



TRANSFER PRICING

A beginner's perspective

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Governments and MNEs have both been putting pressure from either side to get Transfer Pricing policies in their favour just like any other Tax law, Governments want to earn more tax (or save outflow of justified tax) and MNEs want the flexibility to save taxes.

TRANSFER PRICING

Transfer pricing is simply the act of pricing of goods and services or intangibles when the same is given for use or consumption to a related party (e.g. Subsidiary)

There can be either Market-based, i.e. equivalent to what is being charged in the outside market for similar goods, or it can be non-market based. Importantly, two-thirds of the managers say their transfer pricing is non-market based.

There can be internal and external reasons for transfer pricing. Internal include motivating managers and monitoring performance, e.g. by putting a cost to imported inputs. External would be taxes and tariffs.

TRANSFER PRICING MANIPULATION

This leads us to the point of Transfer Pricing Manipulation (TPM). It is TPM that is discouraged by Governments 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 transfer price on non-market basis which generally results in saving the total quantum of organization's tax by shifting accounting profits from high tax to low tax jurisdictions. The implication is moving of one nation's tax revenue to another.

A similar phenomenon exists in domestic markets where different states attract investment by under cutting Sales tax rates, leading to outflow from one state to another, something the Government is trying to curb by way of implementation of VAT.

MOTIVATIONS FOR TPM

It is not just the Corporate Tax differential that induces organizations to manipulations in Transfer Pricing. Some of the other reasons are:

- High Customs Duty – leading to under-invoicing of goods.
- Restriction on Profit Repatriation – leading to over-invoicing of raw materials, etc transferred from parent country, hence compensating for locked forex.
- Ownership Restrictions (E.g. Insurance Sector – 26%) – since this leads to less than justified returns on the technology or knowledge invested in the JV, MNEs circumvent it through over charging on royalties for technology, etc.

There can be various other similar motivations for TPM. The transactions most likely disputed by Governments are Administration & Management Fees, Royalties for intangibles and transfer of finished goods for resale. (*Source: E & Y Survey*)

EFFECTS OF TPM ON NATIONS

1. One primary and well appreciated effect is the loss of Government Tax and Custom Duty revenues. Loss of tax revenues in this form leads to a burden on the rest of the population through over taxation and/or borrowings by the Government, which becomes essential to meet expenditure requirements.
2. TPM also leads to distortions in Balance of Payments between the host and home country, something that has the potential to challenge the sovereignty of nations given the mega size of some of these firms.
3. Another implication is on the location of international production and employment. Given the objective of maximization of global profits, MNEs will open subsidiaries where production is most profitable, which is where tax burden is less and therefore effect the level of FDI a country gets. This linkage is so strong that some like Hongkong and Singapore have no Transfer Pricing controls, making themselves attractive destinations for FDI.

Transfer Pricing has been existing in domestic and importantly international transactions over decades now and there is nothing novel about the concept. What is, however, is the extent of this practice which has now acquired critical mass to be given due consideration by various tax authorities.

TPM GAINING IMPORTANCE

The issue has gained importance in the recent past due to organizations acquiring huge economic power (in some cases more than nations themselves - Of the 100 biggest economies, 51 are companies and 49 are countries) operating in scores of nations, making their sales, production and distribution structure more and more complex to come under the purview of one tax regime.

The other phenomenon is increasing liberalization due to which a larger number of countries are allowing entry of these MNEs and a further larger number making their environment conducive for foreign investment. This has led to establishment of truly global corporations resulting in a higher proportion of intra organization trade in international trade. To substantiate the idea further, one-thirds of total world trade is intra-firm.

A third phenomenon, particularly in countries like India, is one of Government moving away from control of productive resources (by way of divestment, etc.) which has put all the more emphasis on tax revenues in meeting Govt.'s revenue requirements.

CHECKING TRANSFER PRICING MANIPULATION

Having understood the implications and growing importance of Transfer Pricing, more precisely Transfer Pricing Manipulation, we look at what regulations have been enacted to counter this by India.

The Finance Act 2001 introduced detailed Transfer Pricing regulations w.e.f. 1st April, 2001. The basic idea behind regulations is determining whether 'International Transactions' between 'associated parties' are conducted at 'arm's length price'

Arm's Length Price (ALP) – This is the price that would be charged in uncontrollable transactions, i.e. when parties are unrelated. Two most common methods of doing this are

1. Checking the price in a similar transaction between two totally different parties and
A → B vs. C → D
2. Checking the price in a similar transaction between one of the involved party and one unrelated party.
A → B vs. A → C

The various methods prescribed by Indian regulations to find out the arm's length price are

- a) comparable uncontrolled price method (CUP)
- b) resale price method (RPM)
- c) cost plus method (CPM)
- d) Profit split method (PSM)
- e) Transactional net margin method (TNM)
- f) Such other method as may be prescribed by the Board.

There is generally more than one Transfer Price which is defensible in any transaction and hence most countries talk of a transfer pricing band rather than a singular transfer price.

There are clearly some roadblocks in implementation of ALP, like:

- Specialized nature of goods/ services and uniqueness of intangibles
- Independent entities might not undertake similar transactions, because of copyright issues. For e.g. Coke would only share its formula with a related party where it has some stakes.
- There is a huge administrative burden on part of tax authorities in determining the true transfer price and this exercise might sometime take years, by when the situation changes dramatically
- Confidentiality issue may restrict availability of comparable information.

Associated Parties – Those having 26% or more Equity holding, having loans or guarantees over a certain value, having power to appoint Board Members or Managers or when there is dependence for license, copyrights or raw materials for that matter.

International Transactions – "International transaction has been defined as a transaction between two or more associated enterprises, either or both of whom are non-residents. The transactions intended to be covered are purchase, sale or lease of tangible or intangible property, provision of services, lending and borrowing of money cost sharing and any other transaction which have a bearing on the profits, income, losses or assets of an enterprise. As such, virtually every conceivable transaction is proposed to be roped in for scrutiny."

Refer to the <http://finmin.nic.in> or www.indiainfoline.com for detailed information.

The regulations apart from filing of proper tax returns require maintenance of a host of documentary and other evidence to substantiate transfer prices adopted by MNEs and penalties have gotten stricter. An organization can be fined up to 2% of the transaction value for not just evasion of tax but also for non-compliance with procedural requirements.

To give an indication of how strict countries have become against Transfer Pricing, we can see the example of United States where these restrictions are among the toughest. Tax Payers generally prevailed in Transfer Pricing cases in period 1967 – 1995. Post 1996, the Internal Revenue Service has won 10 out of 13 cases it has filed against companies on account of discrepancies in Transfer Prices, where it has lost only 1, the other 2 being ties. Heavy penalties have been put on defaulting companies, discouraging this practice.

CONCLUSION

Transfer pricing is inherent in the way the global economy is structured with sourcing and consuming destinations being different, with numerous organizations operating in multiple countries and most importantly due to varying tax and other laws in different nations.

Also nations have to achieve a fine balance between loss of revenues in the form of outflow of tax and making their country an attractive investment destination by giving flexibility in Transfer Pricing. One can choose to go to extremes like Singapore would be doing especially when it is the low tax country. Given that countries are not integrated into a global system, each of them want increase in total inflow through tax or FDI and something like VAT is not expected to remove this non-competitive method of attracting investment, countries will need to enact legislations on their own. Thus, achieving the mentioned balance, suiting their conditions and pattern of international transactions, according to the stage of economic development they are in, are some of the challenges companies are facing as they become a global economic community.

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