INTERNATIONAL TRANSFER PRICING

INTRODUCTION

Transfer pricing refers to the determination of the price at which transactions between related parties will be carried out. Transfers can be from a subsidiary to its parent (upstream), from the parent to a subsidiary (downstream), or from one subsidiary to another of the same parent. Transfers between related parties are also known as ***intercompany transactions.*** Intercompany transactions represent a significant portion of international trade.

Two factors heavily influence the manner in which international transfer prices are determined. The first factor is the objective that headquarters management wishes to achieve through its transfer pricing practices. One possible objective relates to management control and performance evaluation. Another objective relates to the minimization of one or more types of costs. These two types of objectives often conflict.

The second factor affecting international transfer pricing is the law that exists in most countries governing the manner in which intercompany transactions crossing their borders may be priced. These laws were established to make sure that multinational corporations (MNCs) are not able to avoid paying their fair share of taxes, import duties, and so on by virtue of the fact that they operate in multiple jurisdictions. In establishing international transfer prices, MNCs often must walk a fine line between achieving corporate objectives and complying with applicable rules and regulations. In a recent survey, more respondents (39 percent) identified transfer pricing as the most important issue they face compared to all other international tax issues.

DECENTRALIZATION AND GOAL CONGRUENCE

Business enterprises often are organized by ***division***. A division may be a profit centre, responsible for revenues and operating expenses, or an investment centre, responsible also for assets. In a company organized by division, top managers delegate or decentralize authority and responsibility to division managers. ***Decentralization*** has many advantages, including the following:

i. Allowing local managers to respond quickly to a changing environment.
ii. Dividing large, complex problems into manageable pieces.
iii. Motivating local managers who otherwise will be frustrated if asked only to implement the decisions of others

However, decentralization is not without its potential disadvantages. The most important pitfall is that local managers who have been granted decision-making authority may make decisions that are in their self-interest but detrimental to the company as a whole. The corporate accounting and control system should be designed in such a way that it provides incentives for local managers to make decisions that are consistent with corporate goals. This is known as ***goal congruence***. The system used for evaluating the performance of decentralized managers is an important component in achieving goal congruence.

The price at which an intercompany transfer is made determines the level of revenue generated by the seller, becomes a cost for the buyer, and therefore affects the operating profit and performance measurement of both related parties. Appropriate transfer prices can ensure that each division or subsidiary's profit accurately reflects its contribution to overall company profits, thus providing a basis

for efficient allocation of resources. To achieve this, transfer prices should motivate local managers to make decisions that enhance corporate performance, while at the same time providing a basis for measuring, evaluating, and rewarding local manager performance in a way that managers perceive as fair. If this does not happen (i.e., if goal congruence is not achieved), then the potential benefits of decentralization can be lost.

Even in a purely domestic context, determining a transfer pricing policy is a complex matter for multi-division organizations, which often try to achieve several objectives through such policies. For example, they may try to use transfer pricing to ensure that it is consistent with the criteria used for performance evaluation, motivate divisional managers, achieve goal congruence, and help manage cash flows. For MNCs, there are additional factors that influence international transfer pricing policy.

TRANSFER PRICING METHODS

The methods used in setting transfer prices in an international context are essentially the same as those used in a purely domestic context. The following three methods are commonly used:

1. ***Cost-based transfer price***: The transfer price is based on the cost to produce a good or service. Cost can be determined as variable production cost, variable plus fixed production cost, or full cost, based on either actual or budgeted amounts (standard costs). The transfer price often includes a profit margin for the seller (a "cost-plus" price). Cost-based systems are simple to use, but there are at least two problems associated with them. The first problem relates to the issue of which measure of cost to use. The other problem is that inefficiencies in one unit may be transferred to other units, as there is no incentive for selling divisions to control costs. The use of standard, rather than actual, costs alleviates this problem.
2. ***Market-based transfer price:*** The transfer price charged a related party is either based on the price that would be charged to an unrelated customer or determined by reference to sales of similar products or services by other companies to unrelated parties. Market-based systems avoid the problem associated with cost-based systems of transferring the inefficiencies of one division or subsidiary to others. They help ensure divisional autonomy and provide a good basis for evaluating subsidiary performance. However, market-based pricing systems also have problems. The efficient working of a market-based system depends on the existence of competitive markets and dependable market quotations. For certain items, such as unfinished products, there may not be any buyers outside the organization and hence no external market price.
3. ***Negotiated price***: The transfer price is the result of negotiation between buyer and seller and may be unrelated to either cost or market value. A negotiated pricing system can be useful, as it allows subsidiary managers the freedom to bargain with one another, thereby preserving the autonomy of subsidiary managers. However, for this system to work efficiently, it is important that there are external markets for the items being transferred so that the negotiating parties can have objective information as the basis for negotiation. One disadvantage of negotiated pricing is that negotiation can take a long time, particularly if the process deteriorates and the parties involved become more interested in winning arguments than in considering the issues from the corporate perspective. Another disadvantage is that the price agreed on and therefore a manager's measure of performance may be more a function of a manager's ability to negotiate than of his or her ability to control costs and generate profit.

OBJECTIVES OF INTERNATIONAL TRANSFER PRICING

Broadly speaking, there are two possible objectives to consider in determining the appropriate price at which an intercompany transfer that crosses national borders should be made: (1) performance evaluation and (2) cost minimization.

Performance Evaluation

To fairly evaluate the performance of both parties to an intercompany transaction, the transfer should be made at a price acceptable to both parties. An acceptable price could be determined by reference to outside market prices (e.g., the price that would be paid to an outside supplier for a component part), or it could be determined by allowing the two parties to the transaction to negotiate a price. Policies for establishing prices for domestic transfers generally should be based on an objective of generating reasonable measures for evaluating performance; otherwise, dysfunctional manager behaviour can occur and goal congruence does not exist. For example, forcing the manager of one operating unit to purchase parts from a related operating unit at a price that exceeds the external market price will probably result in an unhappy manager. As a result of the additional cost, the unit's profit will be less than it otherwise would be, perhaps less than budgeted, and the manager's salary increase and annual bonus may be adversely affected. In addition, as upper management makes corporate resource allocation decisions, fewer resources may be allocated to this unit because of its lower reported profitability.

Assume that Alpha Company (a manufacturer) and Beta Company (a retailer) are both subsidiaries of Parent Company, located in the United States. Alpha produces DVD players at a cost of $100 each and sells them both to Beta and to unrelated customers. Beta purchases DVD players from Alpha and from unrelated suppliers and sells them for $160 each. The total gross profit earned by both producer and retailer is $60 per DVD player.

Alpha Company can sell DVD players to unrelated customers for $127.50 per unit, and Beta Company can purchase DVD players from unrelated suppliers at $132.50. The manager of Alpha should be happy selling DVD players to Beta for $127.50 per unit or more, and the manager of Beta should be happy purchasing DVD players from Alpha for $132.50 per unit or less. A transfer price somewhere between $127.50 and $132.50 per unit would be acceptable to both managers, as well as to Parent Company. Assuming that a transfer price of $130.00 per unit is agreed on by the managers of Alpha and Beta, the impact on income for Alpha Company, Beta Company, and Parent Company (after eliminating the intercompany transaction) is as follows:

	Alpha	**Beta**	**Parent**
Sales	130.00	160.00	160.00
Cost of Sales	(100.00)	(130.00)	100.00
Gross Profit	30.00	30.00	60.00
Tax (35% of Profit)	(10.50)	(10.50)	(21.00)
Profit after Tax	19.50	19.50	39.00

Now assume that Alpha Company is located in Taiwan and Beta Company is located in the United States. Because the income tax rate in Taiwan is only 25 percent, compared with a U.S. income tax rate of 35 percent, Parent Company would like as much of the $60.00 gross profit to be earned by Alpha as possible. Rather than allowing the two managers to negotiate a price based on external market values,

assume that Parent Company intervenes and establishes a ***"discretionary"*** transfer price of $150.00 per unit. Given this price, the impact of the intercompany transaction on income for the three companies is as follows:

	Alpha	**Beta**	**Parent**
Sales	150.00	160.00	160.00
Cost of Sales	(100.00)	(150.00)	100.00
Gross Profit	50.00	10.00	60.00
Tax (25%/35%)	(12.50)	(3.50)	(16.00)
Profit after Tax	37.50	6.50	44.00

The chief executive officer of Parent Company is pleased with this result, because consolidated income for Parent Company increases by $5.00 per unit, as will cash flow when Alpha Company and Beta Company remit their after-tax profits to Parent Company as dividends. The president of Alpha Company is also happy with this transfer price. As is true for all managers in the organization, a portion of the president's compensation is linked to profit, and this use of discretionary transfer pricing will result in a nice bonus for her at year-end. However, the president of Beta Company is less than pleased with this situation. His profit is less than if he were allowed to purchase from unrelated suppliers. He doubts he will receive a bonus for the year, and he is beginning to think about seeking employment elsewhere. Moreover, Beta Company's profit clearly is understated, which could lead top managers to make erroneous decisions with respect to Beta.

Cost Minimization

When intercompany transactions cross national borders, differences between countries might lead an MNC to attempt to achieve certain cost-minimization objectives through the use of discretionary transfer prices mandated by headquarters. The most well-known use of discretionary transfer pricing is to minimize worldwide income taxes by recording profits in lower-tax countries. As illustrated in the preceding example, this objective can be achieved by establishing an arbitrarily high price when transferring to a higher-tax country. Conversely, this objective is also met by selling at a low price when transferring to a lower-tax country.

Conflicting Objectives

There is an inherent conflict between the performance evaluation and cost- minimization objectives of transfer pricing. To minimize costs, top managers must ***dictate*** a ***discretionary transfer price***. By definition, this is not a price that has been negotiated by the two managers who are party to a transaction, nor is it necessarily based on external market prices or production costs. The benefits of decentralization can evaporate when headquarters managers assume the responsibility for determining transfer prices.

One way that companies deal with this conflict is through ***dual pricing***. The official records for tax and financial reporting are based on the cost-minimizing transfer prices. When it comes time to evaluate performance, however, the actual records are adjusted to reflect prices acceptable to both parties to the transaction factoring out the effect of discretionary transfer prices. Actual transfers are invoiced so as to minimize costs, but evaluation of performance is based on simulated prices.

Other Cost-Minimization Objectives
In addition to the objective of minimizing worldwide income taxes, a number of other objectives can be achieved through the use of discretionary transfer prices for international transactions. They include:

i. ***Avoidance of Withholding Taxes***: A parent company might want to avoid receiving cash payments from its foreign subsidiaries in the form of dividends, interest, and royalties on which withholding taxes will be paid to the foreign government. Instead, cash can be transferred in the form of sales price for goods and services provided the foreign subsidiary by its parent or other affiliates. There is no withholding tax on payments for purchases of goods and services. The higher the price charged the foreign subsidiary, the more cash can be extracted from the foreign country without incurring withholding tax.
Selling goods and services to a foreign subsidiary (downstream sale) at a higher price reduces the amount of profit earned by the foreign subsidiary that will be subject to a dividend withholding tax. Sales of goods and services by the foreign subsidiary to its parent (upstream sale) at a lower price will achieve the same objective.
ii. ***Minimization of Import Duties (Tariffs)***: Countries generally assess tariffs on the value (based on invoice prices) of goods being imported into the country. These are known as ad valorem import duties. One way to reduce ad valorem import duties is to transfer goods to a foreign operation at lower prices.
iii. ***Circumvent Profit Repatriation Restrictions:*** Some countries restrict the amount of profit that can be paid as a dividend to a foreign parent company. This is known as a profit repatriation restriction. A company might be restricted to paying a dividend equal to or less than a certain percentage of annual profit or a certain percentage of capital contributed to the company by its parent. When such restrictions exist, the parent can get around the restriction and remove "profit" indirectly by setting high transfer prices on goods and services provided the foreign operation by the parent and other affiliates. This strategy is consistent with the objective of avoiding withholding taxes
iv. ***Protect Cash Flows from Currency Devaluation***: In many cases, some amount of the net cash flow generated by a subsidiary in a foreign country will be moved out of that country, if for no other reason than to distribute it as a dividend to stockholders of the parent company. As the foreign currency devalues, the parent currency value of any foreign currency cash decreases. For operations located in countries whose currency is prone to devaluation, the parent may want to accelerate removing cash out of that country before more devaluation occurs. One method for moving more cash out of a country is to set high transfer prices for goods and services provided the foreign operation by the parent and other related companies.
v. ***Improve Competitive Position of Foreign Operation:*** MNCs also are able to use international transfer pricing to maintain competitiveness in international markets and to penetrate new foreign markets. To penetrate a new market, a parent company might establish a sales subsidiary in a foreign country. To capture market share, the foreign operation must compete aggressively on price, providing its customers with significant discounts. To ensure that the new operation is profitable, while at the same expecting it to compete on price, the parent company can sell finished goods to its foreign sales subsidiary at low prices. In effect, the parent company absorbs the discount.
The parent company might want to improve the credit status of a foreign operation so that it can obtain local financing at lower interest rates. This generally involves improving the balance sheet by increasing assets and retained earnings. This objective can be achieved by setting low transfer

prices for inbound goods to the foreign operation and high transfer prices for outbound goods from the foreign operation, thereby improving profit and cash flow.

The table below summarises the transfer price (high or low) needed to achieve various cost minimisation objectives:

OBJECTIVE	**TRANSFER PRICING RULE**
1. Minimise Income Taxes:	
a. Transfer to a country with higher tax rate	High Price
b. Transfer to a country with lower tax rate	Low Price
2. Minimise Withholding taxes:	
3. Downstream transfer	High Price
4. Upstream transfer	Low Price
5. Minimise import duties	Low Price
6. Protect foreign cash flows from currency devaluation	High Price
7. Avoid repatriation restrictions	High Price
8. Improve competitive position of foreign operation	Low Price

It should be noted that these different cost-minimization objectives might conflict with one another. For example, charging a higher transfer price to a foreign affiliate to reduce the amount of withholding taxes paid to the foreign government will result in a higher amount of import duties paid to the foreign government. Companies can employ linear programming techniques to determine the optimum transfer price when two or more cost-minimization objectives exist. Electronic spreadsheets also can be used to conduct sensitivity analysis, examining the impact different transfer prices would have on consolidated profit and cash flows.