A DESCRIPTIVE STUDY ON TRANSFER PRICING

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ABSTRACT: *Transfer pricing is defined as the price which is paid for the goods transferred from one economic unit to another, assuming that the two units involved are situated in different countries, but belong to the same multinational firm. This article is a result of "A study on Transfer pricing". The study includes the methods that are involved in calculating the transfer prices and the applicability of transfer pricing to companies under the sections of Income Tax act. The data collected for this study is secondary data and is collected from the financials of the company. The tools used for calculating transfer pricing for such a company is Cost plus method. The interpretations made for using transfer pricing and its methods are discussed in detail in this study.*

Keywords – Transfer pricing, Arm's length price, Goal congruence

I.INTRODUCTION

Transfer pricing involves the trade of services or goods between two related companies and both can come out as a winner. It improves the efficiency of any business and it also simplifies the accounting process. With such heightened efficiency and streamlined accounting, precious man hours can be saved which leads to greater profitability and helps to focus on business strategy. A transfer pricing arrangement is usually between a parent company and a subsidiary or between two subsidiaries of the parent company. Since transfer pricing involves only sister companies, it does not make sense for one company to sell at above market price or the other company to buy at a below market price.

II.OBJECTIVES

- To study the various methods to derive the arms length price.
- To study the applicability of transfer pricing and international transfer pricing.

III.REVIEW OF LITERATURE

Nicole Bastian Johnson (2006) summarized in his study about the divisional performance measurement and transfer pricing. He explained three methods of transfer pricing viz., i) Royalty Based system ii) Negotiated Transfer Pricing and iii) Renegotiated Royalty based pricing. His study has revealed that, a royalty-based transfer price that can be re-negotiated provides better investment incentives than a non-negotiable royalty based transfer price or a purely negotiated transfer price. This provided efficient cost to the buyer, but creates a problem for the seller which leads to under – investment. The third method combines the features of both the other methods . But it is analyzed that protecting the developer of the intangible from a hold-up problem and providing efficient investment incentives for the buyer and provides first-best investment incentives for some types of investments.

Wittendorf (2010) has summarized in his study that the international transfer pricing which determines how the worldwide income of a multinational enterprise is divided among countries for income tax purposes when transactions occur within the firm. Facts state that the empirical literature documents the ability of multinational enterprises to shift income from high-tax to low-tax countries. On the other hand the theoretical literature reflects the current system that evolved in a world which is clearly not well suited for a world in which value is created by firms based on various factors.

IV.SCOPE OF THE STUDY

This study covers the present scenario of transfer pricing in our country through available information and efforts have been made to evaluate the prospect of it in taxation. One of the cornerstones of transfer pricing is the 'arm's length price' and this concept has today become ubiquitous finding its way into various legislations which is also covered in this study. This study also examines the relationship between transfer pricing and an entity's tax and financial reporting. Duties and taxes should not be allowed to be evaded, but at the same time the manner of regulating transfer pricing should not act as a disincentive to the flow of foreign investment. Therefore the study also makes an analysis of the above. One of the benefits of transfer pricing is, it helps in reducing the duty costs by shipping goods into high tariff countries at minimal transfer prices so that duty base associated with these transactions are low. Evaluations of these are also done in this study.

V.LIMITATION OF THE STUDY

- The financial information which is collected is secondary in nature. In this case , it carries all the information and financial statements which is inherent to limitations.
- Among organisational divisional managers , there can be disagreement between them as to how to set transfer price.

VI.SOURCES OF DATA COLLECTION

➢ **Secondary Data**

The secondary data are those data which have already been collected by someone else and it have already been passed through the statistical information. Thus the data was collected from company books and document reports.

The data were collected from secondary the major source of

secondary data were

1) Balance sheet
2) Form 3CEB of Income Tax Act,2003

VII. METHODS INVOLVED IN CALCULATING TRANSFER PRICING

The major concept which is applied to transfer pricing is Arm's length principle. Rules laid down for Arm's length principle is that the transfer prices between two commonly controlled entities should be treated in such a way that they are two independent entities. It is mainly based on the real markets and also provides a single international standard of tax computation, which enables various governments to collect their share of taxes and at the same time creates enough provisions for MNCs to avoid double taxation.

There are several method which the company uses to set the transfer prices. The most commonly used methods are ,

7.1 Comparable Uncontrolled Price(Market Rate transfer price)

Market rate is the most straightforward methods for calculating transfer prices.In simple terms, it means that the transfer price is the same as the current market price for the goods or services in question. The upstream unit can sell its goods and services with the market rate transfer price, either by conducting its sale internally or externally. The profit for the unit remains the same under both the methods.

7.2 Adjusted market rate transfer price

It is often used to derive transfer prices when the above market rate method is not available. This method accounts for an adjustment to current market price to some stated degree. For example, To eliminate the risk of late payments a company may choose to use a reduced price. In most cases, this stills falls within the arm's length principle.

7.3 Negotiated transfer pricing

With this method of transfer pricing, specific corporate units negotiate a price regardless of the market baseline price which is in fact can be quite different than the prevailing market price.

Companies often opt for negotiated transfer pricing method in situations where the market price is difficult to calculate; the market for the goods or service is limited; or the item in question is highly customized.

7.4 Contribution margin transfer price

Companies usually uses this method in cases where there is no set market price for the goods or services being sold . Under this method, based on the unit's contribution margin the companies calculate a market price "alternative"

7.5 Cost-plus transfer price methodology

This is the method that most of the companies uses. Our study also covers this method of calculating transfer prices. Cost-plus transfer price methodology is used when no valid market price exists. This method is often used in cases where the item in question is a manufactured good.

When calculating the cost-plus transfer price, companies tend to add a margin on the cost of the good by adding the standard cost onto a standard profit margin.

7.6 Cost-based transfer pricing

Some companies sell their goods or services to other units by using the production cost as their price point. If such a product or service is then sold to a third party, that unit can add its own costs to the final price.

Under this method, the company that does the final sale will receive the entire profit of the goods or service. This method is commonly used as a tax avoidance strategy.

VIII. APPLICATION OF TRANSFER PRICING REGULATIONS IN A BUSINESS:

When two or more associated companies enter into a mutual contract during an international transaction in order to apportion a particular cost incurred in relation with a benefit, service or facility offered by any one or all of the companies, such a cost shall be calculated considering the arm's length price of the particular benefit, service, or facility, as applicable.

The provisions of Section 92 to 92F of the Act are applicable only if:

► There are two or more enterprises (defined under Sec 92F)

► The enterprises are Associated enterprises (defined under Sec 92A)

► The enterprises enter into a transaction (defined under Sec 92F)

► The transaction is an International transaction (defined under Sec 92B)

► These Provisions do not apply in certain cases (Section 92(3))

► Further TP provisions shall also apply to specified domestic transactions w.e.f. 1 April 2012.

IX. A CASE STUDY ON GOAL CONGRUENCE:

You got an e-mail from Production Manager, it has been informed that 40 tonnes of material Dx would be required. This material is in regular use by AUS and has a current purchase price of `380 per tonne. Currently, there are 5 tonnes in inventory which cost `350 per tonne. The resale value of the material in inventory is `240 per tonne. Further, with regards to components, it has been informed that 4,000 components would be required. These could be bought externally for `15 each or alternatively they could be supplied by ANZ Ltd. The variable cost of the component if it were manufactured by ANZ Ltd. would be `8 per unit. ANZ Ltd. has sufficient capacity to produce 2,500 components without affecting its ability to satisfy its own external customers. However, in order to make the extra 1,500 components required by AUS Ltd., ANZ Ltd. would have to forgo other external sales of `50,000 which have a contribution to sales ratio of 40%. To have uniformity in the quality of the component, it is assumed that AUS Ltd. would procure its entire requirement of 4,000 components either externally or from ANZ Ltd. The transfer pricing policy of Aditya Group for sales between units aims at goal congruence. The unit selling the goods would be allowed to charge any opportunity cost on account of catering to internal demand, while the purchasing unit should ensure that the company is not at a loss.

SOLUTION:

AUS Ltd. would like to procure 4,000 components either from ANZ Ltd. or externally from the market. At the current production level, ANZ Ltd. (seller) has available capacity to accommodate part of AUS Ltd's request to the extent of 2,500 components. At this point, ANZ Ltd. would be operating at its maximum capacity. To cater to the remaining demand of 1,500 units from AUS Ltd., ANZ Ltd. has to forego external sales of `50,000 to its own customers. Given that the contribution to sales ratio is 40%. Therefore, ANZ Ltd. has to forego contribution of `20,000 (40% of external sales foregone ₹50,000) in order to cater to AUS Ltd.'s request. Fixed cost at ANZ Ltd. is irrelevant, since it would be incurred irrespective of whether AUS Ltd.'s order to catered to or not. Therefore, in spirit of goal congruence, the transfer price that ANZ Ltd. would charge AUS Ltd. would be the variable cost of `8 per unit and `20,000 towards lost contribution as explained above.

Therefore, the transfer price = (`8 per unit × 4,000 components) + `20,000 = `32,000 + `20,000 = `52,000 for 4,000 components Therefore, per component, the price charged would be `52,000 / 4,000 = `13 per component.

This is lower than the external market price of `15 per unit., in the interest of goal congruence the cheaper option is preferred. AUS Ltd. should source Therefore its components from ANZ Ltd, for a total procurement cost of Rs. 52,000.

X. CONCLUSION

The methods to calculate transfer pricing has been briefly listed in the article. It has to be followed as per the transfer pricing regulations. The appropriate methods have to be chosen in order to calculate the total value of transfer pricing.A brief note on applicability of transfer pricing and transfer pricing rules have been explained.

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