction. There are two variations of the profit split method. Under one variant of this approach, the *comparable profit split* method, the profit generated by a related party transaction is divided in the same way as those applicable to similar types of uncontrolled enterprises.

A more sophisticated method is *the residual profit split* method. Under this method, first the routine functions performed by the parent and subsidiaries are priced using relevant benchmarks. Any difference between the total profits earned by the affiliated enterprises and those attributable to the routine functions is considered as residual profits. Then the residual profit so determined is split between the associated enterprises on the basis of functions performed, assets employed or to be employed and risks assumed by each enterprise. Such contribution is valued to the extent possible by any available reliable external data.

Transactional Net Margin Method (TNMM)

This is similar to the Comparable Profits Method of the USA. In case of this method, the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed in the enterprise or having regard to any other relevant base. Such net margin then may be compared with a comparable uncontrolled transaction, which the tax-payer has entered into with an unrelated enterprise (internal comparison). If this is not possible, net margin that would have been earned in comparable transactions by an independent enterprise may be compared (external comparison).