Appendix 1

REPRINTS OF RELEVANT RESEARCH PAPERS NOT FORMING PART OF THE THESIS
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International Transfer Pricing: Pointers towards
Performance Evaluation of Profit Center

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Abstract

International Transfer Pricing today is a subject of high discussion amongst multinationals. Research indicates its use for Tax management, strategic purpose as also for management control purpose. The issue is further highlighted by the fact that the international related party transactions are now more than 60% of international trade. This fact brings up serious questions regarding the implementation of the concept of profit center as a type of responsibility center. The paper points towards the diversion from performance evaluation criteria given under the profit center that is profit. This paper finds pointers towards the changes in the performance evaluation criteria other than profit for a profit center head, through extensive literature survey and discussions with industry professionals.

Keywords: Transfer Pricing, Performance Evaluation, Profit Center, International Trade.

Introduction:

The theory of profit center tells that the performance evaluation criteria for a profit center head should solely be profit of the division. The assumption under the theory that the head of the profit center gets full autonomy and control over the inputs and outputs and that his sourcing decisions are independent is valid only in theory. The corporate level objective always takes a priority and the full autonomy expected is diluted. There are various reasons for this dilution in the autonomy.

The major reason is to achieve the central corporate goal. This gives birth to the utility of transfer price. Other than management control, transfer pricing has numerous other utilities such as investment purpose, risk management purpose, cash management purpose, tax management purpose, protecting intellectual properties and trade secrets or optimum utilization of the firms resources. In any of the above situation the autonomy of the profit center head is lost. In these situations the only option is to have some additional criteria other than profit for the performance evaluation of the profit center head.

This paper finds pointers to the performance evaluation criteria for profit center head considering the international transfer pricing and issues relating to varying environment in foreign subsidiary of a MNC. The fact that this subject is one of the closed doors subjects in the corporate world makes study more reliant on secondary and tertiary sources of data and small pieces of primary data to support the evidences found in the secondary sources.

Methodology:

Literature survey was used as a source of data to find relevance of the profit as a performance evaluation criteria for performance evaluation of the research center head. The theory that divisional profits are to be the sole criteria for performance evaluation of the profit center was challenged.
Further survey into the utility of transfer price was conducted to find alternative strategic use of transfer pricing was conducted. This was also relied upon for through secondary and tertiary sources.

Unstructured interviews of 15 respondents which included corporate heads and tax authorities were conducted which were then horizontalised to find pointers to relation of international transfer price and performance evaluation of profit center.

**Literature Analysis and Data Analysis:**

**Reasons for restrictions on autonomy of profit center head.**

There is a lot of literature written (Choe & Hyde, 2004), (Korn & Lengfeld, 2004), (Shunko, Debo, & Gavirneni), about the international transfer pricing being used as tool for PAT maximization and global tax management.

The theory for the international financial management gives use of transfer pricing as a tool for cash management and risk management as well as resource allocation (Choi & Meek, 2009), so do the theories of international business.

(Cravens, 1997), found through a survey that the MNC’s employ transfer pricing for assisting in achieving competitive advantage along with other corporate goals. It is also found that the transfer pricing influences measures of corporate performance and contributes towards the corporate objectives. The respondents agree that transfer pricing is not purely tax driven mechanism.

(Alles & Datar, 1998) Focus on the use of cost for strategic purpose. In Oligopolistic firms generally the pricing decisions are based on the costs that are communicated to the marketing or selling departments. Thus the sales price determination gets the basis of communicated cost than actual cost. They find imperial evidence in the belief that there is a strategic component in cost system choice and transfer pricing and the fact that the firms may cross subsidize their products.

(Gabrielsen & Schjelderup, 1999), find that in case where the downstream firms buying from upstream firms, are co-owned through joint ventures or otherwise, the transfer pricing is generally over invoiced. Their analysis indicates that transfer pricing plays a strategic role other than tax management even in co-owned downstream firms of MNC’s.

(Martini, 2005), focus on the issue, where the same transfer price is employed to coordinate divisions and to determine their profits. It is presumed that the transfer prices are at arm’s length price. It is found that under negotiated transfer prices, divisional profits are always Pareto efficient but substantially vary with the scheme, whereas there may occur Pareto-inefficient divisional profits that are invariant with the scheme when transfer prices are administered by headquarters.

(Sikdar, 2006) explains how MNC’s are born for which one has to look at the organizational expansion and evolutionary stages in which the sole proprietor business has grown to a multinational enterprise, in which the control of the owners is delegated through the board of directors and the group of enterprises work together towards achievement of their common business objective. With the industrial revolution the organizations started to grow in size and with revolutions in transportation and communication, movement of funds, labor, and ideas across geographies and political boundaries became effective, efficient and easy. The locational advantage started to be appreciated for its cost efficiency and administrative effectiveness. The
companies expanded to different locations which gave them business advantages by way of having branches, affiliates and subsidiaries. This geographic expansion by the companies through branches, affiliates and subsidiaries gave birth to multi-national enterprises. In this case the evaluation of fairness of the price applied in a transaction with a related person arises only where the interested party is adversely affected, that is the transaction generally fetches lower than normal collections to the revenue authorities. Thus the transactions that happen between related persons located in different states are subjected to transfer pricing. Transfer pricing can thus, be said to be as old as international transactions or inter-state transactions. Initially when the organizations were small the international transactions were generally trade of finished goods or raw material between unrelated parties, from place of production to place of consumption. This did not involve much of transfer pricing issues.

(Cools & Emmanuel, 2006), highlight the problem of adoption of tax compliant strategy on design of management control system. The complex relationship between the sub-units contributes towards the economic co-ordination and performance measurement of the affiliated sub-units. They agree to the fact that international related party trade gives rise to the opportunity to MNC’s to optimize global PAT. They find that since 1990 the increased fiscal regulations and compliance to the same have become a potential alternative strategy to overcome clash with the management control system prevailing in the MNC.

(Martini, Niemann, & Simons, 2007), acknowledge the problem of coordinating economic decisions like investment or production within MNC’s. The findings suggest that transfer prices are a widespread device for splitting up complex decision situations and allocating the responsibility for the resulting sub problems to several decision makers. Their findings suggest that transfer prices are a widespread device for splitting up complex decision situations and allocating the responsibility for the resulting sub problems to several decision makers. However apart from doing this transfer prices are also used for tax management.

(Shor & Chen, 2008) They find that the firms can use TP strategically as a collusive device. Firms are individually better off in a centralized organizational format. Collusion on prices is sustainable where as on numbers is not as well the price collusion may also escape legal scrutiny. Cost-shifting between regulated monopolists and their corporate affiliates is regarded as a major concern for regulators and researchers.

(Cools & Slagmulder, 2009) Study the effect of international transfer prices within management control systems. The study is limited to firms using single transfer price for management control system and that of tax purpose. In this situation the TP negotiations are eliminated giving rise to economically harmful decisions. Administrative mechanism for profit determination can lead to suboptimal decisions and lastly revenue or cost centers are designated as profit centers for tax compliance. TP and tax compliance is related to profit centers. In the case study undertaken it was found that the management found utility in treating the associate as profit centre than revenue or cost center.

(Jelena & Danijel, 2010) Find that the transfer pricing affects the divisional revenues, expenditures and results. This creates competition amongst the divisions for increasing their performances. The method used for transfer pricing is thus plays an important role and is of most interest to the managers. They also find that the more successful divisions get more share in the allocation of resources.

In MNC’s where the transfer pricing is not used as a strategy for tax planning, there is a very
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strong case that the tradeoff is made by the managers of the divisions between benefits of tax management and higher share in resources from the management. Also there will be considerations given to the performance based bargaining capacity of the division manager which can have impact on the transfer pricing method as well as price.

(Sikka & Willmott, 2010), highlight on the scattered evidence to show how transfer pricing is not just an accounting technique, but also a method of resource allocation and avoidance of taxes that affects distribution of income, wealth, risks and quality of life.

The above literature brings out reasons as to why the autonomy of input and output pricing for a foreign profit center manager is lost in a MNC setup. There is sufficient evidence that the corporate goals take priority. In this process international transfer pricing is used as a tool for various international investment management, risk management, cash management, tax management, to protecting intellectual properties and trade secrets and optimum utilization of the firms resources. In any of the case above the profit center head loses his autonomy of control over pricing of inputs and outputs and hence the criteria of profit for performance evaluation cannot be implemented absolutely. There is a case that the profit center head gets uncontrollable factors due to managerial decisions in the wider interest of the firm.

Additional performance evaluation criteria for profit center head in international case.

(Sharav, 1974) has identified that transfer prices can vary over a wide range from freely negotiated to the administratively dictated. It is more governed by the corporate goal congruence. (Abdallah, 1989)states that due to foreign exchange rates the transfer pricing policies will lead to financial distortions and the performance evaluation criteria in international case will have to take case of this fact. The Evaluators will have to look into keeping the divisional managers motivated through some other parameters for performance evaluation.

(Dutta & Anctil, 1999) identify the feature of interdepartmental transfer price to be the interdivisional risk sharing. This has an impact on the design of optimal compensations contracts which are liner function of divisional profits and that of firm wide profits.

(Abdualla, Firoz, & Ekeledo, 2005) assess 1. Whether the global performance evaluation measures used are in response to foreign environmental challenges. 2. Whether the relative performance of foreign subsidiary managers reflects the objectives and the operational performance measures of their companies, 3. How frequent changes in currency rates effects the performance of the managers. They find that the performance evaluation has to be based on functions that he performs in relation to the environmental factors present in the foreign subsidiary country. They also find that advanced management accounting methods are required to be developed for the evaluation of foreign subsidiary’s manager.

(Schmid & Kretschmer, 2010) review the contingency framework for performance evaluation and find contradictions or no significant impact of influencing factors.

From the above cases it is clear that the business environmental factors vary from country to country and hence objective comparison of performance of two profit center heads is not possible. Also fluctuations in the currency rates can play misleading role for the evaluation of performance. In doing this the operational performance and the operational efficiencies achieved are neglected and the evaluation system has to take case of this aspect. Uncontrollable external factors also effect the performance of the profit center head and the same is not similar for different foreign subsidiaries of the MNC making it difficult for comparing the performance of
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different heads of different subsidiaries.

Thus the performance evaluation criteria for a head of foreign subsidiary (profit center head) can be divided into two categories; namely controllable factors and uncontrollable factors. The uncontrollable factors can be further divided into uncontrollable due to management decision and uncontrollable due to external factors.

The performance evaluation criteria should to stick to the controllable factors and actions taken to reduce impact of external uncontrollable factors, also uncontrollable factors due to management decision that create external uncontrollable have to be separately dealt.

**Indicators from practice:**

Interviews conducted give clear indications towards the use of transfer price other than management control. The respondents were clear that the transfer pricing was used for tax management purpose or other strategic purpose. This is in line with the findings in the literature. It conclusively brings out the fact that the management decisions creates uncontrollable factors for the foreign subsidiary manager. These may be considered as the limiting factors for the manager for his execution of job thus qualifying as uncontrollable factors due to managerial decisions. It was also revealed that the profit was not the only criteria for performance evaluation of the foreign subsidiary head of the MNC. This contradicts the theoretical concept of the concept of profit center.

**Findings:**

The foreign subsidiary head of a MNC may not be actually working as a profit center head as given in text books. The theoretical criteria for the profit center requires the manager to have full control and autonomy on decisions of sourcing and pricing of inputs and outputs. The input and output pricing decision that have to be under the control of the manager, are actually out of his control. The decisions are made by the management and implemented which become the limiting factors for the manager.

The factors determining the performance of the profit center head can be divided into controllable and uncontrollable factors. The uncontrollable can be further divided into uncontrollable due to management action and other uncontrollable factors. The uncontrollable factors due to management action can also lead to other uncontrollable factors. The performance evaluation requires that the evaluated has to have autonomy of performance and the factors for performance should be under his control. The manager of the profit center has limitation put forward by management decision and the environment. This is out of control of the manager and hence out of preview of his performance evaluation. The profit in this case is not 100% in control of the manager, hence the same has to be modified for the uncontrollable factors.

Further the external uncontrollable factors for comparison between the two managers vary in different subsidiaries. This makes the base of comparison different and hence the impossible. This creates a case for separate evaluation or creating a rating for the different external uncontrollable factors for the managers.

**Conclusions:**

A completely new management accounting system has to be developed which will take care of the uncontrollable factors created due to the management decision. The performance evaluation criteria should also consider the efforts made by the manager in handling the other uncontrollable factors.
factors. The business environment in different countries is different and hence not always the performance of one manager can be compared with that of the other. Hence diversions from the concept of profit as a basic performance evaluation criteria has to be given away with, in view of the varying environment and external uncontrollable factors.

Conclusion is drawn that the foreign subsidiary head of MNC (profit center head) is to be treated as a profit center head for the functional ease but when it comes to his performance evaluation profit cannot be the only criteria for performance evaluation. A new management accounting system has to be evolved to evaluate the decisions made upon uncontrollable factors.

A new rating system for comparison of the profit center heads has to be evolved so as to ensure that the decisions in varying business environments has been given justice and due consideration is given to the efforts of the manager. Direct comparison of the profits of the two divisions will not be correct comparative performance of the two managers in different environments. The two environments have to be got to become comparable for this kind of analysis or the evaluation is to be completely independent without comparison with the other profit center head.

The performance evaluation method for the profit center head in international MNC scenario should ideally be three fold with profit as a major component, rating for environment and a new developed management accounting system to take care of uncontrollables due to managerial decisions.

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International transfer pricing: A review of non-tax outlook

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Abstract

Worldwide there are a lot of controversies and debates between the tax authorities and the MNC’s about the related party transaction pricing. The tax authorities contest on the grounds that non arm’s length price is depriving them of rightful revenue and that the MNC’s are doing this to save on tax liability. This is not the case always. It is one of the considerations in the related party transfer pricing. The study tries to find the objectives behind the pricing strategy by the MNC’s. Through extensive literature survey the study finds that the tax liability management is not the only objective that the MNC’s have while pricing the related party transactions but there are other objectives that have priority in the global strategy of the MNC’s which also play a vital role in pricing strategy. The global objectives demand movement of funds from one location to other for various purposes for which non arm’s length pricing is used. The study finds that non tax outlook in transfer pricing is very strong and in some cases compelling to affect the transfer pricing strategy. The study finds various purposes other than tax liability management which the MNC’s have to attend to while deciding their related party pricing strategy.

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Keywords: Arm’s Length Price; Pricing Strategy; Related Party Transactions; Tax Liability Management; Transfer Pricing.

1. Introduction

There has been a global thinking on the matter of international transfer pricing and a lot of work has been done to streamline and standardizing the practices for the same globally. OECD has played a big role in this matter. The OECD members have adopted the arm’s length principle for valuation of international transfer pricing. The guidelines for the international transfer pricing contain high amount of subjectivity (Stuart, 2009) which are creating an increasing number of disputes amongst the MNC’s and

* Corresponding author: Tel.: +91-942-301-0770; fax: +91-942-301-0770. E-mail address: sjpendse@gmail.com.
the tax authorities. This subjectivity is makes the tax authorities inconsistent in their decision making as found by (Cools M., 2008). There is a belief amongst a wide spectrum of revenue authorities that the MNC’s use transfer price which reduces their profits in the country and hence the rightful government revenue is lost. (Kimberly, 1998) Found evidence in the relation of related party trade and the tax rates. There is a lot of literature written (Choe & Hyde, 2004), (Korn & Lengsfeld, 2004), (Shunko, Debo, & Gavirneni), about the international transfer pricing being used as tool for PAT maximization and global tax management.

However the management control angle of the argument to the same has to be looked at as a genuine requirement of the MNC’s to exercise control over their global operations and such activities are mandatory for them. In the process of management control there are fair chances that the arm’s length principle is violated. The OECD guidelines provide for adjustment for the same as a remedial measure. There is a need to look at the genuine reasons, other than the reasons of tax management that the MNC’s use transfer pricing irrespective of the political boundaries of nations. Risk concerns and use of transfer price is apparently one of the most close to heart reason for the MNC’s. The theory for the international financial management gives use of transfer pricing as a tool for cash management and risk management as well as resource allocation (Choi & Meek, 2009), so do the theories of international business. The performance evaluation and management control system requirements of transfer pricing are well highlighted in the theories and texts (Anthony & Govindarajan, 2010). This study tries to find reasons other than the tax management for which the MNC’s use transfer price as a tool.

2. Literature Survey

A wide range of research is available, but only those which are related to the use of transfer pricing as resource allocation, strategic use, cash management purpose and management control use are narrated.

Tisdell, (1989), acknowledges the use of transfer price in multidivisional firm. The research also talks on the neglected areas of transfer price poor guide for economic value of the firm and that it can retard the technical change, innovation and productivity enhancement within a division.

Cravens,(1997), found through a survey that the MNC’s employ transfer pricing for assisting in achieving competitive advantage along with other corporate goals. It is also found that the transfer pricing influences measures of corporate performance and contributes towards the corporate objectives. The respondents agree that transfer pricing is not purely tax driven mechanism.

Alles & Datar, (1998) Focus on the issue, where the same transfer price is employed to coordinate divisions and to determine their profits. It is presumed that the transfer prices are at arm’s length price. It is found that under negotiated transfer prices, divisional profits are always Pareto efficient but substantially vary with the scheme, whereas there may occur Pareto-inefficient divisional profits that are invariant with the scheme when transfer prices are administered by headquarters.
Sikdar, (2006) explains how MNC’s are born for which one has to look at the organizational expansion and evolutionary stages in which the sole proprietor business has grown to a multi-national enterprise, in which the control of the owners is delegated through the board of directors and the group of enterprises work together towards achievement of their common business objective. With the industrial revolution the organizations started to grow in size and with revolutions in transportation and communication, movement of funds, labor, and ideas across geographies and political boundaries became effective, efficient and easy. The locational advantage started to be appreciated for its cost efficiency and administrative effectiveness. The companies expanded to different locations which gave them business advantages by way of having branches, affiliates and subsidiaries. This geographic expansion by the companies through branches, affiliates and subsidiaries gave birth to multi-national enterprises. In this case the evaluation of fairness of the price applied in a transaction with related person arises only where the interested party is adversely affected, that is the transaction generally fetches lower than normal collections to the revenue authorities. Thus the transactions that happen between related persons located in different states are subjected to transfer pricing. Transfer pricing can thus, be said to be as old as international transactions or inter-state transactions. Initially when the organizations were small the international transactions were generally trade of finished goods or raw material between unrelated parties, from place of production to place of consumption. This did not involve much of transfer pricing issues.

Dikolli & Vaysman, (2006), find that information technology plays as important role in the transfer pricing as a management control tool for MNC’s. They find that the managements prefer the cost based method over the negotiated price method, since the negotiations can defeat the strategic objectives of transfer pricing.

Cools & Emmanuel, (2006), highlight the problem of adoption of tax compliant strategy on design of management control system. The complex relationship between the sub-units contributes towards the economic co-ordination and performance measurement of the affiliated sub-units. They agree to the fact that international related party trade gives rise to the opportunity to MNC’s to optimize global PAT. They find that since 1990 the increased fiscal regulations and compliance to the same have become a potential alternative strategy to overcome clash with the management control system prevailing in the MNC.

Martini, Niemann, & Simons, (2007), acknowledge the problem of coordinating economic decisions like investment or production within MNC’s. The findings suggest that transfer prices are a widespread device for splitting up complex decision situations and allocating the responsibility for the resulting sub problems to several decision makers. Their findings suggest that transfer prices are a widespread device for splitting up complex decision situations and allocating the responsibility for the resulting sub problems to several decision makers. However apart from doing this transfer prices are also used for tax management.

Adams & Drtina,(2008), explore the impact of transfer pricing on capital budgeting. When selling division is under capacity, the economic theory says that the transfer price should be based on differential cost. In such a situation the seller does not generate sufficient revenues to recoup the capital cost. In such situations the divisional managers can reject investment proposals which will increase corporate shareholder value. In such situations Arm’s Length price will affect the short term global profits but the MNC’s must look at the long term impact of the transfer pricing decisions on the profitability and the shareholder value of the company.

Urquidi, (2008) Finds in his Case study based article that the corporate seek to solve the transfer pricing problem for three reasons, namely:

- Satisfies the needs of the business with respect to strategy and internal incentives
- Results in an efficient use of resources
- Provides the “right” transfer pricing answer from a tax perspective

He finds that this is a daunting task for the corporate especially in the financial services sector which does not have any specific transfer pricing regulations. He further finds that the macro economic factors play a vital role in transfer pricing and the firms will have to rely on upon the economic factors to help them navigate the problem of transfer pricing process.
Shor & Chen, (2008) They find that the firms can use TP strategically as a collusive device. Firms are individually better off in a centralized organizational format. Collusion on prices is sustainable where as on numbers is not as well the price collusion may also escape legal scrutiny. Cost-shifting between regulated monopolists and their corporate affiliates is regarded as a major concern for regulators and researchers.

Curtis, (2008), challenges the view that transfer pricing is a responsibility of corporate taxation because it is a matter of taxation and makes a case for multi-functional approach to MNE treasury planning in the context of transfer pricing can be an important component in improving the efficiency of cross-border financial management. The article focuses on MNC’s corporate treasury management responsibilities which includes international capital structure and cost of capital, the financing of cross-border acquisitions, foreign direct investment, international capital budgeting and cash management, management of foreign exchange and transactional risk, and port-folio and investment management. In all of the above when there is a fund movement between international boundaries there is a transfer pricing issue involved.

Doff, Bilderbeek, Bruggink, & Emmen,( 2009), analyze asset and liability management and market risk systems of insurance companies and find that the current system is not goal congruent and does not satisfy necessary conditions for effective control. They find that managers are unable to run their units effectively. They develop a transfer pricing based system which allows the clear separation of underwriting and investment activities, both on the risk and return aspects. It creates the appropriate incentive schemes.

Cools & Slagmulder, (2009) Study the effect of international transfer prices within management control systems. The study is limited to firms using single transfer price for management control system and that of tax purpose. In this situation the TP negotiations are eliminated giving rise to economically harmful decisions. Administrative mechanism for profit determination can lead to suboptimal decisions and lastly revenue or cost centers are designated as profit centers for tax compliance. TP and tax compliance is related to profit centers. In the case study undertaken it was found that the management found utility in treating the associate as profit centre than revenue or cost center.

Jelena & Danijel,(2010) Find that the transfer pricing affects the divisional revenues, expenditures and results. This creates competition amongst the divisions for increasing their performances. The method used for transfer pricing is thus plays an important role and is of most interest to the managers. They also find that the more successful divisions get more share in the allocation of resources.

In MNC’s where the transfer pricing is not used as a strategy for tax planning, there is a very strong case that the trade off is made by the managers of the divisions between benefits of tax management and higher share in resources from the management. Also there will be considerations given to the performance based bargaining capacity of the division manager which can have impact on the transfer pricing method as well as price.

Sikka & Willmott, (2010), highlight on the scattered evidence to show how transfer pricing is not just an accounting technique, but also a method of resource allocation and avoidance of taxes that affects distribution of income, wealth, risks and quality of life.

Dawson & Miller In their undated work find the roots of evolution of transfer pricing. They say one has to look at the organizational expansion and evolutionary stages in which the sole proprietor business has grown to a multi-national enterprise, in which the control of the owners is delegated through the board of directors and the group of enterprises work together towards achievement of their common business objective. In this case the evaluation of fairness of the price applied in a transaction with related person arises only where the interested party is adversely affected, that is the transaction generally fetches lower than normal collections to the revenue authorities. Thus the transactions that are between related persons located in different states are subjected to transfer pricing. Transfer pricing can thus, be said to be as old as international transactions or inter-state transactions. Initially when the organizations were small the international transactions were generally trade of finished goods or raw material between unrelated
parties, from place of production to place of consumption. This did not involve much of transfer pricing issues. With the industrial revolution the organizations started to grow in size and with revolutions in transportation and communication, movement of funds, labor, and ideas across geographies and political boundaries became effective, efficient and easy. The locational advantage started to be appreciated for its cost efficiency and administrative effectiveness. The companies expanded to different locations which gave them business advantages by way of having branches, affiliates and subsidiaries. This geographic expansion by the companies through branches, affiliates and subsidiaries gave birth to multi-national enterprises. The parent company continued to be in one country and the branches, affiliates and subsidiaries were at other locations. The various techniques and strategies adopted by the MNC’s for increased cost efficiency ensured that the volume of transactions between the multinational enterprise group increased many fold. These transactions are also called as intra group transactions or related party transactions. The structure and pricing of transactions within the MNE group is governed by the combination of market and group driven forces with a common objective that is to maximize the group profits and wealth.

3. Methodology

This research is typically a qualitative research. Of the five types of qualitative research, this belongs to Phenomenology. A phenomenological study describes that meaning of the lived experiences for several individuals about a concept or a phenomenon (Creswell, 1998). As noted by (Polkinghorne, 1989), phenomenology explores the structures of consciousness in human experiences.

The researcher has conducted unstructured interviews through discussions with practicing chartered accountants and tax practitioners in the field of international taxation. The data analysis involves horizontalization (i.e., extracting significant statements from transcribed interviews). The significant statements are then transformed into clusters of meanings according to how each statement falls under specific psychological and phenomenological concepts. Finally, these transformations are tied together to make a general description of the purposes for which the transfer pricing is used by the MNC’s operating in India.

4. Transfer Pricing Tool

Transfer pricing is used as a tool for various purposes by MNC’s in their course of business with related parties in international transactions. Significant use of transfer pricing as reported during the research are as follows:

Transfer Pricing as a Management Control Tool: International transfer pricing is used as a tool to facilitate better management control. It is very common that the performance standards are set for the business unit and the transfer pricing facilitates the evaluation of the set performances. This is true especially in the case of lot of transactions which are outbound, i.e. export transactions.

Risk Management and Transfer Pricing: MNC’s invest in new markets and for them the fact that the Indian market is new increases the risk. They expect higher returns on their investments and hence the products imported by their local arm are priced to take care of this added risk of entering into the new market. However this argument is not very well taken since the risk of business is to the Indian arm and not to the overseas arm of the MNC. In fact the international transaction carries lesser risk since it is between related parties. However if the same is viewed from the point of theories of international business, with the MNC looking at the global risk, than, the argument can be said to be valid.

Transfer pricing in relation cash/fund management, investment and capital budgeting, Strategic requirements: The global managers look towards fund allocation for the purpose of investment globally. There are restrictions of the local governments or created due to joint venture partners which have to be
taken care of. Transfer pricing is an easy way to overcome these issues although the same creates problems of taxation which have to be handled separately. However global requirements always get priority.

5. Important observations and findings

1. Transfer pricing is used as a tool for other than tax liability management. The incidences reported are very few in which it is admitted that the primary objective is tax liability reduction.

2. Strategic and investment purposes are the ones for which transfer pricing is used as a tool for international fund management. There are taxation issues arising out of it as a byproduct of the implementation of the tool but they are inevitable.

3. Risk of entering into a new market is also an area in which is managed by the tool of transfer pricing. Even this raises questions of taxation due to transfer pricing. The risk management always takes a top priority over and above the issue of non-arm’s length pricing.

4. Arm’s length principle is very subjective and hence gives flexibility in tackling the taxation issue arising due to strategic decisions of use of transfer price.

5. Transfer pricing when used as a management control tool is a very important aspect of its utility. In this situation the following of arm’s length principle is easier, since the performance evaluation criteria can be decide taking it into consideration. The arm’s length principle can also be considered using a double set of books of accounts; one for the purpose of performance evaluation and other for the statutory tax purpose. In either case the taxation does not become a major issue to be tackled.

6. Conclusion

The reasons for non arm’s length pricing in case of international transfer pricing are not restricted to tax liability management which is a general perspective. They are diverse and varied which include strategic requirement, risk management, investment management and the management control aspect to of the non arm’s length pricing by the MNC’s. In many cases the tax consideration is not a priority while making the transfer pricing decision, however except for cases where arm’s length principle is possible to be followed as in some cases for the management control system induced transfer pricing, there is direct tax liability impact due to non arm’s length transfer price. This creates a notion that the priority of MNC’s is tax liability management.

The taxation for international related party transaction is very subjective and those possess an uncertainty for the MNC’s while making the decisions for the transfer price. There is a strong need to bring in certainty in the method for taxing international related party.

References


International Transfer Pricing Regulations: Freedom of Globalized Management vs. Rightful Tax

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Abstract: As the world comes closer to being a one village, the multinational companies are expanding multifold, tapping possible opportunities to grow and fulfill their goals. In line with the principals of capitalism, one of their primary goals is to maximize their global profit after tax. The globalization does not mean elimination of political boundaries. The economies have to be governed and there is a cost to it, for which taxes are levied. The governments have ever increasing list of welfare activities for which they look for all the rightful taxes, which is in line with the principles of welfare economics. This paper studies the clash in principles of capitalism and the welfare economics, highlighted through international transfer pricing. Through extensive literature and study of arguments for and against the Arm’s Length price working, it is found that the concept of global village comes with a requirement if balancing the coexistence of capitalism and welfare economics.

Key Words: Capitalism, welfare economics, Transfer pricing, global village

1. Introduction:

The international trade over the last decade is growing multifold. The rise of multinational corporations has highlighted the growing business across the globe. The information technology and revolution in transport is making business across the continents easy and fast. The locational advantages are exploited by the multinationals to the possible extent. All this is done for their primary goal of maximization of the owner’s wealth, a principle under capitalism. For this purpose the MNC’s trade across the political boundaries bringing opportunities for them as well as the trading countries for development. This advantage comes with a rider. The MNC’s in their motive may not always retain the profits and benefits earned in the nation from where they are earned. They use all possible strategies and tools available to ensure that their goals are achieved. This includes pricing of related party transactions to suite their strategy, involving international transfer pricing.

The nations have to be governed which requires money. This is provided by the taxation mechanism on the country. The strategies of MNC’s may reduce the tax paid by them in the country, creating a reduction in the rightful tax of the nation. The question in contest is what is rightful for the government. There is no support to quantify the rightful tax quantum except for a few ancient literatures. However the governments want all the possible rightful tax to fulfill the ever increasing demands of the society and the industry, which is the private sector.

This paper tries to bring this clash of principles of the capitalist motives of the MNC’s and the expectancy of rightful tax by the governments, taking base of international transfer pricing as a matter of rising dispute between the two.

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2. Capitalist Motives and International Transfer Pricing as a Tool for the Same

Capitalism is an economic system in which means of production of goods and services are privately owned for generation of profit. It is a well-known fact that the enterprises are created to maximize the profits. When these go beyond the political boundaries of a country they have more opportunities to maximize the profits of the enterprise. Tax management is one of the tools for the same and different strategies are used for the same, one of them being international transfer pricing, to suite to the needs of the strategy.

(Alles & Datar, 1998), find empirical evidence that the firms cross subsidize their products and the pricing is based on communicated cost than that of the actual cost. (Nielsen, Raimondos-MYller, & Schjelderup, 2001), find that the strategic benefits depend upon the relative tax rates in the countries in which the MNC operates. (Urquidi, 2008), states that the firms have to rely on the macroeconomic factors for strategic use and use transfer price as a tool. (Sikka & Willmott, 2010), highlight on the scattered evidence to show how transfer pricing is not just an accounting technique, but also a method of resource allocation and avoidance of taxes that affects distribution of income, wealth, risks and quality of life.

All the above suggests that the capitalist motives give births to strategies to maximize the profits at the global level of the MNC’s, implying that they bound to use all possible tools and techniques to accumulate and maximize wealth. One of the important tools for the same is international transfer pricing. The importance of this tool is highlighted by the figures in table 1. It can be seen that the adjustments in the arm’s length price by the tax authorities is increasing day by day and the same is reached 12.55% of the current account deficit of India in financial year 2009-10, suggesting an important aspect of economics straining the foreign exchange reserves of the country.

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3. Need for Rightful Tax for Governments:

(Dalton, 1922), lays down the principles of social advantage which the root of public finance. Thus the government has to raise funds for maximum social advantage. He states that every tax is evil and that every public expenditure is good. But for the good to happen there has to be an evil. This is for the fact that government has to have source of revenue to fund public expense and tax is one of the major source for public revenue.

(Edwin & Seligman, 1895), defines tax as “a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred”. This brings out that the tax is a compulsory payment for the common benefit of all and common benefit is the duty of the government. Hence tax is a rightful need of the government to fulfill its duties.

The cannons of taxations were first given by Adam Smith which says that the objective of public finance is to raise funds for the government expenditure to fulfill the wants of its citizens (Mithani, 2006). The public economics aims at maximizing equality of distribution of income and social welfare. In doing this the tax system has to be so designed that there is no excess burden to any one and it facilitates equal distribution of
income by taking more tax from the higher income group of the society and lesser from the lower income group. The government cannot carry out its welfare responsibilities if the citizens do not pay taxes.

The governments also require the tax for administration and governance. These days governments have taken up additional responsibilities than the traditional ones of defence and law and order. In addition planning and development, infrastructure, social construction, investment in human capital, etc are also part of government functions for which funds are required. These responsibilities are integral part of the governance. Government also require to invest and spend for infrastructure and other facilities for the private sector to flourish. These expenses require revenue for the government. Tax is one of the important mechanisms for revenue generation for the governments. Thus the governments strive to collect the rightful revenue from the corporates and the public to fulfill their duties.

4. The Balancing Act

(Mithani, 2006), defines tax evasion as “deliberately pretending that the person is not liable to tax by showing himself not in possession of goods or services or income subjected to tax”.

(Marx, 1887) put forth that capitalism cannot take care of the welfare of the labor and hence supported the idea of socialism. However socialism has its own set of problems, which are well highlighted by fall apart of Soviet Russia. The point highlighted by this fact is that the prevalence of capitalist motive behind international transfer pricing and the governments striving for the rightful tax, the welfare motive, cannot prevail together through one legislation.

By introduction of the transfer pricing legislation there is an attempt to balance the difference between the fundamental principles. The OECD guidelines are very subjective and based on the concept of self-restraint and self-compliance by the MNC’s. The same are implemented in India under Income Tax Act 1961. Acceptance of this concept is a hurdle to be crossed.

The capitalist are bound to find the loop holes in the legislation to fulfill their motives of maximizing wealth and the governments getting into litigation to get the rightful tax. This extreme acts have to be rationalized, to find a balance between the rightful tax and hence created legislation and the freedom that the capitalist require for their global management to fulfill their goals.

5. Findings and Conclusions

In the concept of global village, the free trade is to be promoted and the most restraining factor for the same is sovereignty on the nations. The welfare principles and social welfare duties of the governments compel them for rightful tax collection through legislation, whereas the capitalist principles motivate for global profits maximization. The transfer pricing legislation is an attempt to marry two opposite principles prevailing in the economy. The need for the same has arisen from the fact that the governments perceive that they are losing rightful revenue due to transfer price management by MNC’s by lack of self-restraint and self-compliance, and the MNC’s perceive that their freedom for global management is constrained by this legislation and all legal ways and means are to be used for profit maximization.

It is imperative for the concept of global village to flourish in public interest, that the MNC’s accept the responsibility of social cause of giving back to the society which gave the business profits, by adopting self-declaration mechanism and accepting the needs of local governments. At the same time the governments accept the fact that the MNC’s are there to earn profits and only rightful tax is to be demanded from them.

The tight rope walk of need to marry the opposite principles of welfare economics and capitalism is possible not by legislation but by self-imposition and respect to each other’s principles by the MNC’s and the governments, through reasonable profitability and reasonable and simple tax mechanism. This can be better achieved through a forum for mutual agreement.
6. References


International Transfer Pricing: Pointers towards Balance of Payment issues of an economy

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Balance of Payment (BoP) deficit is become a challenging task for the policy makers to manage. Tax differentials have significant impact on the trade deficits, is well proved through research. It is also known fact that the international transfer pricing is used as a strategy by the multinationals. Transfer pricing is looked as an issue of dispute between rightful tax to the governments and freedom of the multinationals for maximizing profits and strategy implementation. However transfer pricing has greater economic impact than mere taxation issues. It has larger impact on the balance of payment of the nation. The adjustment to the arm’s length price by the tax authorities implies probable impact on the BoP. With specific focus on the current account transactions of the BoP, this study focuses on the impact transfer pricing can have on the BoP. It is found that there is a significant impact of international transfer pricing on BoP.

Broad Track: Financial Economics

JLE Codes: F23, M21, H29, F32.

1. Introduction:

Balance of Payment (BoP) deficit is a problem faced by many developing economies. The task of getting the BoP in the acceptable limits is the biggest challenges in front of the policy makers. To address this challenge the policy makers have been using various tools including the promotion of inflows on the capital account. However a healthy current account in the BoP indicates long term strength in the policy making. The capital inflow promotion in long run helps in converting the current account into a positive state is what is the assumption in the measures of promoting the capital inflows. Direct investment into the core sectors help in economic growth, in turn make the economy healthy. A few questions are to be answered though, what if the capital inflows dry up too early than they start generating current account inflows? And that will such capital inflows actually result in the current account inflows in future and help the BoP to be favorable? The answer to the second question depends more on the strategies and priorities of the multinational corporations.

One of the strategy of the multinational corporations is transfer pricing. It has various objectives. There is a lot of literature written (Choe & Hyde, 2004), (Korn & Lengsfeld, 2004), (Shunko, et al., n.d.), about the international transfer pricing being used as tool.

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for PAT maximization and global tax management. There is a belief amongst a wide spectrum of revenue authorities that the MNC’s use transfer price which reduces their profits in the country and hence the rightful government revenue is lost. (Kimberly, 1998) Found evidence in the relation of related party trade and the tax rates. All these international transactions have an effect on the BoP. (Yoshimine & Norrbin, 2007), find that tax differentials have significant impact on trade balance. Links are found between trading activities of multinationals and the US merchandise trade balance (Hipple, 1990). The tax policy of the nations also has an effect on the locational choice of the firms (Devereux & Griffith, 2002).

This study tries to establish the link between the non-arm’s length price for transfer pricing by the multinationals resulting in the transfer of incomes to different locations and its probable impacts on the BoP.

2. Literature Survey:

(Hipple, 1990) finds link between trading activities of multinational firms and US merchandise trade balance. It is found that the activities of multinational companies are important in understanding the US trade deficit.

(Kimberly, 1998), finds that there is a clear relationship between taxes and intra-firm trade flows. He finds that the trade between US affiliates in different foreign countries is influenced by tax considerations. The intrafirm trade balances have with low tax countries are less favorable and that the US exports to related parties in low tax countries are underpriced and that US imports from related parties from low tax countries are overpriced for minimizing total taxes globally. He also finds evidence showing clear relationship between taxes faced by affiliates abroad and their intra-firm trade transactions. Thus there is a tax minimizing behavior by the firms which may lead to intrafirm exports originating in country in higher marginal cost. When the magnitude of the tax differential and the trade balance between associates is considered it is found that 10% difference in the tax rate between the countries of the affiliates leads to lower relative intrafirm trade balance by 4.4%.

(Devereux & Griffith, 2002), find that taxation affect firms location. However they do not quantify how much is the magnitude of the effect. They also find that even if the elasticity for taxation is found there would still be a number of unresolved issues for policy formation; in particular, it would also be necessary to identify the benefits of higher inward Investment and how they accrue.

(Choe & Hyde, 2004) finds that increasing multinationals are using different transfer prices for internal transfer purpose and for tax purpose for the fact that the marginal cost rule for transfer pricing does not give work in purchase decision making for multinationals in the different tax environment. It is found that the optimum incentive transfer price is shown by the weighted average transfer price plus adjustment by a faction of marginal penalty for non-ALP for which the relevant affiliate is held responsible. As long as the tax rates are different in different jurisdictions the firm optimally trades off the benefit of tax arbitrage against the penalty of non-ALP.

(Korn & Lengsfeld, 2004), find that numerous (high-tax) countries presume that multinational firms use their transfer-pricing policies to shift profits into countries with
lower tax rates. The transfer pricing strategic disorders are based on, competition, tax and punishment effect for the non-arm’s length pricing. Tax enforcement goal of the governments directly influences the competition.

It is found that the tighter transfer pricing rules may help firms to mitigate competition and to increase their profits and that non-compliance to the arm's-length principle is part of their equilibrium strategy of the MNC’s.

(Sakurai, 2004) in working paper finds that unlike Japanese MNC’s the British and American MNC’s are proactive in their policy formulation towards transfer pricing and their global tax planning. However the differences are slowly reducing with time and pressure on margins. The non-confrontational regulatory approach of the Japanese is less transparent but the US adversarial approach has a risk of creating creative compliance which escapes the intended impact of law. Transparency and accountability is the key to success due to the subjective nature of the legislature, however cooperative and consultative regulatory approach is also key to the implementation, for which multilateral discussions and adaptation is required to rationalize the tax management styles towards transfer pricing so as to increase cooperation and reduce conflict amongst tax administrators and tax managers.

The research of Sakurai indicates that there is a requirement of creating a relationship of mutual trust between the MNC’s and the tax administrators, which is a very difficult job. An environment has to be created where in the tax managers feel that the law is to be respected not to be worked upon.

(Penelope, 2005) Find very strong evidence that Mexico’s growth is balance of payments constrained and that this constraint has deepened as a result of trade liberalisation. Although NAFTA has worked as a catalyst for attracting FDI and fostering exports, it has also generated some serious difficulties for Mexico’s economic development.

(Sikdar, 2006) explains how MNC’s are born for which one has to look at the organizational expansion and evolutionary stages in which the sole proprietor business has grown to a multi-national enterprise, in which the control of the owners is delegated through the board of directors and the group of enterprises work together towards achievement of their common business objective. With the industrial revolution the organizations started to grow in size and with revolutions in transportation and communication, movement of funds, labour, and ideas across geographies and political boundaries became effective, efficient and easy. The locational advantage started to be appreciated for its cost efficiency and administrative effectiveness. The companies expanded to different locations which gave them business advantages by way of having branches, affiliates and subsidiaries. This geographic expansion by the companies through branches, affiliates and subsidiaries gave birth to multi-national enterprises.

In this case the evaluation of fairness of the price applied in a transaction with related person arises only where the interested party is adversely affected, that is the transaction generally fetches lower than normal collections to the revenue authorities. Thus the transactions that happen between related persons located in different states are subjected to transfer pricing. Transfer pricing can thus, be said to be as old as international transactions or inter-state transactions. Initially when the
organizations were small the international transactions were generally trade of finished goods or raw material between unrelated parties, from place of production to place of consumption. This did not involve much of transfer pricing issues.

(Yoshimine & Norbin, 2007), find that tax differentials have significant impact on trade balance. They find that the trade balances are lower than expected in countries with higher comparative tax rates.

(Urquidi, 2008) finds in his Case study based article that the corporate seek to solve the transfer pricing problem for three reasons, namely:

1. Satisfies the needs of the business with respect to strategy and internal incentives
2. Results in an efficient use of resources
3. Provides the “right” transfer pricing answer from a tax perspective

He finds that this is a daunting task for the corporate especially in the financial services sector which does not have any specific transfer pricing regulations. He further finds that the macro economic factors play a vital role in transfer pricing and the firms will have to rely on upon the economic factors to help them navigate the problem of transfer pricing process.

The author is indicating towards continuous review on transfer pricing policies based on macroeconomic factors so as to satisfy the three reasons cited creating problems of transfer pricing.

(Brada & Tomsik, 2009) Find that the economies receiving large amount of Foreign Direct Investment (FDI) have to be careful in their BoP since the phenomena of FDI life cycle is likely to affect them in future.

(Shunko, et al., n.d.), in undated working paper find that the use transfer pricing to take advantage of tax differentials can help in profit improvement by as large as 30%. They find that the trade-off curve between cost and tax advantage drives global firm's choice for sourcing strategy. The curve demonstrates that the off-shoring option with a significant tax advantage should be considered even if it does not have a cost advantage.

All the above literature brings to a reason for which the economies have to be worried for BoP deficit. The FDI coming into the economy is bound to bring outflows in the future and the policy makers have to be cautious in making the most of the FDI and to delay the out flows. It also brings us that there will be strategies and tools used by the multinationals to achieve their goals which may not necessarily be in line with the national goals.

Transfer pricing is one of such strategies which needs to be studied so as to understand its role in the impact on BoP. The effectiveness of transfer pricing is well recorded and known. The same has been widely studied for taxation effect. This paper further studies this impact and quantifies the impact of transfer pricing on BoP, in Indian context.

3. Methodology:
This research is typically a mix of qualitative research under the category of phenomenology and the quantitative techniques to prove the same. By studying in depth the transfer pricing, its utility for the multinationals and its effects on the taxation, the researchers have extended the logic of direct negative impact of the transfer pricing on taxation to the movement of funds across international boundaries, and further its effect on the nations BoP.

Through unstructured interviews of experts and detailed analysis of the effect of transfer pricing on the tax collection of India through analysis of 500 assessment orders passed by the authorities over a period of 6 years. Simple quantitative techniques are used upon the transfer pricing additions made by Indian tax authorities over a period and the BoP figures as published by the Government of India, to quantify the impact of transfer pricing on BoP. There is no attempt being made to develop any model for measuring the impact, since the published data available is for transfer pricing is available for a relatively shorter period of time. Also major variables within overall impact of transfer pricing are also required to be studied for development of a model.

4. Data Analysis:

The annualized BoP figures for India are also given in the table 1. The figures indicate the current account and capital account BoP status on annualized basis.

Additions made to the income of various assesses over a period of time are given in table 1. These figures indicate the additions made by the authorities via the assessment orders passed. These are in case of the assesse who have related party international transactions. This means that the incomes are increased or costs are reduced. In either case there is no inflow of funds to the economy to that extent, indicating a direct negative impact on the BoP.

Table 1: India’s BoP & Additions to ALP of International Transfer Pricing

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Source: Annual Reports, Ministry of Finance, Government of India; Reserve Bank of India (http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/140T_HBS120911.pdf), (http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/147T_HBS120911.pdf).

It is assumed that all the additions to the income are made on the current account side of the BoP. This assumption is based on the findings of the analysis of the assessment orders passed by the authorities. An insignificant number of cases were
found in which capital account transactions were there in which additions were made by the authorities.

The data for the financial year 2008-09 for transfer pricing additions is not available and hence not considered for the analysis. Also the same data for financial years 2004-05 to 2006-07 are available combined. Hence the same are taken. The US $ conversion rates are taken as simple average for the three years of the US$ average rate for the respective financial years as published by the Reserve bank of India.

5. Findings:

BoP deficit is an issue for economies and specifically the current account deficit depicted by trade deficits. At the same time transfer pricing is emerging as an issue for the authorities from the taxation point of view. If tax management is an issue for the nations due to transfer pricing the same transfer pricing also is an issue when it comes to BoP management.

The additions to the income made by the authorities after due audit for transfer pricing for related party international transactions is 12.55% of the India’s BoP current account figure and 35.83% of the net BoP of India. Also additions on account of transfer pricing are increasing at an increasing rate as compared to the BoP.

6. Conclusions:

Transfer Pricing has a greater impact on the economies than just lack of right full tax and global profit after tax management. It has substantial effect on the BoP management and in turn the currency management by the economies. This implies that it impacts the fiscal and monetary policies of the economies making it a complex and critical issue to study and understand for the authorities.

Further studies have to be conducted for development of models for estimation of the impact of transfer pricing on the BoP and currency fluctuations. Studies should also focus on the quantum of trade between related parties and the foreign direct investment into the economy, the age of the foreign investment, and its effects.

7. References:


http://finmin.nic.in/reports/annualreport.asp