

Factors and Functions Affecting Transfer Pricing

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Abstract

Transfer pricing is one of the hottest topics not only in international businesses but also for tax authorities, since the presence of price manipulation tendency of companies can affect the taxable profit base and at the same time the potential tax revenues of a specific country. The income shifting activities through price manipulations are limited by tax authorities and other international institutions and are regulated with the concept called arm's length principle. This principle requires the intra company charges to be defined at the same conditions which might set up while transacting with independent parties. Transfer pricing has been studied from different approaches: economic theory, linear programming, behavioral and accounting perspective. Besides of tax purposes it has been mentioned for: measuring of divisional performance, goal congruence, clarity of business processes and operations. Three types of Transfer pricing have been considered common for companies: market based, cost based and negotiated Transfer Prices. Cost base Transfer Prices and C+ method are more preferable by service providers, especially by companies providing some specific services for which exact comparisons are difficult to find. According to the analysis of two main TP methods: traditional transactional methods and profit based methods it can be said that there is not a good or a bad Transfer pricing method, the selection depends on the characteristics of the company being analyzed and on the circumstances where it operates. The research approach used in the study is qualitative. A direct observation of one case company engaged in service industry was done. The objective of this research is to understand the importance of Transfer pricing issues and implementation processes in corporate level. Additionally, a one types of semi structured questionnaires were designed and distributed to the company representatives and Transfer pricing experts with the main goal to gain additional insights on how professionals are assessing Transfer pricing importance, and to compare the Transfer pricing issues between the professionals in the field and managers of the companies

Keywords: Transfer Pricing, Arm's Length Principle, International Financial Management, Multinational Companies

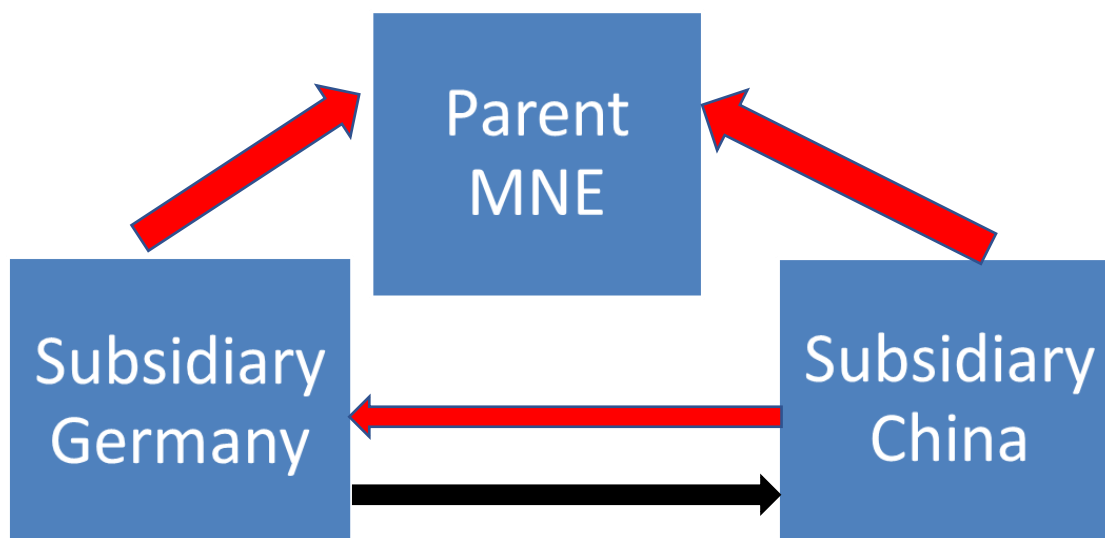
Introduction

Multinational companies operate in different economic, financial, legal, socio-cultural, political environments, so the main goal of the companies is to take advantages from the

country differences, especially from different tax regimes. Transfer prices are very crucial in defining revenues/expenses of the company, thus they can be used to reduce companies' tax liabilities by shifting their profits from a high tax country to a low tax one or completely transferring them to tax heavens. The set high transfer prices can move a company profits to the low tax countries and low transfer prices can position the funds in that country.

In order to utilize the cash resources and to minimize the global tax liability multinational companies are transferring funds from one location to another. These transfers appear as parent –subsidiary and subsidiary-subsidary transfers and are shown in the below figure:

Fig.3 Flows of funds between parent and subsidiaries (Adapted version)



From the above figure it can be seen that the transfer of funds among related entities may be multidimensional in the form of: intra company loans, interest payments, capital investments, dividend payments, royalties, fees, and other trade transactions in the form of products or services charges. All the transactions between related entities are referred to intra group transactions. "There is an evidence that intra group transactions are growing steadily and arguably accounts for more than 30% of all international transactions, especially transactions involving intangibles and multi tiers services.

Prices of goods and services charged by unrelated companies are formed based on market conditions, thus are defined by supply and demand for a particular product or service, unlike market prices transfer prices are created in business transactions between related entities, so they can influence each other and may agree in order to determine the needed transaction prices. The aim of the agreement is to avoid the tax burden and to shape the profits, showing better financial results in the places with lower income tax rates and lower profits in countries with high income tax rates. Transfer prices are one of the main challenges of national economies, especially tax authorities, since they present an outflow of funds from one economy to another.

Transfer pricing is a key issue in international business that has been studied from micro and macro perspectives. Micro level examines the importance of transfer pricing decisions in a company level addressing the problem called corporate transfer pricing problem, whereas macro level tries to measure the impact of transfer pricing in the general economy, addressing

some important issues like: loss on budget revenues and its wider impact on development and poverty alleviation.

Main Research Questions and Hypothesis Formulation

The central research questions that will be addressed in this research paper are as follow:

1. How the company can define the factors affecting transfer pricing strategy?
2. Which of the methods used is appropriate for the case company?

The following hypotheses are stated in order to find answers to the central theme questions;

H1: If Transfer pricing is done properly can improve the overall success of affiliation of the Multinational company

The Hypotheses are formulated in order to gain insight in transfer pricing and to ease the implementation of the transfer pricing strategy as a new concept for the case company.

Literature Review

Transfer pricing became an important concept for international companies which are following divisional and decentralized organizational structures, where divisions are organized in the form of profit centers or strategic business units (SBUs) each of them bearing a responsibility for their own costs and profits. Transfer pricing might have a distorting effect on profits, therefore the performance measurement and units assessments becomes a critical task for business units managers to achieve. Thus, the internal profit allocation gains importance as one of the main function of transfer pricing (Schuster, 2010, p. 142).

The other function of transfer pricing is a coordination function which aims to guide all business unit managers toward the profit maximization goal. When all of business units' managers will be oriented toward this than the overall company goal will be maximized, so their decisions will be identical with group top manager's (ignoring tax and foreign exchange risk factors).

Generally, TP are emphasized by three main types of price determination techniques: market based, cost based and negotiated transfer prices.

Market based transfer prices are used when competitive markets for products or services exist; using market prices reduces the division's manager autonomy to decide on transfer prices, since prices are defined by external market conditions, also there might be cases where a fix discount is subtracted from market price called adjusted external market price. Because the company managers do not have an autonomy to decide on transfer price and it is determined from market conditions these prices can be referred to "arm's length prices". Market based transfer prices are considered more realistic than other types of transfer prices and more preferable by tax authorities.

Cost based transfer prices are used when market prices for particular products or services do not exist, so the seller incorporates the actual standard costs plus a markup in a transfer price. Cost based type is criticized because it does not give to the selling part an incentive to be efficient, because every cost of product or service delivery is passed to the

buying side. Perfect marketplace conditions do not exist in practice, so cost based and negotiated prices become more used than market prices.

Negotiated transfer prices are created as a result of direct negotiations between sellers and buyers. This type of transfer price does not require high level of management engagement since the prices depend on the negotiation between subunits or affiliate managers.

The types of transfer prices and the subunit autonomy level are best described in the below figure:

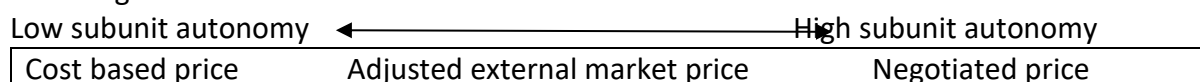


Fig 4. The unit autonomy in Types of transfer pricing Source: Internal and external factors on firms transfer pricing decisions Dan Li.

A survey done (1990) among companies in United States, Japan and Canada showed that cost based transfer pricings were more preferred than other types, the percentages were approximately 47% against 35% for market based TP and 18% for negotiated TP. Cost based transfer prices are usually preferred for service industries when the service provided is so specific and there is no option to find the same or almost the same comparable companies.

Factors Affecting Transfer Pricing

Several studies were done in order to determine the factors affecting transfer pricing decisions and they are categorized into internal and external factors. Within internal factors the nature of internal transfers, technological environment and social environments are the main subjects that were studied.

The nature of internal transfers factor tries to find a link between product being transferred and transfer type which will be used. According to (Dan Li) transfer pricing methods are depended by product life cycle, which means that for products which are newly introduced in market the transfer price will be determined by production costs since there is not any similar product for which comparison can be done. Otherwise, for products that have reached maturity in the market external market prices can be used. Also, studies have considered the relation between product characteristics and chosen transfer price and the conclusions were that in specific products the preferred price was cost base whereas in cases of standardized products the used prices were market based.

Internal technological environment factors are trying to determine the transfer price based on the production technology of a company. Three types of technologies used were analyzed: long linked, mediating, and intensive (Dan, 2007). Companies using long linked technologies are those which rely on mass and standardize production and the transfer price in this case will be determined based on production costs. Mediating technologies are used by companies which rely on a strong interdependence-competition between organizational units.

Internal social environment stresses the importance of cooperation among subunits.

When a high level of trust exists among subunits, the flow of information is easier and the prices which can be easily set are negotiated prices. The opposite circumstances where a level of cooperation among subunits is low require the use of market price when such a price exists

in external market or when market prices are not available a standard mark up to be added to costs can be defined and communicated to subunits.

In the light of external factors some of them were analyzed by different scholars like technological, legal, economic and social factors. Technological factors mainly focus on analyzing the companies operation within stable and unstable technological environments. Companies which operate in stable technological environments, tend to produce more standardized products, thus can use market transfer prices as one of the cheapest and easily utilized transfer pricing methods, whereas companies operating in unstable technological environments where the possibility to find external market prices is difficult use market based or negotiated prices.

Transactional Methods

Comparable uncontrolled price method (CUP) - The comparable uncontrolled price method compares the price of a controlled transaction to the price of comparable uncontrolled transaction in comparable circumstances (UN study on transfer pricing methods, 2012, p.4). The controlled transaction is any transaction between related entities compared to an uncontrolled transaction which refers to the transactions between non related parties. The comparable transactions may be in the form of external and internal comparable where internal comparable is a comparison between an associated enterprise and an unrelated company and external comparable is a comparison between two unrelated entities. The comparison conditions required by CUP method are difficult to be achieved because in practice it is hard to find two identical companies which are trading same products or services and at the same quantities. Moreover, from the market operation point of view it is hard to detect the companies that are exposed to same market conditions and credit terms. Therefore, adjustments are necessary in order to make companies to be comparable. The adjustments may be done for the sales volume, product quality, transaction conditions (credit terms, guarantees), market level (whole sale, retail, distributors)

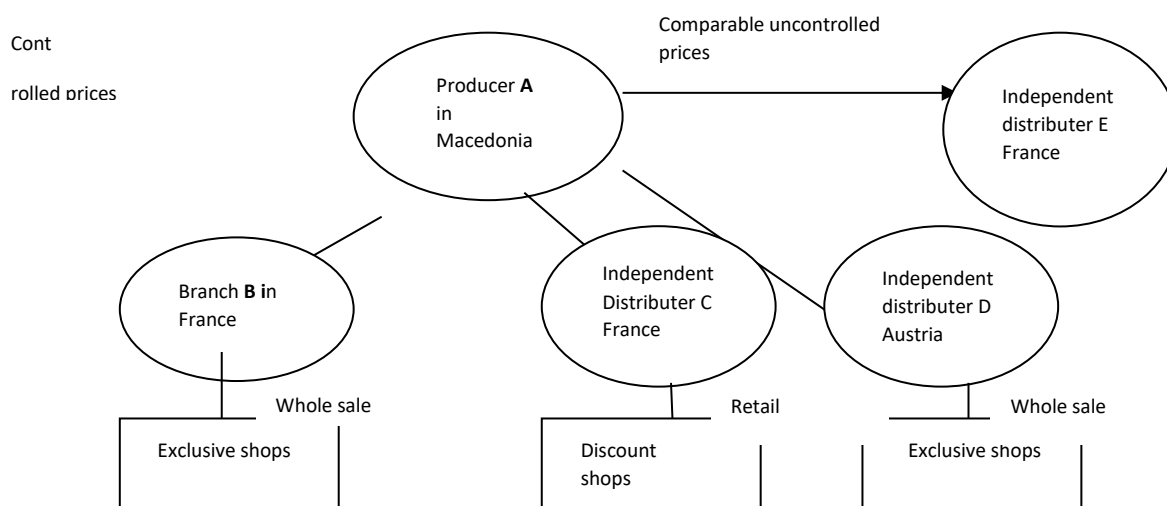


Fig.5 Cup Method between related and non-related parties (Adapted by A. Dimitrievski "Трансферни Цени, поими, карактеристики и нивно препознавање, Рафајловски Консалт, 2012)

Consider the above case of a shoe and bag producer in Macedonia which sells shoes to its branch in France and to unrelated distributors in France and Austria and bags only to the unrelated distributor in France. The branch B and the independent distributor D are selling to exclusive shops, whereas an independent distributor C is selling to discount shops. The branch B pays to the producer A after it sells the goods and the other distributors C, D and E pay to the producer A with the letter of exchange after 30 days. The question is whether the price between the producer A and the branch B are comparable prices? For this reason the prices between unrelated parties C, D and E are compared. The prices of the distributor E are not for comparison because there are two different products which are traded, so the distributor E will be excluded from the analysis. The prices of the distributor C are not for comparison because they are retail prices and this is not for the case of the branch B. The prices of the independent distributor D of Austria can be used as comparable transaction because the transaction conditions and selling prices are almost the same, but with the condition the markets between France and Austria need to be comparable, the necessary adjustments need to be done for the credit terms between B and D.

This method can be applied when homogenous and non-branded products are traded between parties as it is easier to find external comparable for this kind of products. The difficulty in applying this method is finding external comparable.

Resale Price Method - This method is applied in the cases where the same product is sold twice, the first transaction is between a producer which sells the product to its related party and the second is a transaction between the related party B and an unrelated buyer C. The price charged between the unrelated enterprise and the associated enterprise B is a market price- arm's length price and represents the gross margin with which a selling company, associated enterprise B in this case will cover its expenses and will make a profit. The transfer price in this method is calculated with this formula: $TP = RSP * (1 - GPM)$, where RSP is a resale price and GPM is gross profit margin. Example: An associated enterprise A sells a product to an associated enterprise B which then resale it to the unrelated party C at a price at 100\$ and gross margin 20%, so the transfer price between related entities will be calculated as follows : $100\$ * (1 - 20\%) = 80\$$. This method is more used in the cases of distributors and the differences between the characteristics of the products traded are less important than in the case of CUP method. This method requires the comparable companies which are operating in the same level of the trade network, example distributors and the assumption is that the competition between distributors makes them to use almost the same gross margins.

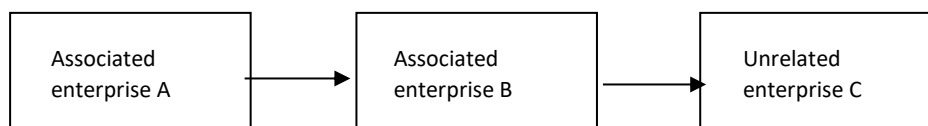


Fig. 6 Resale price method among three entities

Source: Transfer Pricing Methods UN Study

Cost plus method (CPM) – Cost plus method determines an arm's length price by adding a specific mark up on costs incurred by the supplier of goods or services. This method is most appropriate in the case of contracted production, semi production and in the provision of services. The mark up on costs can be defined by the reference to the mark-up that the

supplier can earn in a comparable uncontrolled transaction (internal comparable) or markups of other independent comparable companies can be used (external comparable). It is important to notice that when applying cost plus method and comparing markups, the cost bases of companies must be also comparable. The mark up used in cost plus method is a gross profit markup which is the ratio of gross profit to cost of goods sold, where gross profit is equal to sales minus cost of goods sold. When applying cost plus method it is important to notice that the gross profit margin used in this method uses only direct and indirect costs as cost of goods sold (UN, study on Transfer pricing methods), operating expenses are excluded. Accounting differences between companies analyzed is also important, that is why the necessary adjustments need to be done in this field (example: inventory valuation methods and some expenses included or not in the group of cost of goods sold may influence the gross profit mark-up calculation). Like every method the cost plus method has its advantages and disadvantages, some of the advantages of this method are: the access to cost information is easier as the method is based on internal costs (Un study on TP methods), prices based on full costs can be more defensible than prices defined by the other methods, simplicity, reducing the cost of decision making as in the cases of uncertain market conditions the use of C+ method gives stability to companies, price increases can be justified as costs increase, some of the disadvantages may be: a weak link between costs and market prices may exist, mark ups cannot be comparable due to the existing accounting differences, the method is based on actual costs since this fact can cause the manufacturer or the service provider not to have the incentive to reduce the costs.

Transactional Profit Methods

Transactional profit methods are based on profit analysis or net returns of a particular company with comparable unrelated companies.

Transactional Net profit margin method – This method aims to compare net profits in relation to a particular base costs, sales, assets (OECD, Review on TP Methods) which are realized by a related company in a controlled transaction with net margin of unrelated entities. Also while using this method a functional analysis needs to be carried out in order to determine the best comparable companies which can be as internal or external comparable. In transactional net profit margin method there are three cases of weighting the net profit. The first is net profit weighted to sales, the ratio used in this case is ROS and is a preferred method by distributing companies, the second is measuring net profit against assets with the ratio ROA, is used by companies characterized by capital intensive production process and the third case is using net profit against costs where only those costs which are directly or indirectly related to a transaction may be considered (OECD, Review on TP Methods). The third case is more common for service and manufacturing activities. The advantages of the net profit margin method is that there is an availability of external comparable (published financial ratios), this method tolerates more the functional differences between controlled and uncontrolled transactions. The weaknesses of the method can be that sometimes taxpayers might not have enough information regarding the profits of comparable uncontrolled transactions; also if not very good standard of comparability is applied while selecting comparable companies the reliability of transactional method can be affected.

Profit split method – This method is used by companies in which transactions between related companies are so interrelated that cannot be evaluated separately. The transfer prices

according to this method are determined based on profit allocation between related entities in the same manner as unrelated entities. There are two main approaches used for profit allocation: contribution and residual approach. Under the contribution analysis (CPSM) the overall profit of a company is split between enterprises based on the importance of the functions of those enterprises. When evaluating the importance of the functions and their impact on sales a neutral analysis is needed in order to determine which functions adds more value to the company, example sometimes a good marketing strategy can boost sales or a detailed operational planning was critical to the success.

Residual analysis of profit split (RPSM) is done through two stages, at the first stage the profit is equally split by the non-unique characteristics of the enterprises (Deloitte, Profit split methods, wave of the future? February, 2012, p.5), than in the second stage the remaining residual profit is allocated based on the contribution of every party on company profits, but also taking into consideration the allocation criteria used by independent third parties. The profit split methods are not heavily depended on the date of comparable third parties as profits are allocated based on every affiliate contribution, and because of this fact this method requires: a constant cooperation between related parties and an objective assessment of each enterprise functions.

Methodology Used

Methodology used in the study is exploratory research. The research starts from the research question formulation based on the problem statement and continues with the hypothesis formulation. A semi structured questionnaire is designed for this purpose.

The questionnaire will target the quality, the persons which are directly or indirectly involved in the transfer pricing issue that are: company tax consultants, finance employees and tax consultants from auditing companies that are specialized on this issue. The questionnaires are designed for is targeting company professionals and the other transfer pricing experts dealing with this issue.

TP is a new and unexplored topic for the Macedonia case which will influence companies operating in the country so a detailed analysis of country legislation covering this issue was done as the legislation part will have a significant impact on future strategic decisions of the case company.

Data Collection and Data Presentation

The Company (a case study selected) is an international company which delivers life support and infrastructural services targeting task forces, aid organizations and other private companies which operate in remote places. The company has shown to be very successful in the establishment of these services and was awarded with many references by his business partners and well recognized international service standards. In order to be efficient and reduce its operational costs, the company has spread its activities in different parts of the world, headquartered in UAE it has established other affiliates in different countries like: USA, China, Turkey, Kuwait and Macedonia. The affiliate operating in Macedonia has been established for recruitment and other administrative support services. As the company is multinational it deals with providing some services to its related companies or other affiliates,

so the question of pricing the intra company transactions becomes highly important for the company itself.

In order to answer the main research questions which aim to measure the importance of TP strategy and its factors and methods implementation within a case company, the most appropriate TP for services provided and the TP strategy compatibility with country legal requirements a semi structured questionnaire was prepared and distributed to the finance personnel. The aim of the questionnaire was to understand the implementation process of TP within a company and what company values most during this process of implementation. Some additional TP experts were included in the respondent base so as to compare their opinions with the understanding of company representatives on this topic.

When it comes to the pricing of intra company transactions TP is the only option which can be applied in international business stage, it is a universally accepted principle, defined and regulated in detail by OECD. All respondents gave almost the same answer to this question. Some of them mentioned that in less developed countries where the concept of TP is relatively new, tax authorities usually request a pricelists for products or services without mentioning the necessity of TP documentation. In the literature there is an approach called “unitary taxation with formula apportionment” where the overall profit of a company is apportioned based on one agreed formula which can be: third party sales, assets located in a particular affiliate, or employees engaged for fulfillment of company activities. This approach gives importance to the economic activity of a company, but again it resembles to the profit split method of TP. The approach was used in the US a century ago.

TP concept	Company representatives	Experts
TP is a unitary concept in international business	Yes even with some alternatives	Yes
Pros of TP implementation are almost the same	Yes	Yes
Arm’s length principle affects TP	Yes	Yes
Company factors crucial for TP are almost the same	No	No
TP adds value to the companies’ fundamental goals	Yes	Yes
TP requires managerial and legal know how	Yes	Yes
C+ method is the most appropriate for the service companies	Yes	Yes but alternatives are possible
Same markups to the same cost base must be added	Yes/No	Yes/No depends on the case
The chosen TP method is compatible with Macedonian legislation	Yes	Yes

TP policies must be regularly updated and reviewed	Yes	Yes
Budgeting process is important for the pricing policy	Yes	Yes
Implementation process is as important as the determination of the arm's length range	Yes	Yes
Risks are directly linked with the TP process	Yes	Yes
Centralized TP strategies are more favorable than the decentralized strategies	Yes	Yes/No depends on the case

All the respondents agreed that the question of adding value to company's fundamental goal was very important, addressing the aim of TP implementation. The main goal of every company is profit maximization and TP strategy must be defined in a way which will facilitate the fulfillment of this goal. Companies are spreading their value creation activities- indifferent parts of the world in order to increase their efficiencies while performing these value creating functions and with this the role of transfer pricing increases, as the pricing of intra company transactions inside the value chain will determine the tax obligations of every affiliate. So, a well-defined, sound, reviewed and defensible TP policy in front of tax authorities can or what it is called a right TP applied can save a company huge amounts in taxes and make spread the activities in a Value Chain in a more efficient way. A concept called "Value Chain tax management" will ensure that business and tax goals of a particular MNE are fulfilled. Also legitimacy, transparency to the stakeholders and transparency of the business processes (tax authorities, banks and others), protecting of brand name are some additional benefits of TP which were mentioned by respondents. All of these arguments are in favor of the benefits of a well-documented TP policy, and confirm the first hypothesis, that TP is a tool which helps the company in fulfillment of its main profit maximization goal.

The answer given by respondents to the following questions justifies the second stated hypothesis which is about the choosing the most appropriate method for the case company and to come up with the process of a successful TP implementation policy.

Contribution of the Study

Transfer pricing is one of the actual topics for tax administrations and companies; it became important as a result of increasing penalties of noncompliance with the arm's length principle. It is obvious that the tendencies of tax administrations will be: increasing their staffing on this issue, documentation requirements, and geographical scope of inspections and tightening of benchmarking rules, to which companies must respond with additional preparations, staffing and specific implementation procedures. So this research paper shows how "the transactions must be kept at arm's length" which means that legal entities must behave independently or must avoid the conditions of becoming connected with someone or something.

Pricing of intra company transactions has become a major concern of Multinational Corporations' management. The price used to transfer goods and services between related entities is referred to Transfer Pricing. The income shifting activities through price manipulations are limited by tax authorities and regulated with the concept called arm's length principle. This principle requires the intra company charges to be defined at the same conditions which might set up while transacting with independent parties. The Transfer pricing (TP) concept and arm's length principle in the world literature and practices are well known concept, whereas in North Macedonia this is a new and unexplored topic, which legally was regulated in Income Tax law after 2011 year.

Conclusion

Transfer Pricing is a unitary principle that must be followed by every company (affiliate) engaged in intra company transactions. The C+ method is more preferred for service industries, especially for specific services, but the possibility of using internal comparable also exist, if the CUP method cannot be applied, than the C+ methods are next to be considered, the appropriate method is defined based on the functional analysis of a company, the most suitable method for intra group services (accounting, management, IT, marketing etc) where the level of costs better describes the value added by that entity and thus the market price

The implementation and monitoring process within a company is as important for price determination, thus every affiliate is responsible for following the established Transfer Pricing policies and procedures. Transfer Pricing are not created for once they must be regularly reviewed and updated based on the changing business circumstances (business activities, restructurings, organizational structures), thus any process change must be communicated to the central company level in order to be decided which changes need to be done in the central TP strategy. TP decisions are strategic and important decisions as they shape the company's profitability, they are defined by central level of corporate group and communicated to the affiliates. Affiliates are responsible of creating their own policies and following the predefined rules.

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