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INTERNATIONAL TRANSFER PRICING

Transfer pricing refers to how the prices at which transactions between related parties are carried out are determined. It can also be referred to as intercompany transactions and represents a larger portion of international trade. The objectives that the headquarters management wishes to achieve through transfer pricing, as well as, the law that exists in various countries guiding the manner in which intercompany transactions across borders are priced, are both major factors that influence how international transfer prices are determined. Transfer pricing has been identified in a recent survey, as the most important issue faced in comparison to other international tax issues.

Most business enterprises are organised by divisions which involves the top managers delegating or decentralizing authorities. This allows for local managers to adapt to changing environment, it divides large problems into manageable pieces and also motivates local managers since they have been granted decision – making authority. This however could cause the local managers to make decisions that benefit their self-interest and are harmful to the company at large. Goal congruence should be adopted by providing incentives to motivate local managers to make decisions that are in line with the corporate goals of the firm. Transfer pricing allows for efficient allocation of resources and it achieves this by motivating local managers to make decisions that enhance corporate performance while measuring, evaluating and rewarding their performance as deemed fair by the managers (goal congruence), If goal congruence is not achieved then the potential benefits of decentralization can be lost.

The most common methods used to set transfer prices are; 1. Cost-based transfer price. Here, the transfer price is based on the cost of producing goods and services. Although it is easy to use, the problems of which measure of cost to use and transfer of inefficiency of one unit to the others could arise.

2. Market-based transfer price. Here, transfer price is determined based on the price that will be charged to an unrelated customer or by reference to sales of similar products of other companies to unrelated parties. Its efficiency is determined by existence of competitive markets and dependable market quotations.

3. Negotiated price. Transfer price is determined by negotiation between buyer and seller and may be unrelated to cost or market value. Its efficiency relies on external markets as information source for basis of negotiation. It could be disadvantageous because negotiations may take a while.

International transfer pricing has two objectives, performance evaluation and cost minimization. Performance evaluation has to do with evaluating the performance of both parties and for this to be done fairly; the transfer price should be one that is acceptable to both parties. Cost minimization has to do with the use of optional transfer prices mandated by headquarters to meet up with differences between countries in intercompany transactions. Some objectives of cost minimization include; avoidance of withholding taxes, minimization of import duties, improving competitive position of foreign operation etc.

The two objectives have a point of conflicting interest and cost-minimization also has conflicting objectives within itself. To fix the conflict between performance evaluation and cost minimization which is dictation of transfer prices to minimize costs, the companies could employ dual pricing. While to fix the conflicts between costs minimization e.g. companies can employ linear programming techniques to determine the optimum transfer.