Transper pricing

Transfer PricingTransfer pricing provisions primarily require any income arising from an international transaction between two or more Associated Enterprises (??? AE??™) to be at arm??™s length price and comparable to similar transactions between unrelated enterprises. OBJECTIVES OF TRANSFER PRICINGChief Executive of a big company cannot monitor and control operations of each and every sub-unit. So the sub-units are turned into Investment Centers and necessary authority is delegated to their managers. But in a decentralization, there are difficulties in evaluating the performance of the managers.

Further, there is a problem of coordination. So a method is needed to ascertain contribution of each sub-unit to the total profit of the organization. A common solution to this problem is to set prices for intermediate goods which are transferred from one division to another. These prices are known as transfer prices to be used for: Performance evaluation of each manager based on the contribution made by the sub-unit. Coordination of all sub-units for achieving the organisational goals. Deciding what to charge for transfer a product or service to the next department.

to preserve autonomy of a sub-unit. Motivation of the managers as they would certainly get rewards for good performance through a transparent system. Methods of Transfer Pricing1) EXTERNAL MARKET PRICEIf an external price is available, it would be a good price indicator.

The transfer price should be the same as market price less an amount representing savings in packing and transportation cost etc. In an ideal situation, a sub-unit would have an option to sell directly to the maket should a reasonable transfer price is not agreed upon. Same is the case with the buying department. 2) COST PLUS MARKUPSub units can fix a markup on cost to get a reasonable return which would enable them to achieve the required ROI. Such a markup may be based on variable cost or full cost. It would make no difference except that basing on variable cost would be convenient. Supposing variable and full costs of a department are Rs.

300 and Rs. 500 respectively. Suppose further that the manager thinks a fair price for his or her product to be Rs. 600. So in case of variable cost, the markup would be 100% and in case of full cost 20%.

Same results would be achieved in both the cases. 3) NEGOTIATED PRICESIf there is no outside market, the buying and selling department may negotiate pricesProblems and IssuesOperational Difficulties ?¦ Determination of ALP ?¦ Some intra-group transactions are so unique that they can-not be compared ?¦ TP reports of two AE??™s would have conflicting conclusions ?¦ No recommended Profit Level Indicator (PLI) ??“ wide fluctuations may result depending upon each PLI. ?¦ Corporates hesitant to disclose information ?¦ Major countries do not require rejection of other methods ?¦ Associated Enterprise ?¦ Whether Section 92A(1) overrides section 92A(2)(a)? ?¦ Applicability of Section 92A(2)(h) & clause (i) to trading companies ?¦ Databases ?¦ Time gap in search of Databases ?¦ Non availability of recognized databases ?¦ Lack of comparables ?¦ Benchmarking ?¦ No recommended method for benchmarking ?¦ Transaction by Transaction ?¦ Aggregate of similar Transactions ?¦ Based on Functions ?¦ For each AE separately ?¦ Arm??™s Length Range Vs Arithmetic Mean ?¦ Pricing of Intangibles ??“ soft targets ?¦ Difficulty in justifying adjustments for factors having a bearing on prices ?¦ Insufficient information available for calculating gross marginsLegal Issues ?¦ Rule 10D(2) ??“ No documents required for transactions below 1 Crore, but still to justify Arm??™s Length basis ?¦ Determination of AE??™s ??“ unusual/ irrelevant situations ?¦ Whether AO can open previous years??™ assessments on the basis of TP report ?¦ Whether transactions which do not affect profitability are covered??“ e. g reimbursements ?¦ Whether Liaison Offices are coveredAccounting Issues ?¦ Segmental accounts were not mandatory in India till 2001 ?¦ How to factor Internal Set-offs ?¦ Comparability in special circumstances ??“ startup losses, market strategy, government controls, winding-up. Problems in Documentation ?¦ Duplication of Documents in case a Foreign Company (FC) earns Royalty, technical fee, interest on ECB etc ??“ ie FC also required to file a ROI, TP report ?¦ How to document discussions over phone and in meetingsTax assessments ?¦ Not an exact science ?¦ Concept of TP is still in its infancy. ?¦ Flexibility to apply a method other than that prescribed or apply a combination of methods ?¦ Use of secret comparables ?¦ Confidentiality of information ?¦ Authenticity & reliability of databasesIssues relating to Allied Laws ?¦ Whether Customs authorities can take recourse of valuation in TP report ?¦ FERA/FEMA issues on higher valuation in TP reportWay Forward ?¦ Transfer pricing “ band” rather than a transfer pricing “ price” ?¦ ??? Safe harbour” rules ?¦ Procedures for obtaining “ Advance Pricing Agreements (APA)??? ?¦ Use of multiple year data ?¦ Objective and reasonable approach of the tax officerSummaryA good accounting system should promote goal congruence among its employees.

In other words, all employees should work and take decision keeping in view objectives of the company. Various techniques have been used for this purpose such as Management By Objectives. The accounting system can make its contribution by segregating profitability of each division or sub division through declaring each division as an Investment centre. ROI, RI and EVA are used as performance indicators but the transfer mechanism has to be addressed. An example was given of a Packaging Company. While its Package Unit sells in the market and earns revenues, this was not the case when paper was transferred to Printing Unit and printed sheets were passed on to Packaging Division.

Here comes the question of Transfer Pricing. As a general rule, a transfer price should be equal to opportunity cost for the product. With a sound system of Transfer Pricing, it become easy to prepare unit wise P&L account and to observe non-financial factors to evaluate performance of an individual unit.

With such a transparency and accountability, overall results of company would be smooth? achieving targets set at the start of the year.