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TRANSFER PRICING POLICIES AND PROCEDURES AND ITS IMPACT ON PERFORMANCE EVALUATION

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ABSTRACT

Transfer pricing is portrayed as a technique for optimal allocation of cost and revenues amongst divisions, subsidiaries and joint ventures within a group of related entities such practice of transfer pricing simultaneously acknowledge and include how it is deeply implicated in process of wealth retentiveness that enable the companies to avoid taxes and facilitate the flight of capital. Transfer pricing practices are responsive to opportunities for determining values in way that are consequential for enhancing private gains and thereby contributing to relative social impoverishment, by avoiding the payment of public taxes. Transfer pricing policies are highly related to the organizational structure of the company, characterized by degree of autonomy of divisions. There are four main reason company use transfer pricing: Saving on taxes, Facilitating performance measurement, providing relevant information for trade off decisions, inducing goal congruent decision. The price at which two unrelated parties would agree to a transaction, this is most often an issue in the case of companies with international operations whose international subsidiaries trade with each other. For such companies, there is often an incentive to reduce overall tax burden by manipulation of inter-company prices. Tax authorities want to insure that the inter-company price is equivalent to arm's length price, to prevent the loss of tax revenue. There are different methods to determine the arm's length price. They are-Resale price method, Cost plus method, Profit split method, Transactional net margin method and any other basis approved by the central govt. which has the effect of valuing such transaction at arm's length price.

Keywords: Transfer Price, Arm's length, Tax manipulation

INTRODUCTION

Within the past 5 to 10 years, transfer pricing has become a significant issue to the broader business audience. It is portrayed as a technique for optimal allocation of cost and revenues amongst divisions, subsidiaries and joint ventures within a group of related entities such practice of transfer pricing simultaneously acknowledge and include how it is deeply implicated in process of wealth retentiveness that enable the companies to avoid taxes and facilitate the increase in capital. Transfer pricing practices are responsive to opportunities for

determining values in way that are consequential for enhancing private gains and thereby contributing to relative social impoverishment, by avoiding the payment of public taxes. Transfer pricing policies are highly related to the organizational structure of the company, characterized by degree of autonomy of divisions. In highly decentralized divisions such as investment centers and profit centers, transfer prices are necessary.

Various economic factors must be considered perhaps the most vexing concern is the need for multinationals to solve the "corporate transfer pricing problem" by establishing transfer pricing policies and practices that: (i) satisfy the needs of the business with respect to strategy and internal incentives; (ii) result in an efficient use of resources; and (iii) provide an appropriate transfer pricing answer from a tax perspective. The impact of transfer pricing, however, is felt well beyond the confines of the individual firm, and can affect the economy at large.

Meaning and Definition of Transfer Pricing

Transfer pricing is the pricing procedure whereby there is a mutual transfer of product and services. It happens whenever two related companies – that is, a parent company and a subsidiary, or two subsidiaries controlled by a common parent – trade with each other, as when a US-based subsidiary of Coca-Cola, for example, buys something from a French-based subsidiary of Coca-Cola. When the parties establish a price for the transaction, they are engaging in transfer pricing. This can be either market based, that is equivalent to what is being charged in the outside market for similar goods, or it can be non- market based.

It is a mechanism for distributing revenue between different divisions which jointly develop, manufacture and market products and services. Transfer pricing refers to the setting, analysis, documentation, and adjustment of charges made between related parties for goods, services or the use of property (including intangible property).

Reasons for Using Transfer Pricing

The four main reasons which induce the company to use transfer pricing are-

Saving on taxes- The best known inducement to the use of transfer pricing is difference in taxes among the countries. If taxes rates on profit are higher in country B than in country A and the parent transactional corporation from A supplies imports to the subsidiary in B, it would pay the firm to overprice these transactions and transfer profits to A as long as the difference in effective tax rates exceeds the tariff in B on those imports.

Remittance of dividend, royalties, interest on loan, technical and management fees etc. - Transfer pricing is only one of the way by which a transactional corporations can transfer funds. Other avenues to transfer funds that a transnational corporation may consider are dividends, royalties, interest on loans, technical and management fees, etc. Limits imposed on remittance of dividends etc. can be a contributing factor to the use of transfer pricing.

Changes in exchange rate- Transfer pricing may constitute an important element of the monetary and financial management of a transnational corporation. For instance, when devaluation is believed to be imminent, it is likely that a corporation will, to the extent possible, shift profits and cash balances out of country via transfer pricing mechanism.

Inducing goal congruent decision- Producing a product internally may not be the most economical decision for the company. The purchasing division may be able to obtain a similar product for a lower cost than the transfer price, while the supplying division may be able to use the capacity to produce something more profitable. However, there could be strategic reasons to buy internally.

Transfer Pricing Methods

There are several different methods for determining transfer prices. The basic methods are *market based pricing, negotiated transfer pricing and cost –based transfer pricing*. The transfer pricing method used must be the one most beneficial to the enterprise. The following, interrelated criteria should be used to evaluate adequacy of the transfer pricing methods that are currently being used by profit or investment centers.

Market- based transfer pricing- Market-Based Pricing occurs when a perfectly competitive market exists in the outside market. This means that the transfer price and the market price for the good being transferred are equal. This type of market is extremely rare; prices are almost always influenced by producers. This method is often used by the producers.

Negotiated transfer pricing- Here, the firm does not specify rules for the determination of transfer prices. Divisional managers are encouraged to negotiate a mutually agreeable transfer price. Negotiated transfer pricing is typically combined with free sourcing. In some companies, though, headquarters reserves the right to mediate the negotiation process and impose an “arbitrated” solution.

Cost- based transfer pricing- In the absence of an established market price many companies base the transfer price on the production cost of the supplying division. It is the simplest transfer pricing method. Under the cost-based transfer pricing the different methods to calculate transfer pricing are- Full Cost, Cost-plus and Variable Cost plus Lump Sum charge.

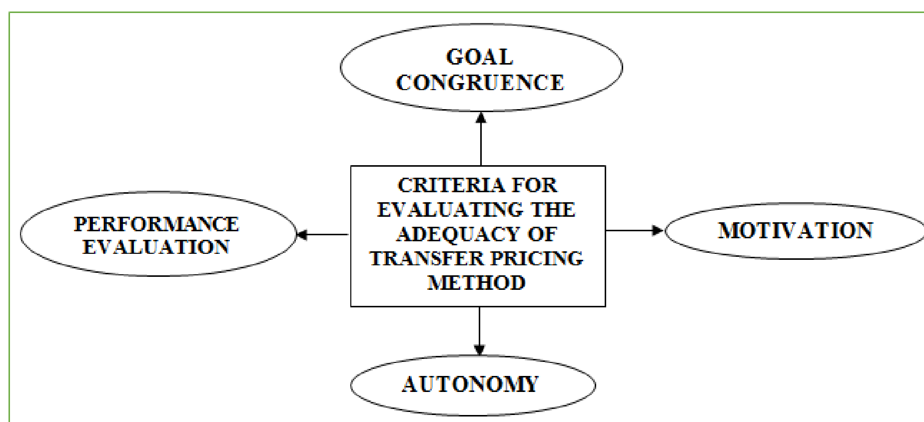

Fig.1. Criteria’s for evaluating the adequacy of transfer pricing

OBJECTIVES OF STUDY

This study basically focuses upon the practical applicability of various transfer pricing methods and their consequential impact upon the autonomy and performance of various strategies business units.

- To analyze the tax manipulations done through transfer pricing, by various corporate houses following OECD guidelines and to review steps taken by government to curb such practice
- To analyze the objectives of transfer pricing influenced by various environmental and firm specific variables of hypothetical enterprise

REVIEW OF LITERATURE

Smith (1755) investigated that how best to protect national tax revenues. Developing countries, like Ghana, have adopted the U.N. Model Tax Convention in the hope that it will protect more of their national tax revenues and help them build infrastructure to spur FDI growth. Poor administrative and enforcement standards, however, hamper the country’s goal of establishing the proper transfer pricing methodologies under the arm’s length method. Thus, this Article suggests that the government institute equity restrictions which will force multinationals operating in Ghana to form joint-ventures with domestic partners. To improve Ghana’s standing in the world, the government must develop tax policies, monitoring standards, and enforcement mechanisms that safeguard the interests of both multinational corporations and domestic entities.

Pretty II et al (1972) recognized the determinants of an optimal transfer pricing network for a multinational firm. The study pointed out the ability to examine the host of relevant elements in a systematic fashion is paramount. In order to do this, the linear relationships in the pricing system were represented in the linear programming format. This format provides an avenue by which the worldwide organizations may determine the most advantageous intercompany prices in light of the prevailing environment.

Burns (1980) investigated that to what extent the firm’s transfer pricing decision are influenced by external factors. A total of 210 companies were selected and they were divided into the five dichotomous categories and then it was analyzed that out of 14 variables which variables affected the company most or which group is more influenced by transfer pricing decision.

Gresik (1998) analyzed that an environment in which a host country has incomplete information about a multinational's foreign operations. It shows that a policy that seeks to achieve arm's-length transfer prices is consistent with broader welfare objective. This result was based on a previously unidentified externality created by the opportunity for multinationals to engage in strategic transfer pricing. The model presented incorporates three such features of transfer pricing and its regulation: private cost information transfer regulation based upon negotiation with individual firms and commensurate with income regulation. The paper concluded that an arm’s length transfer price policy is always socially optimal.

Al- eryani et al (1990) examined the influence of environmental and firm-specific variables on the selection of international transfer pricing strategies. The primary data were obtained from 164 multinational enterprises by means of a questionnaire. Responses were analyzed by performing factor analysis and constructing a probit model. The paper concluded that legal constraints and firm size are significant determinants in the selection of international transfer pricing strategies by U.S. multinationals. These results suggest that legal considerations such as compliance with tax and custom regulations, anti-dumping and antitrust legislations, and financial reporting rules of host countries are influential in the use of market-based transfer pricing. However, the economic restrictions such as exchange controls, price controls, and restrictions on imports, political-social conditions, and the extent of economic development in host countries are either unimportant or are secondary determinants of a market-based transfer pricing strategy.

Antic (2000) analyzed some characteristics of transfer pricing Methods. The study estimated of adequacy of the methods with decentralized structure and a large number of profit centers with possible internal transfer of products and services. It also examined the establishing organizational units includes fragmentation of resources of enterprises and transferring competences and responsibilities for their allocation on cost, profit and investment centers.

Baldenius et al (2003) examined transfer pricing in multinational firms when individual divisions face different income tax rates. The paper analyzed the effectiveness of alternative pricing rules under both cost- and market-based transfer pricing. The paper argued that optimal internal transfer price should be a weighted average of the pre-tax marginal cost and the most favorable arm's length price and it also argued that for internal performance evaluation purposes firms should generally not value internal transactions at the prevailing market price if the supplying division has monopoly power in the external market. By imposing intra company discounts, firms can alleviate attendant double marginalization problems and, at the same time, realize tax savings which take advantage of differences in income tax rates. The paper characterized optimal intra company discounts as a function of the market parameters and the divisional tax rates.

Gox et al (2006) analyzed the-transfer pricing model and discuss the basic structure of the most widely used model extensions. Review of transfer pricing models with asymmetric information, transfer pricing models in incomplete contracting settings, strategic transfer pricing models, and international transfer pricing models with rams operating in deferent tax jurisdictions. The overall objective of the study was efficient allocation of resources within the organization and transfer prices are one instrument for achieving it.

OECD Secretariat et al (2012) analyzed the number of transfer pricing issues related to stock options. The analysis is limited to transfer pricing issues arising between associated enterprises to the exclusion of Permanent Establishment issues. The study focused on plans in listed companies. Three main situations are identified where transfer pricing issues arise. There is currently limited experience and evidence of what unrelated parties actually do with respect to stock options when determining the value of participants‟ contributions to a Cost Contribution Agreement (CCA). It is only possible to hypothesize what unrelated parties might be expected to do at arm's length. The paper concluded that if stock options are remuneration, independent enterprises dealing at arm's length would not enter into a CCA in

which a significant element of employee compensation was omitted from the determination of the participants' contributions.

RESEARCH METHODOLOGY

Scope of the Study

This study basically focuses upon the practical applicability of various transfer pricing methods and their consequential impact upon the autonomy and performance of various strategies business units. The study also aims at summarizing the OECD guidelines applicable to the concept of transfer pricing and to review various situations where by big corporate houses have been penalized by the government for doing the transfer pricing manipulation.

Sources of Data

The type of the data which is taken into consideration is secondary data.

Sampling Technique

Convenience sampling

Analysis of Tax Manipulations Done Through Transfer Pricing, By Various Corporate Houses Following OECD Guidelines And To Review Steps Taken By Government To Curb Such Practice:

The organization for economic corporation and development (OECD), released the final version of its transfer pricing guidelines. The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalization. A separate code on transfer pricing under Sections 92 to 92F of the Indian Income Tax Act, 1961 (the act) covers intra group cross-border transactions and is applicable from 1 April 2001. Transfer pricing methods, impose extensive annual transfer pricing documentation requirements, and contain harsh penal provisions for noncompliance. The various requirements, disclosure, documents required and penalties imposed under the transfer pricing guidelines.

Requirement of arm’s length transfer prices- All transactions between a company and the related party or between two business segments of the company shall be at arm’s length transfer pricing except as provided below.

Exceptions to arm’s length transfer price- In exceptional cases, the company may decide to use a non- arm’s length transfer pricing provided: Board Of Directors as well as the audit committee of the Board are satisfied for the reason to be recorded in writing that it is in the interest of the company to do so, and the use of a non-arm length transfer price, the reason therefore, and the profit impact thereof and disclosed in the annual report.

Transfer price policy statement and implementation report- The company shall prepare a Statement on Transfer price policy (the “Policy Statement”) and a report on implementation of transfer price policy (the Implementation report)

- The policy statement would explain the specific transfer pricing method used for different class of transaction with different parties with special emphasis on those

transaction where a Comparable Uncontrolled Price/ Transaction method could not be adopted.

- The implementation report would document the compliance with the policy statement and could include the actual detailed computation of an arm's length price for every material transaction with a related party or internal business segment.

Disclosure in annual report- The director's report would also certify that the transfer pricing guidelines have been compiled with and that transactions entered into are at arm's length unless otherwise stated and are not prejudicial to the company. The director's report would disclose any use of a non- arm's length transfer price, the reasons therefore, and the profit impact thereof.

The annual report would also contain disclosures required in AS 18 and that includes:

- Name and nature of the related party relationship where control exist should be disclosed irrespective of whether or not there have been transacting between the related prices.
- If there has been transaction between related parties, during the existence of the related party relationship.
- The name of the transacting related party.
- A description of the relationship between the parties.
- A description of the nature of transaction.

Authentication of the documents provided by the company-The information/ documents provided by the company to the auditor for certification as provided in clause 7 hereof shall be signed on behalf of the Board by the company secretary and at least one Director of the company. In the absence of the company secretary in the company, the same shall be signed by the least two Directors of the company on behalf of the Board.

Director's Certificate-

Director's certificate on transfer pricing guidelines:-

It is certificated that the company has complied with the transfer pricing guidelines issued under Section 209(1) (e) of the companies Act 1956. The information pursuant to these guidelines is given in Annexure "A" to this certificate we believe that the records of transactions entered in to with related parties during the period from ----------- through ---------------- are at arm's length and not prejudicial to the interested of the company. These transactions are entered in to on the basis of a transfer pricing policy adopted by the company. All transaction has been submitted to the independent auditors for audit. [No adverse remarks have been made in their report on the audit of such transaction]. [The auditors have qualified their report and audit report is attached.]

Date:-

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Penalties imposed by the government- Penalty have been provided as disincentives for non- compliance with procedural requirement are as follows:-

a) Penalty for concealment of income – 100 to 300 % on tax evaded.

b) Failure to maintain/ furnish prescribed documentation- 2% of the value of the international transaction.

c) Penalty for non- furnishing of accountants report – INR 100000 (Fixed)

The above penalty can be avoided if the taxpayer proves that there was reasonable cause for such failures.

Transfer Pricing Manipulation (TPM)

TPM is discouraged by government as against transfer pricing which is the act of pricing. However, in common parlance, it is transfer pricing which is generally used to mean TPM. TPM is fixing market pricing on the non-market basis which generally results in saving the total quantum of organization’s tax by shifting accounting profit from high to low tax jurisdictions. The implication is moving on one nation’s tax revenue to another.

Now we will see how companies" uses transfer price as a mechanism to evade tax, especially between countries that have treaty against double taxation. This has been explained by taking hypothetical example.

Illustration of Tax Issues (Shoe Company)

Suppose there is an MNC shoe corporation with a subsidiary in India. The Indian subsidiary manufactures shoes at a cost price of Rs. 50 per unit and supplies it to MNC. The MNC sells the same shoes in its own country at Rs. 200 to be fair, the transfer price , which the Indian subsidiary should get is cost plus a reasonable rate of return(that is Rs. 50 plus). In India corporate tax on profits is at 35%. Suppose for the MNC country the rate of tax is 45%.

CASE 1- The MNC decides the Rs 100 is the correct transfer price then the scenario look like this-

	Indian subsidiary	MNC	Grand total
Cost price	50	100	
Selling price	100	200	
Profit	50	100	150
Tax	17.5	45	62.5
Net profit	32.5	55	87.5

The transfer price becomes the cost price for the MNC and then it earns a profit of Rs 100 per unit. Post tax its profit is whittled down to Rs 55. Overall the total profit after tax earned by MNC (including the subsidiary profit) is Rs 87.5 per unit.

CASE 2- The MNC decides that Rs 150 is the correct transfer price. Then the scenario look like this.

	Indian subsidiary	MNC	Grand total
Cost price	50	150	
Selling price	150	200	
Profit	100	50	150
Tax	35	22.5	57.5
Net profit	65	27.5	92.5

The MNC's profits post tax in its own country comes down to Rs 27.5 but the overall profit surges to Rs 97.5.

CASE 3 The MNC decides that Rs 200 is the correct transfer price. In such a case, the MNC earns a zero profit in its own country but its subsidiary pays a 35% on its profit of Rs 150 and thus ove

	Indian subsidiary	MNC	Grand total
Cost price	50	200	
Selling price	200	200	
Profit	150	0	150
Tax	52.5	0	52.5
Net profit	97.5	0	97.5

CASE 4- The MNC decides that Rs 300 is the correct market price. In this case MNC earns a loss of Rs 100 per unit of shoe sold in the home country. Meanwhile, its subsidiary earns Rs 162.5 as profit after paring Rs 87.5 as tax but the clever MNC gets a tax write off at home worth Rs 45

	Indian subsidiary	MNC	Grand total
Cost price	50	300	
Selling price	300	200	
Profit	250	-100	150
Tax	87.5	-45	42.5
Net profit	162.5	0	192.5

FINDINGS AND SUGGESTIONS

- The study reveals that there are so many factors which affect the transfer pricing and transfer pricing itself is a very vast topic and it takes number of years to get a good research.
- This study is based upon the tax issue and manipulation done by the big corporate houses in the transfer pricing methods or under assessment of income as methods adopted by the company for valuing the goods and services sold to overseas associated enterprise was not correct.
- The study also shows various techniques that is shifting of profit from high tax country to low tax country, creation of tax heaven subsidiaries -used by the multinational companies to evade taxes and increased their overall profits.
- Many multinational companies' uses branch adjustments to evade taxes. This can be explained with the help of an example- suppose if the profit of the parent company is

Rs 100 and that of subsidiary is Rs 20 and taxes are levied on the profits above Rs 40 so the parent company transfers Rs 20 to subsidiary through transfer pricing and reduce their payment of taxes. So these kind of branch adjustments should be avoided.

- The difference in tax rates needs to be minimized, so that the inducement for transfer of business profits is minimized consequently.
- Government should check in a consistent way whether the companies engaging in transfer pricing are adhering to the transfer pricing guidelines that is requirement of arm's length price etc. and if not then they should be penalized.

CONCLUSION

As importance of the transfer pricing is increasing, it is generally considered as a major international taxation issue faced by MNCs today. The tools is particular attractive because it is largely invisible to the public and is difficult and expensive for regulatory authority to detect. Transfer pricing is important to corporations because its affect calculation of divisional, segmental, product and global profits. The reported price matter to stock markets because they effect earning, dividend, share price and return on capital. They matter to co. executive because there financial rewards are frequently linked to corporate earnings. Transfer pricing matter to the state because they affect the taxes that it can levy upon corporate profit to finance public goal to secure its legitimacy

Transfer pricing, like science and technology, is a neutral phenomenon. It is its use or abuse which makes it an innocuous commercial practice or a cognizable offence. Transfer pricing is not an immoral or illegal act. It can be purely for business considerations without any intentional or unintentional endeavor to defraud government or any concerned party. Therefore transfer pricing is generally conceived as a permissible practice like other administrative or commercial practices of business entities. So transfer pricing should be treated as normal routine practice and not a tool to evade tax.

FUTURE STUDY

The future study I am thinking to do on transfer pricing is related to:

- Impact of different factors on transfer pricing.
- To review the manipulations in transfer pricing through court cases.

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