INTERNATIONAL TRANSFER PRICING REGULATIONS: FREEDOM OF GLOBALIZED MANAGEMENT VS. RIGHTFUL TAX

Shantanu Jayant Pendse[1]

Abstract: As the world comes closer to being a one village, the multinational companies are expanding multifold, tapping possible opportunities to grow and fulfill their goals. In line with the principals of capitalism, one of their primary goals is to maximize their global profit after tax. The globalization does not mean elimination of political boundaries. The economies have to be governed and there is a cost to it, for which taxes are levied. The governments have ever increasing list of welfare activities for which they look for all the rightful taxes, which is in line with the principles of welfare economics.

This paper studies the clash in principles of capitalism and the welfare economics, highlighted through international transfer pricing. Through extensive literature and study of arguments for and against the Arm's Length price working, it is found that the concept of global village comes with a requirement if balancing the coexistence of capitalism and welfare economics.

Key Words: Capitalism, welfare economics, Transfer pricing, global village

1. Introduction:

The international trade over the last decade is growing multifold. The rise of multinational corporations has highlighted the growing business across the globe. The information technology and revolution in transport is making business across the continents easy and fast. The locational advantages are exploited by the multinationals to the possible extent. All this is done for their primary goal of maximization of the owner's wealth, a principle under capitalism. For this purpose the MNC's trade across the political boundaries bringing opportunities for them as well as the trading countries for development. This advantage comes with a rider. The MNC's in their motive may not always retain the profits and benefits earned in the nation from where they are earned. They use all possible strategies and tools available to ensure that their goals are achieved. This includes pricing of related party transactions to suite their strategy, involving international transfer pricing.

The nations have to be governed which requires money. This is provided by the taxation mechanism on the country. The strategies of MNC's may reduce the tax paid by them in the country, creating a reduction in the rightful tax of the nation. The question in contest is what is rightful for the government. There is no support to quantify the rightful tax quantum except for a few ancient literatures. However the governments want all the possible rightful tax to fulfill the ever increasing demands of the society and the industry, which is the private sector.

[1] Shantanu Jayant Pendse: Tel.: +91 20 27654880; Mobile: +91 9423010770;
E-Mail address: sjpendse@gmail.com

This paper tries to bring this clash of principles of the capitalist motives of the MNC's and the expectancy of rightful tax by the governments, taking base of international transfer pricing as a matter of rising dispute between the two.

2. Capitalist motives and international transfer pricing as a tool for the same

Capitalism is an economic system in which means of production of goods and services are privately owned for generation of profit. It is a well-known fact that the enterprises are created to maximize the profits. When these go beyond the political boundaries of a country they have more opportunities to maximize the profits of the enterprise. Tax management is one of the tools for the same and different strategies are used for the same, one of them being international transfer pricing, to suite to the needs of the strategy.

(Alles & Datar, 1998), find empirical evidence that the firms cross subsidize their products and the pricing is based on communicated cost than that of the actual cost. (Nielsen, Raimondos-MYller, & Schjelderup, 2001), find that the strategic benefits depend upon the relative tax rates in the countries in which the MNC operates. (Urquidi, 2008), states that the firms have to rely on the macroeconomic factors for strategic use and use transfer price as a tool. (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.

All the above suggests that the capitalist motives give births to strategies to maximize the profits at the global level of the MNC's, implying that they bound to use all possible tools and techniques to accumulate and maximize wealth. One of the important tools for the same is international transfer pricing. The importance of this tool is highlighted by the figures in table 1. It can be seen that the adjustments in the arm's length price by the tax authorities is increasing day by day and the same is reached 12.55% of the current account deficit of India in financial year 2009-10, suggesting an important aspect of economics straining the foreign exchange reserves of the country.

Table 1.

Financial Year	**Balance of Payment (US $ Million)**				**Transfer Pricing Additions**				
	Current Account	Capital Account	Errors & Omissions	Net Balance	Rs. Million	US $ Rates	US $ Million	% of Current Account	% of Net Balance
2009-10	-38383	53397	-1573	13441	228380	47.4166	4816.46	12.55	35.83
2007-08	-15737	106585	1316	92164	61554	40.2410	1529.64	9.72	1.66
2006-07 2005-06 2004-05	-19467	98695	452	77817	69381	44.8300	1547.66	7.95	1.99

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

3. Need for rightful tax for governments:

(Dalton, 1922), lays down the principles of social advantage which the root of public finance. Thus the government has to raise funds for maximum social advantage. He states that every tax is evil and that every public expenditure is good. But for the good to happen there has to be an evil. This is for the fact that government has to have source of revenue to fund public expense and tax is one of the major source for public revenue.

(Edwin & Seligman, 1895), defines tax as “a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred”. This brings out that the tax is a compulsory payment for the common benefit of all and common benefit is the duty of the government. Hence tax is a rightful need of the government to fulfill its duties.

The cannons of taxations were first given by Adam Smith which says that the objective of public finance is to raise funds for the government expenditure to fulfill the wants of its citizens (Mithani, 2006). The public economics aims at maximizing equality of distribution of income and social welfare. In doing this the tax system has to be so designed that there is no excess burden to any one and it facilitates equal distribution of income by taking more tax from the higher income group of the society and lesser from the lower income group. The government cannot carry out its welfare responsibilities if the citizens do not pay taxes.

The governments also require the tax for administration and governance. These days governments have taken up additional responsibilities than the traditional ones of defence and law and order. In adddition planning and development, infrastructure, social construction, investment in human capital, etc are also part of government functions for which funds are required. These responsibilities are integral part of the governance. Government also require to invest and spend for infrastructure and other facilities for the private sector to flurish. These expences require revenue for the government. Tax is one of the important mechanisms for revenue generation for the governments. Thus the governments strive to collect the rightful revenue from the corporates and the public to fulfill their duties.

4. The Balancing Act

(Mithani, 2006), defines tax evasion as “deliberately pretending that the person is not liable to tax by showing himself not in possession of goods or services or income subjected to tax”.

(Marx, 1887) put forth that capitalism cannot take care of the welfare of the labor and hence supported the idea of socialism. However socialism has its own set of problems, which are well highlighted by fall apart of Soviet Russia. The point highlighted by this fact is that the prevalence of capitalist motive behind international transfer pricing and the governments striving for the rightful tax, the welfare motive, cannot prevail together through one legislation.

By introduction of the transfer pricing legislation there is an attempt to balance the difference between the fundamental principles. The OECD guidelines are very subjective and based on the concept of self-restraint and self-compliance by the MNC’s. The same are implemented in India under Income Tax Act 1961. Acceptance of this concept is a hurdle to be crossed.

The capitalist are bound to find the loop holes in the legislation to fulfill their motives of maximizing wealth and the governments getting into litigation to get the rightful tax. This extreme acts have to be rationalized, to find a balance between the rightful tax and hence created legislation and the freedom that the capitalist require for their global management to fulfill their goals.

5. Findings and Conclusions

In the concept of global village, the free trade is to be promoted and the most restraining factor for the same is sovereignty on the nations. The welfare principles and social welfare duties of the governments compel them for rightful tax collection through legislation, whereas the capitalist principles motivate for global profits maximization. The transfer pricing legislation is an attempt to marry two opposite principles prevailing in the economy. The need for the same has arisen from the fact that the governments perceive that they are losing rightful revenue due to transfer price management by MNC's by lack of self-restraint and self-compliance, and the MNC's perceive that their freedom for global management is constrained by this legislation and all legal ways and means are to be used for profit maximization.

It is imperative for the concept of global village to flourish in public interest, that the MNC's accept the responsibility of social cause of giving back to the society which gave the business profits, by adopting self-declaration mechanism and accepting the needs of local governments. At the same time the governments accept the fact that the MNC's are there to earn profits and only rightful tax is to be demanded from them.

The tight rope walk of need to marry the opposite principles of welfare economics and capitalism is possible not by legislation but by self-imposition and respect to each other's principles by the MNC's and the governments, through reasonable profitability and reasonable and simple tax mechanism. This can be better achieved through a forum for mutual agreement.

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