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Transfer Pricing and Its Implications on Global Indirect Taxation

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Transfer pricing refers to the price set for goods, services, intangibles, and capital transferred between one unit of an organization to units in different countries. This impacts the allocation of pre-tax profits earned by each party as well as the amount of corporate tax payable in each country. Consider a UK pharmaceutical company that wants to buy raw material from its subsidiary in China. Transfer price refers to how much the UK arm will pay the Chinese one for each unit of raw material. This will have a direct bearing on the profit earned by both parties and the local taxes they must pay in China and UK. Transfer pricing is an important function that helps multinational organizations to expand their business globally and reduce tax burden. But this practice can be misused and manipulated by unscrupulous companies. In fact, 60 percent of the global market is engaged in related-party transactions and such malpractices related to transfer pricing necessitate strict regulations for this function.[1]

The Principles Governing Transfer Pricing

The "arm's length" principle is the most used transfer pricing rule. This says that a transfer price should be comparable to a market transaction between two independent companies. Given the nature of related-party transactions, a range of arm's-length prices may exist for the same transaction.

There may not even be a correct arm's length price if there are no comparable third-party transactions, and in such cases, they may be difficult to infer. Comparable transactions may be expensive for the tax authority to observe due to information asymmetry. And because of these loopholes, multinational companies (MNCs) can sometimes work with artificially low prices on exports to low tax countries or artificially high prices for imports coming in from low tax countries in a bid to reduce their global tax liability.

Many countries implement transfer pricing regulations to mitigate revenue losses from incorrect pricing of inter-firm transfers. These regulations vary from mere acknowledgements of the arm's length principle to detailed reports. Stringent regulations increase the cost of mispricing and are effective in curbing the extent of profit shifting in developed countries. Compliance with transfer pricing regulations is critical so companies don't have to pay double taxes at a later stage and noncompliance can also lead to disputes with tax authorities, litigation, and substantial penalties.

Transfer Pricing Methods

There are a few established methods for transfer pricing practices:

Comparable Uncontrolled Price Method:
Prices in a transaction between two arms of a company are compared to that between two unrelated organizations. And to be fit for comparison the transactions must be as similar as possible. This method is recommended by the OECD and the arm's length principle can be applied to it easily as well. But finding a comparable transaction can prove to be difficult, which is why this is used only when there is enough information on the two transactions to compare.

The Resale Price Method:
he price of the product is the focal point in this. First it is reduced by a gross margin that is calculated by comparing with that in a transaction between unrelated entities. After this, miscellaneous costs such as custom duties are deducted. The resulting final amount is the arm's length price. This is very effective when there is data pertaining to comparable deals. But the fact that every contract is different makes this method difficult to carry out.

The Cost Plus Method:
This involves comparing the gross profits to cost of sales. The supplier costs in a deal between related parties is calculated, after which a markup is added to the amount. The markup amount usually depends on similar costs applicable to deals between unrelated companies. This is a useful method for routine, and relatively risk-free deals as it is easily calculated and implemented.

The Comparable Profits Method:
This is also called the transactional net margin method (TNMM) method. This is a very commonly used method and here the net profit of a deal between related companies is compared to that of companies not related to each other. Since it only calls for financial information, it is relatively easier to use. Product manufacturers with simple deals usually find this easier to work with. But it does not consider information on both parties in the deal, and this is why many tax regulators are increasingly rejecting this method for companies dealing in complex matters such as intellectual property.

The Profit Split Method:
Sometimes, transactions between related companies cannot be separately observed. In such cases they can use this method in which they agree to share the profits. This involves careful study of the terms and conditions pertaining to related and controlled deals and understanding how profits would be shared between unrelated companies making the same deal. This provides a wider and more accurate evaluation of an organization's financial status. This is very useful when transactions involve intangibles like intellectual property or when there are many transactions happening at the same time. But it is risky as the profit criteria is subjective and not compliant with the arm's length principle. Usually highly integrated organizations where all arms have equal value and assume equal risk go for this method.

The Right Technology for Managing Transfer Pricing

Transfer pricing processes can be complex and has its own challenges. Organizations require a robust transfer pricing process and a platform to manage the process seamlessly. The solution must:

- **Enable access to data:**
  The platform must let the organization compile the company's tax data from across the globe on one platform. With one consolidated data repository, the organization can simplify tax activities, reduce operational costs, and enhance intercompany transparency.
- **Ensure compliance:**
  The platform must be able to present a full picture of company's tax data. This allows tax teams to improve compliance. Organizations can thereby set stronger controls, enhance traceability and audit trails, and reduce the risk of audits by tax authorities.
- **Be driven by automation:**
  Relying on manual processes for complex and data-intensive tasks is not only prone to errors but also opens the business up to additional risks. Data errors can lead to inaccuracies in the transfer pricing process. Automation can help increase efficiency. An advanced, automated platform can improve data reliability, ensure quick processing of large volumes of data and help analyze records to create operational reports.
- **Allow real-time adjustments:**
  Having the organization's tax data in one place is a powerful tool. With the ability to view and handle real-time data, the organization can ensure that transfer pricing processes are accurate without having to wait until the end of the close cycle.
- **Enable profitability analysis:**
  Organizations can explicitly define profitability ranges and include profit goals with an advanced platform. With increased visibility into data, they can adjust the transfer pricing strategy as per market environment and changing tax regulations.

A robust transfer pricing solution is compliant with the rules governing it and will help the company ensure greater profits and a flourishing international business.

Sources:

[1]Tax justice