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Transfer Pricing: An Important Tool for Tax Planning

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ABSTRACT

In this age of liberation and globalization Transfer Price has become an important issue. This issue has been discussed extensively in business literature over the past three decades or so. With the expansion of business activities of companies into the international arena, the problem has acquired new dimensions. Multinational enterprises today transfer large proportions of their total output between related business companies. Approximately forty per cent of all international trade consists of transfers between related business entities. In the context of multinational corporations (MNCs) the problem takes on new and more complex proportions as a result of complicating variables such as differential taxes, tariffs, government regulations, political risks, inflation and the like.

Keywords : *Transfer Price, Tax, MNCs*

The last four decades have witnessed enormous expansion of trade and industry in North America, Japan and a part of Europe, as a result of growth, takeovers and acquisitions. This expansion has been accompanied by a process of industrialization leading to the evolution of MNCs, i.e. companies which operate via subsidiaries in a number of countries. A consequential side effect of the growth and internationalization of MNCS is an increase in their management problems. The numerous techniques suggested by management pundits to solve these problems include management by objectives, decentralization, and divisionalization. These techniques attempt to combine the advantages of a big company with those of a small one, If these techniques are not to be more fashionable but vague theories, they have to be based on a sound management control system of which transfer pricing has to be an important part.

Transfer pricing is a significant aspect of divisionalization. If we define decentralization as delegation of decision-making authority to levels. Other than top management of a company, then divisionalization is decentralization plus delegation of profit responsibility to levels at which decision-making authority also vests. This process of delegation of authority and responsibility results in specific changes in the organizational structure of the company. The structure then consists of a number of independent units known as responsibility centers, whose sphere of operation is also defined within the accounting system and is the responsibility of a manager. These responsibility centers may take various forms such as cost, revenue, profit or investment centers. The yardstick generally used for measuring the performance of these

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responsibility centers (except the cost center) is profit, which depends to a considerable extent on an appropriate transfer pricing policy. Commenting on the importance of a proper transfer pricing policy Veriage observes, "In the absence of proper transfer pricing, the application of a management philosophy based on profit center is not only ineffective but also dangerous"[1]

It will thus be seen that transfer pricing developed as logical result of the movement towards divisionalization of operations by large business organizations like General Motors and General Electric in America during the early part of the present century. Highly centralized operations were decentralized by establishing numerous profit centers in the search for more productivity. The delegation of increased authority to local managers in turn give rise to the need for a mechanism of internal pricing that would serve the dual purpose of on the one hand optimizing allocation of corporate resources and on the other, motivating the divisional managers to operate their units at a high degree of efficiency so that goal congruence prevails between divisional and corporate management. At the same time it served as a device for monitoring the performance of divisional managers.

DEFINITION OF TRANSFER PRICING

A division, branch, department or any other component of an entity may transfer goods and services to other subdivisions of the same entity. The transfers may be of tangible property like raw material, unfinished components or ready to sell items or services like marketing and distribution, and research and development. The amount used to record such transfers between divisions is known as transfer price. Horngren and Foster define transfer price as, “The price one segment of an organization (subunit, department, division and so on) charges for a product or service supplied to another segment of the same organization".[2] A slightly modified version of this definition would include intercompany transfer between affiliates.

According to A. Mallick & D. Rakshit,”The value at which goods or services are transferred from one unit to another unit is called intra company transfer price.”[3] Nilesh V Suchak says that” Transfer pricing is an important tool for tax planning.”[4.] “Transfer price is the value of price at which transactions take place amongst related parties',”[5] as per Dr. R.S. Agarwal. Dr. GS Mehta & Seema Kumbhat describes” Transfer price as a decision making tool.”[6] OECD has defined that” Transfer price is a price at which multinational enterprises transfer physical goods and intangible property or provide services to the associated enterprises.”[7]

Transfer price refers to the amount used in accounting for transfer of goods or services from one responsibility center to another from one company to another which belongs to the same group. Therefore, price for accounting for transfer of finished goods from manufacturing department to marketing department can also be referred to as transfer price. Similarly, price used for accounting of any cross-border transfer of goods or services from one company to another company which is a member of the same group is termed as International Transfer Price.

CHARACTERISTICS OF TRANSFER PRICE

(i) It is a price at which transfers take place.
(ii) It is a top management decision.
(iii) In large scale organization, transfer pricing has been accepted as a tool for the decentralized structure of organization.

(iv) This is a price, which is charged by one segment of an organization to another
(v) It may be the price of tangible property like "Raw-material" or service like "Marketing".
(vi) It is a significant aspect of divisionalization .
(vii) This price is used for accounting of transfer of finished goods from manufacturing department to marketing department.

OBJECTIVES OF TRANSFER PRICING

The objectives of transfer pricing will be studied under two heads; domestic and international[9]. This classified analysis is essential for a better insight into the host of additional constraints an enterprise encounters as it progresses into the international arena.

(A) DOMESTIC OBJECTIVES

The objective of transfer pricing in these diversified domestic organizations is to control operations, motivate managers to maximize their profits. Transfer prices are meant to motivate division managers to make the right decisions to operate their units at a high degree of efficiency and promote the welfare of the corporation as a whole. To what extent decisions of unit managers will be influenced by transfer prices would depend upon number of variables like the information or data available, the pricing policy or strategy of the unit, the elasticity of market demand, and the role of the unit within the organization.

An appropriate in-house pricing mechanism serves as a monitoring device in the evaluation of decentralized divisional performance. It is essential, however, transfer prices be compatible with the role of the units in order to provide valid measures. Where inappropriate roles are assigned to subunits both before and during evaluation, the resulting transfer pricing practice produces a heap of worthless information. Cowen, Phillips and Still bower have aptly summed up the objectives of transfer pricing as:

“The primary purpose of all transfer pricing system is to maximize the following set of management objectives:
(i) Assure that divisional, branch and/or subsidiary objectives coincide with the overall objectives of the company,
(ii) Motivate managers of such sub-entities to make decisions which are congruent with overall company objectives;
(iii) Assure an efficient allocation of resources among and within such sub-entities
(iv) Provide an adequate measure upon which to evaluate the performance of all corporate entities, and
(v) Assure effective communication within the entire company.”[10]

Transfer pricing presents a dilemma of substantial proportions for complex domestic organizations. Various degrees of decentralization prevalent are reflected in structures varying from vertical to horizontal and all sorts of combinations in between. Besides, the units may also operate as cost, profit or investment centers. Domestic transfer pricing objectives are as conflicting as the roles of the units. Decentralized operations are based on the edifice of autonomy, which entails sacrifice in control and decision-making this in turn necessitates the development of appropriate mechanisms to monitor the effectiveness of delegated decisions.

The pursuit of equity thus defines the critical path usually followed in selecting domestic transfer pricing methods. The number of conflicting roles and goals necessarily dictate that some trade-offs be made. Consequently, transfer prices vary over a wide range from freely negotiated to the administratively dictated, and they may be determined by either market or cost factors.

(B) INTERNATIONAL OBJECTIVE

Over the last few years cross border business activities has increased and these business activities have been brought the concept of transfer pricing into focus since it is a price on which tangible or intangible properties are sold, or services are provided to associated companies.

Many MNCS have divisions located in different countries, when a multinational corporation transfers goods between these divisions International Tax issue arises and this tax is calculated on the basis of transfer Price

IMPORTANCE OF TRANSFER PRICING

(i) Performance Evaluation
(ii) Management Motivation
(iii) Price and product Emphasis
(iv) External market recognition
(V) Tool for tax Planning
(vi) Finding overall income of the company
(vii) Competition position of subsidiary in their respective market

SUMMARY

Transfer pricing is the process by which related parties set the price at which they pass goods, services, and finance and intangible assets between each other. International transactions across border are growing rapidly and are becoming much more complex. Last four decades have witnessed enormous expansion of trade and industry approximately all over the world. In a multi-segment enterprise the segmental revenue and results are mostly influenced by transfer pricing decision. Accordingly in the absence of adequate disclosure of the transfer pricing formula not only the users may be misguided from segmental performance but also the application of a management philosophy based on profit center is ineffective.

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Conflict of Interest
The author declared no conflict of interest.

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