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TRANSFER PRICING AND THE MULTINATIONAL CORPORATION

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Abstract

This paper discusses the three major methods of determining the transfer price for goods traded within a multinational firm - the comparable uncontrolled price method, the resale price method, and the cost plus method. In addition to tax considerations, five other factors affecting transfer pricing are discussed - foreign government considerations, funds positioning effects, fluctuating foreign currency, foreign import duties, and performance evaluation. Finally, a detailed example of applying the resale price method is provided. Since this is the most difficult method to apply, this example is of particular use to small firms with limited experience in transfer pricing.

I. INTRODUCTION

Transfer pricing is hardly a new area of concern for the managers of the multinational corporation. However, in recent years, transfer pricing practices have come under increased scrutiny from both U.S. and foreign tax authorities. The term transfer pricing refers to the value placed upon products sold within a firm. Under normal circumstances, these "products" relate not only to physical assets such as raw material or finished goods, but also to intangible assets such as patents and trademarks. This paper limits discussion to the transfer of physical assets between affiliated companies. This paper analyzes only United States domiciled corporations. The terms will deal only with U.S. parent companies and their foreign subsidiaries.

It is no secret that companies have been trying to move income into low tax rate countries. Prior to the Revenue Act of 1962, U.S. companies had significant opportunities to move profits - especially when the tax haven used happened to be a U.S. possession such as Puerto Rico. Multinational companies no longer have this luxury because the Internal Revenue Service has begun to monitor intra-corporate, or transfer, pricing much more closely. Since transfer pricing decisions have the potential for abuse and because major sums are involved, tightening of controls is natural by governments seeking additional sources of revenue. Many companies are currently being assessed large tax adjustments as a result of IRS investigations that have found their international transfer pricing policies abusive.

The purposes of this paper are (1) to review the options multinational companies may use for buying/selling products within their organization structures and (2) to understand the impact on reported earnings and financing decisions. In Section II, we will discuss the different transfer pricing methods that are allowed by the IRS. Section III will explain the additional concerns that must be considered such as foreign government acceptance and

subsidiary performance evaluation. A simple example of a transfer pricing model will be presented in Section IV that will take into consideration some of the key points made in the previous section.

II. TRANSFER PRICING METHODS

Transfer pricing refers to the price at which a U. S. parent company will sell or buy its products to or from its foreign subsidiaries. In its simplest form, the parent would sell a finished product to a foreign sales subsidiary that would in turn sell the product to a customer outside the firm. The transfer price the parent places on the product should allow both the parent and the subsidiary a "reasonable" profit for the level of expenditures incurred. This is what is referred to as "arm's length" pricing. The IRS examines comparable transactions between unrelated parties in attempting to determine if a given transaction is in fact an "arm's length" transaction. In determining what is considered to be a reasonable price, the IRS will analyze the activities of not only the U.S. parent but also the activities of the foreign subsidiary. What each contributes to the finished product and the risks each assumes are two factors that are considered. Should the IRS determine that the intra-company price is not an arm's length price, it has the power to allocate income between the parent and the subsidiary and to assess taxes based on this allocation. The real danger to the multinational firm when this occurs is that the foreign government would not accept the IRS "arm's length" allocation which would result in double taxation on a portion of the profits of the company. In a worst case scenario, the taxes could exceed the real profits of the transaction.

In more complex multinational organizations, the problem of proper profit allocation becomes very difficult. Organizations that have manufacturing plants in many different countries have varying amounts of total manufacturing effort performed in each facility. In addition, each plant may have the option to sell its product to either outside parties or to related parties within the organization.

Profit allocation between companies, and therefore between countries, would not be of concern to multinational companies if there were no taxes. As the income tax rates vary between countries, the level at which transfer prices are determined will have a direct impact on the net income of both the parent and the subsidiary.

There are two basic types of transfer pricing systems in use today - (1) those based on internal costs and (2) those based on external market prices. The prices derived from using either of these systems tend to converge at some percentage of mark-up or mark-down. Selection of either system is often arbitrary. The primary consideration of the IRS is how much these transfer prices vary from the property's real value. In the U.S., the IRS concentrates on market based prices when reviewing a firm's transfer prices. IRS regulations provide for three methods that should be used by multinational companies to establish "arm's length" transfer prices. These methods are (1) comparable uncontrolled prices, (2) resale prices, and (3) cost plus.

1. Comparable Uncontrolled Prices

Use of this method is considered the best evidence of arm's length pricing. Under this method, the arm's length price is determined by reference to the price paid in a comparable sale between unrelated parties. To be comparable, the physical equipment sold between related parties must be identical to that sold to an unrelated party. Also, the circumstances of the sale must be identical. In other words, the price arrived at through

transactions in the same goods that occur between the multinational firm and unrelated customers is the price that should be used for transactions within the multinational firm. Differences may exist only if they have no effect upon price or can be reflected by ascertainable adjustments to the price. Obvious factors to consider when determining comparability of prices are volume, price, market level, terms of sale, profitability, and service commitments.

2. Resale Price Method

The second acceptable approach to the IRS for determining an arm's length priced between related parties begins with the uncontrolled selling price of the subsidiary. This price is then reduced by an "appropriate" mark-up based on the gross profit percentage of the subsidiary. The subsidiary selling price minus gross profit determines the allowable selling price for the parent. That is, the selling price from the parent will be at a discount from the final customer purchase price. This allows the subsidiary to cover its selling and administrative expenses as well as earn a reasonable profit. As with the Comparable Uncontrolled Price Method, the physical property sold and the circumstances and conditions of the sale must be similar. However, in this case, factors that must be considered which will differentiate this activity from that of an uncontrolled price situation are: (1) the type of property, (2) the functions performed by both the seller and the buyer, (3) the intangible property used, and (4) the geographic market.

3. Cost Plus Method

The third method of arriving at arm's length prices is for the seller to add an appropriate mark-up for profit to total full costs. The appropriate mark-up to use should be the gross profit percentage from similar uncontrolled sales by the seller. In this situation, physical similarity of the property is not necessary. One advantage of using this method over market based prices is flexibility. Because cost elements that enter into the computation of the base price can be changed, the selling price can be changed.

It should be noted that the three methods are a hierarchy that the IRS uses to determine the "reasonableness" of intra-company pricing. When competitive market prices exist, the burden of proof is on the company to justify any departure from this price. For this reason, companies must monitor their particular situations very closely when developing and revising transfer prices. Each alternative must be considered starting with the comparable uncontrolled price method and working downward through the hierarchy. A strong defense of method selection should be developed when setting a transfer price in anticipation of audits by either U.S. or foreign tax authorities.

III. ADDITIONAL CONSIDERATIONS

The income tax effect of choosing a particular transfer pricing mechanism and IRS acceptance of the method chosen are not the only items with which a multinational corporation should consider when setting intra-corporate prices. Some other areas of concern are listed.

1. Foreign Government Acceptance

Governments are not alike, nor are they equally concerned with intra-corporate prices and the tax effects of transfer pricing. For the most part, foreign tax authorities concentrate on market based prices in determining the reasonableness of transfer pricing. Most governments use the same hierarchy as the IRS in determining whether or not a selling price is acceptable. However, governments may not agree

on the price even though they agree on the particular method used to determine the price.

2. Funds Positioning

Transfer pricing is one of many devices that the multinational company has to position funds within the company. A high transfer price to a subsidiary is an effective way for the parent to draw funds from a subsidiary. Alternatively, through the use of lower transfer prices, the subsidiary can easily be funded. Should there be a limit on the amount of dividends that can be paid by the subsidiary to the parent, e.g., a percentage of net income, the level of the transfer price will have a direct impact on the actual dividend paid. High transfer prices mean a low net income to the subsidiary and, therefore, a smaller dividend payment to the parent. A careful review of both the pricing and the dividend policies of the foreign country must be made before making final transfer price decisions.

3. Fluctuating Currencies

Foreign currency fluctuations can result in significant gains or losses for the multinational firm. Transfer pricing can be used to help minimize these earnings fluctuations, or at least shift them to the most desirable affiliate. The parent can shift foreign exchange exposure between the buyer and the seller simply by dictating the currency of payments. Alteration of the terms and timing of payment or the volume of shipments, through transfer pricing, affects the net foreign exchange exposure of the firm.

4. Foreign Import Duties

The amount of import duties a company must pay to a foreign government is usually a percentage of the value of an item entering the country. The effect of tariffs on a company as a result of a particular transfer price counteracts the income tax effect of the transfer price. However, the dollar value of duties is normally smaller than the dollar value of taxes. With low transfer prices, import duties will be low, however, income taxes will be high. Correspondingly high transfer prices lead to high duties and lower income tax rates.

5. Performance Evaluation

Evaluating management's performance in the subsidiary becomes a difficult task for the multinational firm when transfer prices are involved. The foreign subsidiary usually does not have much control over the determination of what it will be charged for a product by the parent. This is because of the many factors that affect multinational transfer pricing such as acceptance by both U.S. and foreign government tax officials of the price used, the tax effect, the funds positioning, and fluctuating currencies. How to resolve this problem has plagued the multinational for decades. Many companies maintain two sets of books in order to determine the subsidiaries performance if all intra-corporate profits are eliminated from the transactions. If transfer prices were used in evaluating a subsidiary's performance, a disincentive may arise as the managers of the subsidiary may believe that they are being evaluated on financial statements over which they have no real control.

IV. A NUMERICAL EXAMPLE

In this section, we will review how transfer pricing can affect the reported results of a U.S. multinational corporation. This company consists of the U.S. parent and one foreign subsidiary whose only function is to sell the parent's finished product in the subsidiary host country. For purposes of this analysis, we will assume that the company uses the Resale Price Method for determining its transfer prices. We do this because the sub-

sidiary is incurring all selling and marketing expenses and assumes market and accounts receivable risk. The parent sells its product to the subsidiary at a discount from customer purchase price to allow the subsidiary to cover its expenses and earn a reasonable profit for the level of risk assumed. In this example, we will review how fluctuating currencies and changing parent-to-subsidiary discounts affect the financial statements of the consolidated company.

The following information about both the parent and the subsidiary is used throughout the model:

Parent:	
Cost of product sold to sub	1000$
U.S. tax rate	40%
Subsidiary:	
Expected revenues	10,000LC
Cash operating expenses	1,000LC
Depreciation expense	400LC
Foreign tax rate	50%
Import duty rate	5%
General information:	
Expected exchange rate	0.25$/LC

Other assumptions relevant to this model are that the subsidiary cannot change its local currency selling price and its cash and depreciation expenses are fixed in local currency. Also, the currency in which the parent sells to the subsidiary is the U.S. dollar.

Let us now determine the impact of the following:

- setting the parent-to-subsidiary dis count at 20%, 30%, and 40%
- the dollar appreciates to .20$/LC and again to .15$/LC
- the dollar depreciates to .30$/LC and again to .35$/LC

Table 1 shows how changing discounts and fluctuation exchange rates affect the results of the company in question. Net profit in dollars varies significantly depending on the discount rate used and the foreign exchange rate in effect. Although this is of major concern to the company, the U.S. and foreign governments are more likely to be concerned with the return on revenues for each company as well as the profits split between the two companies.

Table 2 shows that at the expected exchange rate of .25 $/LC, the consolidated percentage return on revenues decreases as the discount from the parent-to-subsidiary goes from 20% to 40%. However, it should be noted that as the discount increases, the return for the subsidiary increases while the return to the parent decreases.

As the dollar appreciates, the return to the subsidiary decreases at all three discount rates with the 20% discount resulting in the largest loss to the subsidiary. The opposite holds true as the dollar depreciates with the 40% discount resulting in the largest return to the subsidiary. Note, however, that the return to the parent is constant at each discount rate even though the exchange rate is fluctuating. This is because the selling price is fixed in dollars and fixed at the expected exchange rate.

Table 3 shows the percentage split of total company profits between the subsidiary and the parent at each discount rate and at each exchange rate. Although we have already seen in Tables 1 and 2 the situations in which the subsidiary is operating at a loss, the information provided in this table is quite useful for other reasons. From this information, we can determine whether or not the profit split earned by the parent and subsidiary are reasonable for the level of expenditures and risks assumed by each.

The information in the three tables can be used by the company in setting prices for intra-corporate transfers. The information can also be

Table 1

NET PROFIT ($)

	20% Discount			30% Discount			40% Discount		
$.LC	Sub	Parent	Consol	Sub	Parent	Consol	Sub	Parent	Consol
.15	(405)	600	195	(273)	450	177	(142)	300	158
.20	(190)	600	410	(59)	450	391	72	300	372
.25	25	600	625	156	450	606	287	300	587
.30	240	600	840	371	450	821	502	300	802
.35	455	600	1055	586	450	1036	717	300	1017

Table 2

% RETURN ON REVENUES

$/LC	Sub	Parent	Consol	Sub	Parent	Consol	Sub	Parent	Consol
.15	(27.0)	30.0	13.0	(18.2)	25.7	11.8	9.5	20.0	10.5
.20	(9.5)	30.0	20.5	(3.0)	25.7	19.6	3.6	20.0	18.6
.25	1.5	30.0	25.0	6.2	25.7	24.2	11.5	20.0	23.5
.30	8.0	30.0	28.0	12.4	25.7	27.4	16.7	20.0	26.7
.35	13.0	30.0	30.1	16.7	25.7	29.6	20.5	20.0	29.1

Table 3

% OF TOTAL COMPANY PROFIT

	20% Discount		30% Discount		40% Discount	
#/LC	Sub	Parent	Sub	Parent	Sub	Parent
.15	(207.7)	307.7	(154.2)	254.2	(89.9)	189.9
.20	(46.3)	146.3	15.0	115.0	19.4	80.6
.25	4.0	96.0	25.7	74.3	48.9	51.1
.30	28.5	71.5	45.2	54.8	62.6	37.4
.35	43.1	56.9	56.6	43.4	70.5	29.5

used as a justification of prices for either the U.S. or foreign governments should either question the prices used. It should be noted, however, that numerical calculations alone are not enough to justify a particular price. Should the company used in the example choose the 30% discount rate for selling to its subsidiary, it should have well documented evidence justifying the 30% discount.

From the tables, it would appear that the 30% discount rate would be the appropriate rate to use given an expected exchange rate of .25 $/LC. This is because the return on revenues and the percentage split of total profits appear reasonable for the level of expenditures and risk assumed by each entity. However, at this discount rate, the return on revenues is not the best the company could have achieved at the expected exchange rate, 24% rather than the 25% return on investment achieved at the 20% discount rate. This is something that the company will have to accept as departures from the 30% discount rate would be difficult to justify to both the U.S. and the Foreign tax authorities.

The company must make its pricing decisions based on what it expects the exchange rate to be during the period, .25 $/LC, in this example. The information provided in the appendix can be useful to the company during the year should the exchange rate move in a way other than that expected. Quick reference to the tables will provide management with information that can be used to determine whether or not pricing changes are in order. However, pricing changes are not always easy to implement for many of the reasons mentioned throughout this paper. Management can still use the information provided in the tables to review other alternatives such as changing the currency of payment or changing the timing of payments in attempting to preserve reported earnings.

V. CONCLUSIONS

The area of transfer pricing and how it affects the multinational corporation is a very complex subject. Income taxes have historically been the driving force behind many transfer pricing decisions. However, there are many areas which must be considered in detail before any pricing decisions are made. Many of these areas were discussed in this paper.

When used properly, transfer prices allow a multinational company to run its business effectively and efficiently. However, if the wrong pricing decisions are made, the company could create difficulties with domestic and/or foreign tax authorities. For this reason, companies would be well advised not to allow tax rate considerations be the sole basis for determining transfer prices.

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