International Transfer Pricing: A review of Non Tax Outlook

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ABSTRACT

Worldwide there are a lot of controversies and debates between the tax authorities and the MNC's about the related party transaction pricing. The tax authorities contest on the grounds that non arm's length price is depriving them of rightful revenue and that the MNC's are doing this to save on tax liability. This is not the case always. It is one of the considerations in the related party transfer pricing. The study tries to find the objectives behind the pricing strategy by the MNC's. Through extensive literature survey the study finds that the tax liability management is not the only objective that the MNC's have while pricing the related party transactions but there are other objectives that have priority in the global strategy of the MNC's which also play a vital role in pricing strategy. The global objectives demand movement of funds from one location to other for various purposes for which non arm's length pricing is used. The study finds that non tax outlook in transfer pricing is very strong and in some cases compelling to affect the transfer pricing strategy. The study finds various purposes other than tax liability management which the MNC's have to attend to while deciding their related party pricing strategy.

KEY WORDS

Arm's Length Price; Pricing Strategy; Related Party Transactions; Tax Liability Management; Transfer Pricing.

INTRODUCTION

There has been a global thinking on the matter of international transfer pricing and a lot of work has been done to stream line and standardizing the practices for the same globally. OECD has played a big role in this matter. The OECD members have adopted the arm's length principle for valuation of international transfer pricing. The guidelines for the international transfer pricing contain high amount of subjectivity (Stuart, 2009) which are creating an increasing number of disputes amongst the MNC's and the tax authorities. This subjectivity is makes the tax authorities inconsistent in their decision making as found by (Cools M. , 2008). 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. 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.

However the management control angle of the argument to the same has to be looked at as a genuine requirement of the MNC's to exercise control over their global operations and such activities are mandatory for them. In the process of management control there are fair chances that the arm's length principle is violated. The OECD guidelines provide for adjustment for the same as a remedial measure. There is a need to look at the genuine reasons, other than the reasons of tax management that the MNC's use transfer pricing irrespective of the political boundaries of nations. Risk concerns and use of transfer price is apparently one of the most close to heart reason for the MNC's. The theory for the international financial management gives use of transfer pricing as a tool for cash management and risk management as well as resource allocation (Choi & Meek, 2009), so do the theories of international business. The performance evaluation and management control system requirements of transfer pricing are well highlighted in the theories and texts (Anthony & Govindarajan, 2010). This study tries to find reasons other than the tax management for which the MNC's use transfer price as a tool.

LITERATURE SURVEY

A wide range of research is available, but only those which are related to the use of transfer pricing as resource allocation, strategic use, cash management purpose and management control use are narrated.

(Tisdell, 1989), acknowledges the use of transfer price in multidivisional firm. The research also talks on the neglected areas of transfer price poor guide for economic value of the firm and that it can retard the technical change, innovation and productivity enhancement within a division.

(Cravens, 1997), found through a survey that the MNC's employ transfer pricing for assisting in achieving competitive advantage along with other corporate goals. It is also found that the transfer pricing influences measures of corporate performance and contributes towards the corporate objectives. The respondents agree that transfer pricing is not purely tax driven mechanism.

(Alles & Datar, 1998) Focus on the use of cost for strategic purpose. In Oligopolistic firms generally the pricing decisions are based on the costs that are communicated to the marketing or selling departments. Thus the sales price determination gets the basis of communicated cost than actual cost. They find imperial evidence in the belief that there is a strategic component in cost system choice and transfer pricing and the fact that the firms may cross subsidize their products.

(Gabrielsen & Schjelderup, 1999), find that in case where the downstream firms buying from upstream firms, are co-owned through joint ventures or otherwise, the transfer pricing is generally over invoiced. Their analysis indicates that transfer pricing plays a strategic role other than tax management even in co-owned downstream firms of MNC's.

(Nielsen, Raimondos-MYller, & Schjelderup, 2001) Find that contrary to the belief of policy makers and economist the formula apportion method does not eliminate the profit shifting incentives under oligopolistic competition. The MNC's use transfer pricing as a device to win local market share, especially if, quantity is the strategic variable. The strategic benefits although depend upon the relative tax rates in the countries in which the MNC operates. The drawbacks of the separate accounting system are not eliminated in the formula apportionment method.

(Martini, 2005), focus on the issue, where the same transfer price is employed to coordinate divisions and to determine their profits. It is presumed that the transfer prices are at arm's length price. It is found that under negotiated transfer prices, divisional profits are always Pareto efficient but substantially vary with the scheme, whereas there may occur Pareto-inefficient divisional profits that are invariant with the scheme when transfer prices are administered by headquarters.

(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, labor, 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.

(Dikolli & Vaysman, 2006), find that information technology plays as important role in the transfer pricing as a management control tool for MNC's. They find that the managements prefer the cost based method over the negotiated price method, since the negotiations can defeat the strategic objectives of transfer pricing.

(Cools & Emmanuel, 2006), highlight the problem of adoption of tax compliant strategy on design of management control system. The complex relationship between the sub-units contributes towards the economic co-ordination and performance measurement of the affiliated sub-units. They agree to the fact that international related party trade gives rise to the opportunity to MNC's to optimize global PAT. They find that since 1990 the increased fiscal regulations and compliance to the same have become a potential alternative strategy to overcome clash with the management control system prevailing in the MNC.

(Martini, Niemann, & Simons, 2007), acknowledge the problem of coordinating economic decisions like investment or production within MNC's. The findings suggest that transfer prices are a widespread device for splitting up complex decision situations and allocating the responsibility for the resulting sub problems to several decision makers. Their findings suggest that transfer prices are a widespread device for splitting up complex decision situations and allocating the responsibility for the resulting sub problems to several decision makers. However apart from doing this transfer prices are also used for tax management.

(Adams & Drtina, 2008), explore the impact of transfer pricing on capital budgeting. When selling division is under capacity, the economic theory says that the transfer price should be based on differential cost. In such a situation the seller does not generate sufficient revenues to recoup the capital cost. In such situations the divisional managers can reject investment proposals which will increase corporate shareholder value. In such situations Arm's Length price will affect the short term global profits but the MNC's must look at the long term impact of the transfer pricing decisions on the profitability and the shareholder value of the company.

(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.

(Shor & Chen, 2008) They find that the firms can use TP strategically as a collusive device. Firms are individually better off in a centralized organizational format. Collusion on prices is sustainable where as on numbers is not as well the price collusion may also escape legal scrutiny. Cost-shifting between regulated monopolists and their corporate affiliates is regarded as a major concern for regulators and researchers.

(Curtis, 2008), challenges the view that transfer pricing is a responsibility of corporate taxation because it is a matter of taxation and makes a case for multi-functional approach to MNE treasury planning in the context of transfer pricing can be an important component in improving the efficiency of cross-border financial management. The article focuses on MNC's corporate treasury management responsibilities which includes international capital structure and cost of capital, the financing of cross-border acquisitions, foreign direct investment, international capital budgeting and cash management, management of foreign exchange and transactional risk, and port-folio and investment management. In all of the above when there is a fund movement between international boundaries there is a transfer pricing issue involved.

(Doff, Bilderbeek, Bruggink, & Emmen, 2009), analyze asset and liability management and market risk systems of insurance companies and find that the current system is not goal congruent and does not satisfy necessary conditions for effective control. They find that managers are unable to run their units effectively. They develop a transfer pricing based system which allows the clear separation of underwriting and investment activities, both on the risk and return aspects. It creates the appropriate incentive schemes.

(Cools & Slagmulder, 2009) Study the effect of international transfer prices within management control systems. The study is limited to firms using single transfer price for management control system and that of tax purpose. In this situation the TP negotiations are eliminated giving rise to economically harmful decisions. Administrative mechanism for profit determination can lead to suboptimal decisions and lastly revenue or cost centers are designated as profit centers for tax compliance. TP and tax compliance is related to profit centers. In the case study undertaken it was found that the management found utility in treating the associate as profit centre than revenue or cost center.

(Jelena & Danijel, 2010) Find that the transfer pricing affects the divisional revenues, expenditures and results. This creates competition amongst the divisions for increasing their performances. The method used for transfer pricing is thus plays an important role and is of most interest to the managers. They also find that the more successful divisions get more share in the allocation of resources.
In MNC's where the transfer pricing is not used as a strategy for tax planning, there is a very strong case that the trade off is made by the managers of the divisions between benefits of

tax management and higher share in resources from the management. Also there will be considerations given to the performance based bargaining capacity of the division manager which can have impact on the transfer pricing method as well as price.

(Sikka & Willmott, 2010), highlight on the scattered evidence to show how transfer pricing is not just an accounting technique, but also a method of resource allocation and avoidance of taxes that affects distribution of income, wealth, risks and quality of life.

(Dawson & Miller) In their undated work find the roots of evolution of transfer pricing. They say 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. 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 are 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. With the industrial revolution the organizations started to grow in size and with revolutions in transportation and communication, movement of funds, labor, 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. The parent company continued to be in one country and the branches, affiliates and subsidiaries were at other locations. The various techniques and strategies adopted by the MNC’s for increased cost efficiency ensured that the volume of transactions between the multinational enterprise group increased many fold. These transactions are also called as intra group transactions or related party transactions. The structure and pricing of transactions within the MNE group is governed by the combination of market and group driven forces with a common objective that is to maximize the group profits and wealth.

METHODOLOGY

This research is typically a qualitative research. Of the five types of qualitative research, this belongs to Phenomenology. A phenomenological study describes that meaning of the lived experiences for several individuals about a concept or a phenomenon (Creswell, 1998). As noted by (Polkinghorne, 1989), phenomenology explores the structures of consciousness in human experiences.

The researcher has conducted unstructured interviews through discussions with practicing chartered accountants and tax practitioners in the field of international taxation. The data analysis involves horizontalization (i.e., extracting significant statements from transcribed interviews). The significant statements are then transformed into clusters of meanings according to how each statement falls under specific psychological and phenomenological concepts. Finally, these transformations are tied together to make a general description of the purposes for which the transfer pricing is used by the MNC's operating in India.

TRANSFER PRICING TOOL

Transfer pricing is used as a tool for various purposes by MNC's in their course of business with related parties in international transactions. Significant use of transfer pricing as reported during the research are as follows:

1. **TRANSFER PRICING AS A MANAGEMENT CONTROL TOOL:**
   International transfer pricing is used as a tool to facilitate better management control. It is very common that the performance standards are set for the business unit and the transfer pricing facilitates the evaluation of the set performances. This is true especially in the case of lot of transactions which are outbound, i.e. export transactions.

2. **RISK MANAGEMENT AND TRANSFER PRICING:**
   MNC's invest in new markets and for them the fact that the Indian market is new increases the risk. They expect higher returns on their investments and hence the products imported by their local arm are priced to take care of this added risk of entering into the new market. However this argument is not very well taken since the risk of business is to the Indian arm and not to the overseas arm of the MNC. In fact the international transaction carries lesser risk since it is between related parties. However if the same is viewed from the point of theories of international business, with the MNC looking at the global risk, than, the argument can be said to be valid.

3. **TRANSFER PRICING IN RELATION CASH/FUND MANAGEMENT, INVESTMENT AND CAPITAL BUDGETING, STRATEGIC REQUIREMENTS:**
   The global managers look towards fund allocation for the purpose of investment globally. There are restrictions of the local governments or created due to joint venture partners which have to be taken care of. Transfer pricing is an easy way to overcome these issues although the same creates problems of taxation which have to be handled separately. However global requirements always get priority.

IMPORTANT OBSERVATIONS AND FINDINGS

1. Transfer pricing is used as a tool for other than tax liability management. The incidences reported are very few in which it is admitted that the primary objective is tax liability reduction.

2. Strategic and investment purposes are the ones for which transfer pricing is used as a tool for international fund management. There are taxation issues arising out of it as a byproduct of the implementation of the tool but they are inevitable.

3. Risk of entering into a new market is also an area in which is managed by the tool of transfer pricing. Even this raises the questions of taxation due to transfer pricing. The risk management always takes a top priority over and above the issue of non-arm's length pricing.

4. Arm's length principle is very subjective and hence gives flexibility in tackling the taxation issue arising due to strategic decisions of use of transfer price.

5. Transfer pricing when used as a management control tool is a very important aspect of its utility. In this situation the following of arm's length principle is easier, since the performance evaluation criteria can be decide taking it into consideration. The arm's length principle can also be considered using a double set of books of accounts; one for the purpose of performance evaluation and other for the statutory tax purpose. In either case the taxation does not become a major issue to be tackled.

CONCLUSION

The reasons for non arm's length pricing in case of international transfer pricing are not restricted to tax liability management which is a general perspective. They are diverse and varied which include strategic requirement, risk management, investment management and the management control aspect to of the non arm's length pricing by the MNC's. In many cases the tax consideration is not a priority while making the transfer pricing decision, however except for cases where arm's length principle is possible to be followed as in some cases for the management control system induced transfer pricing, there is direct tax liability impact due to non arm's length transfer price. This creates a notion that the priority of MNC's is tax liability management.

The taxation for international related party transaction is very subjective and those posses an uncertainty for the MNC's while making the decisions for the transfer price. There is a strong need to bring in certainty in the method for taxing international related party.

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