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Multinational Transfer Pricing and International Taxation: What, Why, How and Reporting Challenges

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Abstract

International transfer pricing issues are the subject of this paper. The huge and growing volume of tangible and intangible goods and the motivation (profit, politics and finance) for manipulations involved in transfer pricing situations makes this an important area of study. Multinational transfer pricing has so much reporting challenges due to the measurement and international taxation complexities. This paper identifies the complexities in the arm's length measurements and the various loopholes for manipulating transfer prices. It calls for prudence in the measurement and revenue collection process given the vulnerability of subsidiary's country in loosing revenue.

Keywords: Transactional Methods, Cost Plus Method, Transfer Pricing, International Taxation

Introduction

Today globalized markets, international foreign direct investment, and worldwide procurement combine to create a complex, integrated and dynamic business environment. Transfer prices are the value assigned to intermediate goods, which move between the divisions of a vertically integrated firm. The transfer or movement of raw materials, parts, or partially finished goods may occur in the context of either national or international production process. Intra-firm trade which includes services, technology, capital goods, intermediate goods, and finished goods for resale, constitutes a significant portion of world trade. In general, governments constrain transfer pricing decision choices through trade policy, foreign direct investment incentives, labor laws, foreign exchange rates, currency regulations, local content requirements, traditional business practices and taxation. Taxation has remained an ever-green subject for business groups and continues to remain so.

The multinational firms want to maximize shareholder value through higher stock prices, a function of current and long term profits. To this end they try to minimize taxes. As Williamson (1975) pointed out, when a firm expands its operations either domestically or internationally, transactions are influenced by the visible hand of managerial authority rather than the invisible hand of the competitive price system. Accordingly, one of the primary advantages of a multinational firm versus a domestic corporation lies in its flexibility to transfer resources across borders through a globally maximizing network (Kogut, 1983). "It is clear that the potential for tax arbitrage that results from globalisation creates a considerable and continuing incentive for domestic companies to internationalize their business (Plender and Simon, 2004)". Since transfer prices are the value assigned to intermediate goods, which move between the divisions of a vertically integrated firm, the fact that they are, related party transactions between organizational units can reduce the expected macroeconomic benefits. Intra-firm trade differs from basic arms length transactions between unrelated parties because it is shaped by the global parent's strategy to control upstream supplies and downstream markets (Encarnation, 1994; Eden, 1994). Plender and Simon's (2004) investigation suggests transfer pricing threatens global tax revenues, they conclude the "tax authorities face substantial difficulties in unraveling complex operations between subsidiaries of multinational groups". Back in 1973 this kind of trade accounted for one

third of all US goods (Lall, 1973). By 1996 US intra-firm trade with overseas manufacturing affiliates reached $243 billion (Monthly Bulletin of Statistics, 1998). This trend is not limited to US firms; Department of Commerce figures, worldwide two-way intra-firm trade increased from 102 billion in 1977 to 337 billion (Tang, 1990). Regional trade agreements such as NAFTA and the European Union accelerate the trend (Zwick, 1998). In 2004 intra-company trade among corporate subsidiaries "accounted for 46% of the $1.33 trillion US imports and 31% of $731 billion in exports (Sunday Tribune, 2004).

Here I discuss about Transfer Pricing as a distinctive concept of 'International Taxation', its meanings and attributes (in 'What'), its significance and need (in 'Why'); its implementation and other related issues (in 'How'); and the reporting challenges (the problems and strategies). The accounting and economics literature, government documents and business publications have been reviewed to uncover the underlying rationale for various government regulations.

Placing International Taxation in Context

Transfer pricing is essentially an outcome of globalization. A distinctive part of International Taxation, it has come to mark the legal responses to business' profit maximizing tendencies. To give a prelude to Transfer Pricing, International Taxation is to be understood. This is one specific branch of taxation which taxes the profits arising from Inbound Investment (i.e. taxation of income earned by a foreign company in a host country) and Outbound Investment (i.e. taxation of income earned by a domestic country abroad). The purpose of International Taxation is to ensure that the earnings of a company from a foreign company neither go tax free nor are doubly taxed.

To illustrate, let us suppose a premises that a European Company has a branch in Nigeria and that it earns a hefty business income from that branch. Now since the income earned in respect to that branch has been sourced or earned from Nigeria, the natural tendency of Nigerian government will be to impose a tax on that portion of income of the European Company which is attributable to business in Nigeria. This levy by Nigeria is called 'Source Taxation' for it seeks to levy tax only on the portion of income which is sourced from/in Nigeria.

Now once the income has been subject to tax in Nigeria, it comes in the hands of the European Company in Germany as the profits earned by its

branch and technically and legally a part of the profits earned by the European Company. Since the European Company is legally and factually situated in Germany, the Government of Germany will be inclined to tax the profits of the European Company fully and exclusively (this is called the 'Residence Taxation' principle wherein the country in which the Company or individual is resident applies tax on all income earned by the Company/individual).

This would lead to a double taxation in the hands of the company if so much of the profits earned in one country are being subjected to taxation in two countries. In order to mitigate this wasteful costs (because ultimately taxes are costs of doing business), countries are obliged to enter into double taxation avoidance agreements (**DTAA**s, also called **DTC**s or Double Tax Conventions) wherein under one of the countries forgoes its right to tax and therefore tax is effectively levied only in one jurisdiction, which would be determined under the DTAA (Nieckles, 1976).

Under the DTAA, generally one only country can tax. However what is not determined here is the rate at which the country would tax. Therefore despite the DTAA, countries remain free to charge the rate of tax which they generally would be charging in other international tax situations. For illustration, the rate of tax in Germany is higher than that imposed under European Union (EU). Here, since the objective of the business is to reduce the costs (and tax being a cost to the business), the transactions sought to be done between the two would seek to be done in a manner which brings out the minimum possible tax implication thereon. It is in this context that Transfer Pricing gains solid ground.

What is Transfer Pricing?

Transfer Pricing is an offshoot of this tendency of business to install a base in two or countries and try to carry out its operations in a manner which would render most profitable activities in the country with low tax rate. An illustration would clarify the matter.

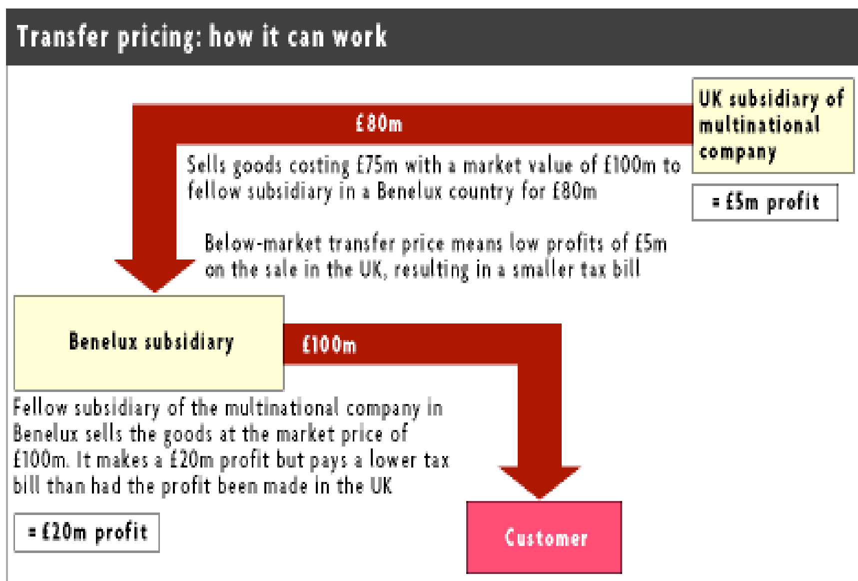
In the diagram below, we have the case of two countries which have different tax rates i.e. **X** and **Y** with **30%** and **50%** respectively. In this scenario, a group company has two associate companies operating in X and Y. While Company **A** is engaged in manufacturing, Company **B** is engaged in trading. **A** sells its manufactured products to **B** whereupon **B** sells it to third parties.

In the above diagram, we have two situations. In the first situation, the **A** sells to **B** at a mark-up of 50 (upon its manufacturing cost of 50) and therefore that 50 of profit are chargeable to tax in **X**, which is a lower tax jurisdiction. **B** sells at a profit of 40, which are chargeable to tax in **Y** at a rate higher than in country **X**. In this situation, the tax payable by **A** and **B** together in **X** and **Y** come out to be **35** units.

However, the group finds that it can save a bit on those taxes by just changing the price at which **A** and **B** transact. Thus now **A** sells the same product at a price of 120 and thus earns a profit of 70 which results into a reduction in **B's** profits (considering that it does not change its price charged to third parties) to 20 and consequently also reduced the tax liability of **B** in **Y**. The net impact of this change is that in situation 2, **A** and **B** together pay only **31** units of tax in **X** and **Y**. Thus by a mere change in the pricing, the company has reduced its overall tax liability by shifting the profits legitimately earned in **Y** to **X**.

This shifting of profits from a higher tax jurisdictions to lower tax jurisdictions by related entities (or affiliate enterprises) by changing the pricing policy at which the transactions between these related entities take place is described as transfer pricing.

X Country			Y Country		
((Taxes @ 30% of profits)			(Taxes @ 50% of profits)		
Cost of manufacturing in A's hand	Profit in A's hand	Selling price	Profit in B's hand	Selling price	
A → 50 →	50 →	100 →	B → 40 →	140	Situation #1 Total tax Payable =15+20=35
Taxes payable in X 50x30%=15			Taxes payable in Y 40x50%=20		
Cost of manufacturing in A's hand	Profit in A's hand	Selling price	Profit in B's hand	Selling price	
A → 50 →	70 →	120 →	B → 20 →	140	Situation #2 Total tax Payable =21+10=31
Taxes payable in X 70x30%=21			Taxes payable in Y 20x50%=10		



Source: Plender and Simon, 2004

Why Does A Country Need Transfer Pricing Rules?

Understanding the nooks and crannies of transfer pricing, implies an understanding of the direction of its impacts. It has a significant effect on the revenue collection of the various countries. Because of the manipulations under the transfer pricing policies, countries lose out their genuine share of the tax they are entitled to collect on the transactions which take place in the country. In our original illustration, **Y** country is losing out on a tax of **10** units (20-10). Given the size of operations which take place between these affiliate parties, these figures grow in size to give a considerable set-back to the revenue collection targets of the countries.

Each country would expect a fair share of taxes to be paid by companies operating in their territory as they exploit the resources made available to them by the country and thus they are entitled to collect taxes to reflect the cost of the resources being made available. Further, the change of tax collected in the case of these affiliate enterprises is not because of a significant change in the way business has been operating but only because

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conditions for dealing have been imposed between these companies, which would not have been existing has the transaction been undertaken between independent parties. While the companies' tax payments get reduced and thus their overall profits increase, this is only because of an adjustment in prices and transfer of profits (artificially) from one country to the other.

As shown in Figure 1 the motivation for transfer price manipulation tend to fall into a few general categories: profits, politics, and financial issues.

But, various conditions have been found to be particularly conducive to the formation of a global transfer price strategy. The MNE can use transfer pricing strategies to avoid or mitigate local content requirements, qualify for special treatment or avoid other legal barriers. Often a profit or loss in one center is “transferred” to another division where (when) tariff and subsidy conditions exist. Alternately, multinational enterprises (MNEs) can use transfer prices to diversify risk across countries and currencies thereby lowering the discount premium on cash flows. Risk reduction via diversification gives global firms the ability to obtain below market rates on financial lending and hedging lower cost making them more competitive and efficient. Transfer prices can be manipulated to avoid or minimize the effect of tariffs and local content regulations. The local government may impose a higher or lower tax rates (Phillips, 2001) and actively engage in foreign exchange speculation. Empirically, Arpan (1972) found that management views transfer pricing as a tool to minimize taxes and more importantly to circumvent foreign exchange restrictions. International business diversification has created a need and opportunity for foreign exchange risk management. From a social responsibility and a welfare economics focus, free trade implies all countries should receive due benefits. However, Lall (1973) posited, the home country of a multinational may gain unfairly at the expense of a less developed host country. He explains how conceptually transfer price manipulation reduces host country welfare; because gains from foreign direct investment are less than would have been.

This is not tolerated by the countries which provide infrastructure and support for the countries to operate and thus they seek to disregard the prices which are adopted between the affiliate parties. What is sought to be done by these countries is an adoption of 'Transfer Pricing Rules' whereby they seek to determine the actual prices that would have been charged had the parties been independent and on that basis come to arrive at the correct figure of profits due to be taxed in their country.

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What are Transfer Pricing techniques?

Establishing the need to have rules to check the transfer pricing policies of related parties, presupposes an understanding as to how this would be done. Primarily countries adopt the '**Arm's length standard'**. This basically implies that prices are considered to be acceptable if the transactions are at an arm's length distance (i.e. at a distance which is considered to be **acting independently and not being influenced by the other**). If the transactions are not at an arm's length, in that case the prices are recasted to determine the arm's length price value.

There are essentially two ways of negating Transfer Pricing effects i.e. for determining the arm's length price. These are;

(i) transactional methods,

(ii) Non-transactional methods (Taylor, 2008; The Tax Executive, November/December 2003).

These are further divided into three and two parts respectively (thus a total of five different techniques for transfer pricing). These can be briefly (briefly because an exhaustive discussion of each can fill volumes of treatises) described as under;

(I) Transactional Methods: These are called so as they generally intend to work out the transactions in specific detail to arrive at the arm's length value for each transaction in question and thus arrive at the overall recast profits figure when the transactions undertaken by the company have been brought at a fair value terms. There are three methods collated in this transactional approach;

(a) Comparable Uncontrollable Price Method (or CUP method): In this method, the essence is essentially to find out a similar transaction to the one in review which takes place between independent parties and adopt the value which exists in that similar transaction to determine the profits under the transaction in review. For example, in our original illustration, if Company A was selling steel of particular grade to Company B and was charging 120 units of currency for each unit of steel, what was the price being charged by other companies to independent companies around the same time at which this transaction took place. If independent parties were charging 100 units of currency, that price of 100 units would be adopted and the company B's profit redetermined in accordance with these changed prices.

(b) Cost Plus Method: In this method, the arm's length prices are sought to be arrived at by starting with the cost of inputs in the hands of a company and adding a proportionate mix of manufacturing and other expenses of production, marketing and selling expenses and a reasonable level of profits and thus arriving at a constructed arm's length price. This method is generally adopted wherein the entity in question is engaged in manufacturing and thus it is easier in their case to come out with a constructed arm's length price.

(c) Resale Price Method: This method is quiet the converse of the Cost Plus Method. In this method the profit-margins are fixed first (depending upon the industry average of profits being charged) and these are then deducted from the sale price to come out with the costs that would have been imputable to the company in an arm's length transaction scenario. Once this arm's length price is arrived at, profits are recomputed and taxes levied thereon.

(II) Non-Transactional methods: As the name suggests, unlike the transactional methods (wherein each transaction is looked into specific detail), these methods apply in a broader perspective wherein the overall figures of related entities are taken into account and adjusted to arrive at arm's length terms. There are two essential methods for this approach:

(a) Profit Split Method: Under this method, the profits of related parties are collated and then split up between the two in a manner which in the opinion of the national authorities is a right allocation of profits on the basis of commercial and productive activity carried out within their territory. This would, therefore, take into account factors such as level of risk undertaken by an enterprise, the level of productive activity undertaken, etc. and on this basis divide the profits.

(b) Transactional Net Margin Method (or TNMM method): This method generally takes into account the margin that is earned by a related entity in question. For example, in our original illustration the margin in first situation is 40 wherein in second situation is 20. TNMM takes into account the margin figures and seeks to adjust them on the basis of the real nature and depth of the operations in question. So the first step is to arrive at a margin to be charged in the dealings between related parties at a level which would have been a case had the transaction been between independent parties. Once the margins are set, the profit levels are recomputed on an aggregate basis (unlike on a transaction-to-transaction basis as in transactional methods case)

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and thus taxable amounts determined accordingly. This method is otherwise known as the Basic Arms length method (BALM).

How Transfer Pricing Rules are implemented?

For companies which undertake transactions with related parties, there certainly are mechanisms designed in place to record the details of transaction to precise details to prove before the taxation authorities that the prices charged reflect a fair value (Tang, 1993, Ernst & Young 1991, Borkowski 1990; Springsteel, 1999).Even otherwise, these transfer pricing rules are integrated in the tax systems in a precise detail as the non-integration would imply losing out on prospective revenues and therefore the tax authorities must exercise due care to ensure that things relating to transfer pricing are in order.

Tax authorities will no longer accept transfer-pricing documentation as evidence that tax returns are filed in accordance with the arm's length principle. Globally, tax authorities are increasingly querying whether transfer pricing policies have been implemented correctly, and if they are being calculated correctly on a yearly basis. Figure 2 outlines the steps associated with a leading practice in transfer pricing care and maintenance strategy.

To reduce compliance risks, corporate treasuries should ensure that transfer pricing policies are implemented correctly, and the implementation process should regularly be assured (either by internal audit or a third party).

In fact most countries offer an 'Advanced Transfer Pricing' (APA) agreement which the companies operating in their territory can enter into. This saves the re-computation of figures in future as the companies agree to follow a particular methodology for dealing with related parties, as the host country would tell them to under the APA. Also an approach is suggested to corporate treasuries in achieving efficiency in transfer pricing implementation. It’s called the potential transfer pricing risk and opportunity assessment model.

Assessment of Potential Transfer Pricing Risks and Opportunities

The transfer pricing risk and opportunity assessment framework presented below can be utilised by corporate treasurers to assess if they have either a potential transfer pricing risk exposure, or alternatively an opportunity to structure their operations in a more tax-efficient manner.

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As the hunters learn to shoot without missing, the birds are also learning to fly without perching. This is intriguing and can also be used to the advantage of the government.

The Reporting Challenges

The level of the transfer price will have implications for the underlying taxable profitability of the different legal entities. Tax authorities are concerned that some multinationals might manipulate transfer prices to obtain unjustified tax arbitrage between high- and low-tax countries. To address this concern, tax authorities require companies to demonstrate that transactions between legal entities have been entered into on an arm's length basis, that is, in a manner that is consistent with dealings between unconnected parties. For example, in an instance where the corporate treasury gives a guarantee to a third-party bank for a loan entered into by an affiliate, due consideration should be given to the guarantee fee paid by the subsidiary to the company carrying on the treasury activities.

The Organisation for Economic Cooperation and Development (OECD) Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations (OECD Guidelines) set out guidance on how to determine arm's length transfer prices. The OECD Guidelines form the basis of many countries' local transfer pricing legislation. However, it is recognised by the OECD that it can be difficult to price some transactions, especially financial transactions that occur between connected parties.

What Type of Transactions Give Rise to a Potential Transfer Pricing Exposure?

All services provided by a corporate treasury to group companies give rise to an inter-company transaction that should be priced in accordance with the arm's length principle. Andrews, Ernst and Young, (2008) typically observe that clients' corporate treasuries are engaged in the following types of inter-company transactions Inter-company funding:

- Cash pooling.
- Provision of financial guarantees.
- Asset management of surplus cash.
- Foreign exchange and commodity risk management.
- Payments and netting services.
- Factoring and forfaiting of receivables.

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- Carbon trading.
- Arranging of global credit facilities.
- Captive insurance of group risks.

Given the increased scope of corporate treasury activities and the increase in inter-company transactions, it is important for groups to reassess their transfer pricing disclosures to ensure that they are consistent with the arm's length principle as most of these transactions are not reported or inadequate for consumption by interested parties. Such an assessment can ensure that the group's treasury transfer pricing policies are both tax-efficient and robust.

This challenge has led to the growth in transfer pricing audits by tax authorities and associated penalties for non-compliance. Ernst & Young's (2008) Global Transfer Pricing Survey found that over half (52%) of all respondents have undergone a transfer pricing examination since 2003, with 27% resulting in adjustments by tax authorities. The survey also found that 78% of all respondents believe a transfer-pricing audit is likely in the next two years. The survey also observed that tax authorities are increasingly focusing their attentions on treasury transfer pricing transactions. Among respondents to their survey, 41% said that inter-company financing was a category of inter-company transactions particularly susceptible to a transfer-pricing dispute in the future.

Although significant penalties (and interest) could be levied under local transfer pricing legalisation for noncompliance with the arm's length principle, many countries require that companies prepare contemporaneous documentation to demonstrate that transactions were entered into on an arm's length basis over the course of the year. In addition to the potential for penalties for non-compliance, dealing with transfer pricing enquiries is a costly and time-consuming process. Preparing backward-looking transfer pricing documentation is distracting to management, and can cause significant disruptions to day-to-day business activity. In addition, preparing documentation retrospectively (that is to support a pre-existing position) is generally more challenging than preparing the documentation prospectively.

Given the above, many corporations give considerable thought to their transfer pricing policies, and often design their policies to achieve tax efficiency on a group-wide basis. However, the corporate treasury activity is often overlooked from both a tax efficiency and compliance perspective. The large majority of corporate treasuries are operated as cost centres, and charge affiliates a fee based on the costs incurred plus a mark-up (a 'cost plus' fee).

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Under such a policy, the groups marked-up treasury costs are often allocated to group companies using an arbitrary allocation key, which is often not consistent with the arm's length principle.

Many tax authorities are challenging this approach, and asserting that treasury services should only be charged out to group affiliates under a cost plus approach if the services being provided are low value and routine in nature. The inter-company services being provided by many corporate treasuries are equivalent to those that are provided externally by financial service organisations. Such organisations charge a transaction fee for providing value adding services and this fee will not (typically) be directly linked to the costs associated with providing the service. As such, tax authorities are increasingly asserting that corporate treasuries should be remunerated on a transactional fee basis, rather than a cost plus basis.

Essentially, they are arguing that treasuries should price financial transactions in a similar way to how banks might price the same transaction if the group did not operate an internal treasury function. A detailed functional and risk analysis should therefore be undertaken to ascertain the specifics of the services being provided, to ensure that the appropriate transfer pricing method is being used. Opportunities exist for many groups to amend their transfer pricing policies to reflect the reality of the functions being performed, by re-characterising the corporate treasury from being a cost centre to a profit centre. This process may also involve relocating the treasury function to a low-tax jurisdiction. However, due consideration needs to be given to the commercial considerations associated with any centralisation or relocation of the treasury function.

Conclusion

It is concluded that groups regularly reassess their transfer pricing policies to ensure that they are consistent with the arm's length principle. By reassessing treasury transfer pricing policies, groups can ensure that they identify any opportunities to obtain tax efficiencies. This can also help them reduce the likelihood of transfer pricing enquires, which can be very costly and time consuming and can result in additional tax, interest and transfer pricing-related penalties. Solid transfer price documentation translates directly into bottom line (Bobbin, 1998). Lopatin (2003) suggests it is really impossible to know how much tax a transnational corporation has paid in each jurisdiction or territory. Therefore, transfer pricing manipulation will flourish as long as

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there is "no obligation to report the split between third-party and inter-group trading".

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Figure 1: Transfer Price Management

Transfer Price Motivation

Profits: taxes, union demands, and government subsidy.

Politics: local content rules, political stability, citizenship.

Finance: foreign exchange volatility, diversification, capital cost.

Source: Taylor, 2008

Figure 2: Leading Practice in Transfer Pricing Care and Maintenance Strategy

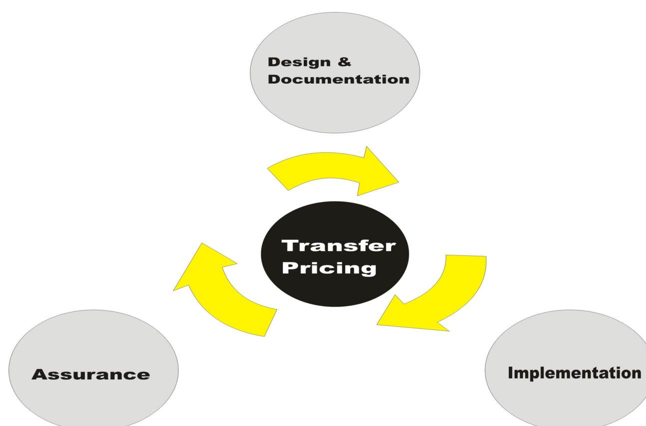


Figure 3: Transfer Pricing (TP) Risk and Opportunity Assessment Framework

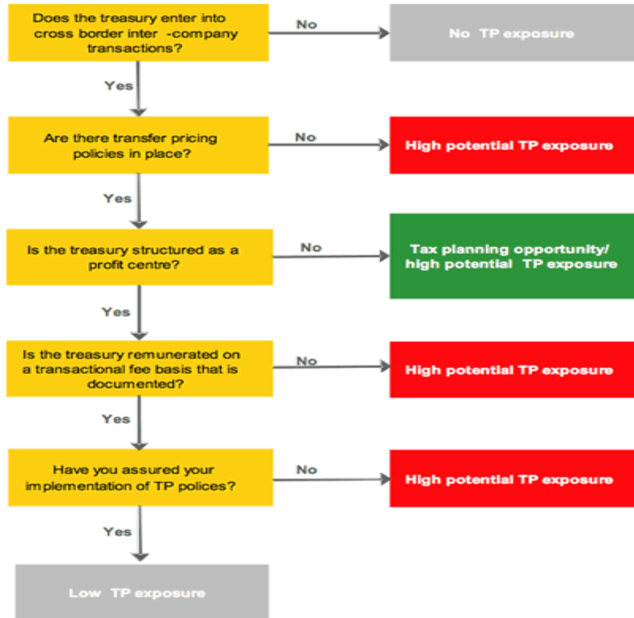
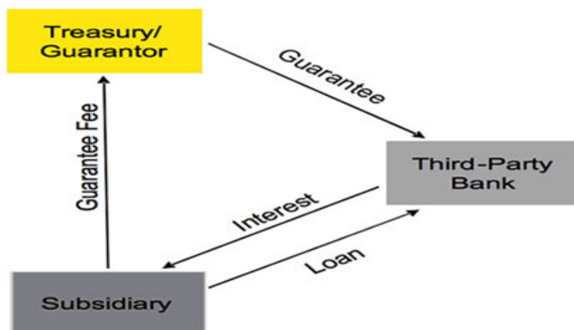


Figure 1: Transfer Pricing Implications of an Inter-company Guarantee



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