INTERNATIONAL TRANSFER PRICING: POINTERS TOWARDS BALANCE OF PAYMENT ISSUES OF AN ECONOMY

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Abstract:

Balance of Payment (BoP) deficit is become a challenging task for the policy makers to manage. Policy makers are not keeping any stone unturned to ensure that the BoP does not go unfavourable. This is true especially in developing and underdeveloped economies. Tax differentials have significant impact on the trade deficits, is well proved through research. It is also known fact that the international transfer pricing is used as a strategy by the multinationals. This is not only to maximize their group profit after tax but also as a tool for tax management, resource allocation, risk management.

Transfer pricing is looked as an issue of dispute between rightful tax to the governments and freedom of the multinationals for maximizing profits and strategy implementation. However transfer pricing has greater economic impact than mere taxation issues. For the governments the impact of transfer pricing is not limited to taxation aspect. It has larger impact on the balance of payment of the nation. The adjustment to the arm’s length price by the tax authorities implies probable impact on the BoP. With specific focus on the current account transactions of the BoP, this study focuses on the impact transfer pricing can have on the BoP. Taking published data from Government of India the study tries to quantify the impact of the transfer pricing on the current account of India over the period of financial year 2004-05 to 2009-10.

Key Words:

Transfer Pricing, Balance of Payment, Current account transactions, Trade Deficit, Balance of Payment Crisis.

Introduction:

Balance of Payment (BoP) deficit is a problem faced by many developing economies. The task of getting the BoP in the acceptable limits is the biggest challenges in front of the policy makers. To address this challenge the policy makers have been using various tools including the promotion of inflows on the capital account. However a healthy current account in the BoP indicates long term strength in the policy making. The capital inflow promotion in long run helps in converting the current account into a positive state is what is the assumption in the measures of promoting the capital inflows. Direct investment into the core sectors help in economic growth, in turn make the economy healthy. A few questions are to be answered though, what if the capital inflows dry up too early than they start generating current account inflows? And that will such capital inflows actually result in the current account inflows in future and help the BoP to be favorable? The answer to the second question depends more on the strategies and priorities of the multinational corporations.

One of the strategy of the multinational corporations is transfer pricing. It has various objectives. There is a lot of literature written (Choe & Hyde, 2004), (Korn & Lengsfeld, 2004), (Shunko, Debo, & Gavirneni), about the international transfer pricing being used as tool for PAT maximization and global tax management. There is a belief amongst a wide spectrum of revenue authorities that the MNC’s use transfer price which reduces their profits in the country and hence the rightful government revenue is lost. (Kimberly, 1998) Found evidence in the relation of related party trade and the tax rates. All these
international transactions have an effect on the BoP. (Yoshimine & Norrin, 2007), find that tax differentials have significant impact on trade balance. Links are found between trading activities of multinationals and the US merchandise trade balance (Hipple, 1990). The tax policy of the nations also has an effect on the locational choice of the firms (Devereux & Griffith, 2002).

This study tries to establish the link between the non-arm’s length price for transfer pricing by the multinationals resulting in the transfer of incomes to different locations and its probable impacts on the BoP.

**Literature Survey:**

(Hipple, 1990) finds link between trading activities of multinational firms and US merchandise trade balance. It is found that the activities of multinational companies are important in understanding the US trade deficit.

(Kimberly, 1998), finds that there is a clear relationship between taxes and intra-firm trade flows. He finds that the trade between US affiliates in different foreign countries is influenced by tax considerations. The intrafirm trade balances have with low tax countries are less favorable and that the US exports to related parties in low tax countries are underpriced and that US imports from related parties from low tax countries are overpriced for minimizing total taxes globally. He also finds evidence showing clear relationship between taxes faced by affiliates abroad and their intra-firm trade transactions. Thus there is a tax minimizing behavior by the firms which may lead to intrafirm exports originating in country in higher marginal cost. When the magnitude of the tax differential and the trade balance between associates is considered it is found that 10% difference in the tax rate between the countries of the affiliates leads to lower relative intrafirm trade balance by 4.4%.

(Devereux & Griffith, 2002), find that taxation affect firms location. However they do not quantify how much is the magnitude of the effect. They also find that even if the elasticity for taxation is found there would still be a number of unresolved issues for policy formation; in particular, it would also be necessary to identify the benefits of higher inward Investment and how they accrue.

(Choe & Hyde, 2004) finds that increasing multinationals are using different transfer prices for internal transfer purpose and for tax purpose for the fact that the marginal cost rule for transfer pricing does not give work in purchase decision making for multinationals in the different tax environment. It is found that the optimum incentive transfer price is shown by the weighted average transfer price plus adjustment by a fraction of marginal penalty for non-ALP for which the relevant affiliate is held responsible. As long as the tax rates are different in different jurisdictions the firm optimally trades off the benefit of tax arbitrage against the penalty of non-ALP.

(Korn & Lengsfeld, 2004), find that numerous (high-tax) countries presume that multinational firms use their transfer-pricing policies to shift profits into countries with lower tax rates. The transfer pricing strategic disorders are based on, competition, tax and punishment effect for the non-arm’s length pricing. Tax enforcement goal of the governments directly influences the competition.

It is found that the tighter transfer pricing rules may help firms to mitigate competition and to increase their profits and that non compliance to the arm's-length principle is part of their equilibrium strategy of the MNC’s.

(Sakurai, 2004) in working paper finds that unlike Japanese MNC’s the British and American MNC’s are proactive in their policy formulation towards transfer pricing and their global tax planning. However the differences are slowly reducing with time and pressure on margins. The non-confrontational regulatory
approach of the Japanese is less transparent but the US adversarial approach has a risk of creating creative compliance which escapes the intended impact of law. Transparency and accountability is the key to success due to the subjective nature of the legislature, however cooperative and consultative regulatory approach is also key to the implementation, for which multilateral discussions and adaptation is required to rationalize the tax management styles towards transfer pricing so as to increase cooperation and reduce conflict amongst tax administrators and tax managers.

The research of Sakurai indicates that there is a requirement of creating a relationship of mutual trust between the MNC’s and the tax administrators, which is a very difficult job. An environment has to be created where in the tax managers feel that the law is to be respected not to be worked upon.

(Penelope, 2005) Find a very strong evidence that Mexico’s growth is balance of payments constrained and that this constraint has deepened as a result of trade liberalisation. Although NAFTA has worked as a catalyst for attracting FDI and fostering exports, it has also generated some serious difficulties for Mexico’s economic development.

(Sikdar, 2006) explains how MNC’s are born for which one has to look at the organizational expansion and evolutionary stages in which the sole proprietor business has grown to a multi-national enterprise, in which the control of the owners is delegated through the board of directors and the group of enterprises work together towards achievement of their common business objective. With the industrial revolution the organizations started to grow in size and with revolutions in transportation and communication, movement of funds, labour, and ideas across geographies and political boundaries became effective, efficient and easy. The locational advantage started to be appreciated for its cost efficiency and administrative effectiveness. The companies expanded to different locations which gave them business advantages by way of having branches, affiliates and subsidiaries. This geographic expansion by the companies through branches, affiliates and subsidiaries gave birth to multi-national enterprises.

In this case the evaluation of fairness of the price applied in a transaction with related person arises only where the interested party is adversely affected, that is the transaction generally fetches lower than normal collections to the revenue authorities. Thus the transactions that happen between related persons located in different states are subjected to transfer pricing. Transfer pricing can thus, be said to be as old as international transactions or inter-state transactions. Initially when the organizations were small the international transactions were generally trade of finished goods or raw material between unrelated parties, from place of production to place of consumption. This did not involve much of transfer pricing issues.

(Yoshimine & Norrbin, 2007), find that tax differentials have significant impact on trade balance. They find that the trade balances are lower than expected in countries with higher comparative tax rates.

(Urquidi, 2008) finds in his Case study based article that the corporate seek to solve the transfer pricing problem for three reasons, namely:

1. Satisfies the needs of the business with respect to strategy and internal incentives
2. Results in an efficient use of resources
3. Provides the “right” transfer pricing answer from a tax perspective

He finds that this is a daunting task for the corporate especially in the financial services sector which does not have any specific transfer pricing regulations. He further finds that the macro economic factors play a vital role in transfer pricing and the firms will have to rely on upon the economic factors to help them navigate the problem of transfer pricing process.

The author is indicating towards continuous review on transfer pricing policies based on macroeconomic factors so as to satisfy the three reasons cited creating problems of transfer pricing.
(Brada & Tomsik, 2009) Find that the economies receiving large amount of Foreign Direct Investment (FDI) have to be careful in their BoP since the phenomena of FDI life cycle is likely to affect them in future.

(Shunko, Debo, & Gavimeni), in undated working paper find that the use transfer pricing to take advantage of tax differentials can help in profit improvement by as large as 30%. They find that the trade off curve between cost and tax advantage drives global firm’s choice for sourcing strategy. The curve demonstrates that the off-shoring option with a significant tax advantage should be considered even if it does not have a cost advantage.

All the above literature brings to a reason for which the economies have to be worried for BoP deficit. The FDI coming into the economy is bound to bring outflows in the future and the policy makers have to be cautious in making the most of the FDI and to delay the out flows. It also brings us that there will be strategies and tools used by the multinationals to achieve their goals which may not necessarily be in line with the national goals.

Transfer pricing is one of such strategies which needs to be studied so as to understand its role in the impact on BoP. The effectiveness of transfer pricing is well recorded and known. The same has been widely studied for taxation effect. This paper further studies this impact and quantifies the impact of transfer pricing on BoP, in Indian context.

**Methodology:**

This research is typically a mix of qualitative research under the category of phenomenology and the quantitative techniques to prove the same. By studying in depth the transfer pricing, its utility for the multinationals and its effects on the taxation, the researchers have extended the logic of direct negative impact of the transfer pricing on taxation to the movement of funds across international boundaries, and further its effect on the nations BoP.

Through unstructured interviews of experts and detailed analysis of the effect of transfer pricing on the tax collection of India through analysis of 500 assessment orders passed by the authorities over a period of 6 years. Simple quantitative techniques are used upon the transfer pricing additions made by Indian tax authorities over a period and the BoP figures as published by the Government of India, to quantify the impact of transfer pricing on BoP. There is no attempt being made to develop any model for measuring the impact, since the published data available is for transfer pricing is available for a relatively shorter period of time. Also major variables within overall impact of transfer pricing are also required to be studied for development of a model.

**Data Analysis:**

The annualized BoP figures for India are also given in the table 1. The figures indicate the current account and capital account BoP status on annualized basis.

Additions made to the income of various assesses over a period of time are given in table 1. These figures indicate the additions made by the authorities via the assessment orders passed. These are in case of the assessee who have related party international transactions. This means that the incomes are increased or costs are reduced. In either case there is no inflow of funds to the economy to that extent, indicating a direct negative impact on the BoP.

Table 1.
<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Balance of Payment (US $ Million)</th>
<th>Transfer Pricing Additions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current Account</td>
<td>Capital Account</td>
</tr>
<tr>
<td>2009-10</td>
<td>-38383</td>
<td>53397</td>
</tr>
<tr>
<td>2007-08</td>
<td>-15737</td>
<td>106585</td>
</tr>
<tr>
<td>2006-07</td>
<td>-19467</td>
<td>98695</td>
</tr>
<tr>
<td>2005-06</td>
<td>-19467</td>
<td>98695</td>
</tr>
<tr>
<td>2004-05</td>
<td>-19467</td>
<td>98695</td>
</tr>
</tbody>
</table>

Source: Annual Reports, Ministry of Finance, Government of India; Reserve Bank of India (http://rbidos.rbi.org.in/rdocs/Publications/PDFs/140T_HBS120911.pdf), (http://rbidos.rbi.org.in/rdocs/Publications/PDFs/147T_HBS120911.pdf).

It is assumed that all the additions to the income are made on the current account side of the BoP. This assumption is based on the findings of the analysis of the assessment orders passed by the authorities. An insignificant number of cases were found in which capital account transactions were there in which additions were made by the authorities.

The data for the financial year 2008-09 for transfer pricing additions is not available and hence not considered for the analysis. Also the same data for financial years 2004-05 to 2006-07 are available combined. Hence the same are taken. The US $ conversion rates are taken as simple average for the three years of the US$ average rate for the respective financial years as published by the Reserve Bank of India.

**Findings:**

BoP deficit is an issue for economies and specifically the current account deficit depicted by trade deficits. At the same time transfer pricing is emerging as an issue for the authorities from the taxation point of view. If tax management is an issue for the nations due to transfer pricing the same transfer pricing also is an issue when it comes to BoP management.

The additions to the income made by the authorities after due audit for transfer pricing for related party international transactions is 12.55% of the India’s BoP current account figure and 35.83% of the net BoP of India. Also additions on account of transfer pricing are increasing at an increasing rate as compared to the BoP.

**Conclusions:**

Transfer Pricing has a greater impact on the economies than just lack of right full tax and global profit after tax management. It has substantial effect on the BoP management and in turn the currency management by the economies. This implies that it impacts the fiscal and monetary policies of the economies making it a complex and critical issue to study and understand for the authorities.

Further studies have to be conducted for development of models for estimation of the impact of transfer pricing on the BoP and currency fluctuations. Studies should also focus on the quantum of trade between related parties and the foreign direct investment into the economy, the age of the foreign investment, and its effects.
References:

17. http://finmin.nic.in/reports/annualreport.asp