Case 12-1; litchfield corporation

Finance

Case 12 Litchfield Corporation al Affiliation The US tax law charge no Value Added Tax (VAT) is charged on productsexported to other countries. However, the Federal income taxation applies to all exporters. The tax applied against the exporters is on their profits. The implication extends as far as exporters whose export sales are done through offshore stores and employees, direct exporters, offshore representative office, dependent sales agents and independent sales agent. However, the resale margins made by an exporter's UK subsidiary for instance; is not likely to be included in a US exporter's profits that the federal government charge income tax unless;

The subsidiary allocates its resale margins to the parent company though a dividend

The subsidiary in a foreign country is at least 10% owned by the US exporting company

The subsidiary is flow through entity for tax purposes

This means that despite Litchfield Corporation of a favourable environment to operate in the UK, the perceived profits will decline as the margin is to be taxed by the federal government. The establishment of an offshore subsidiary firm enables the institution split its profits into two where; export profits from the sale of the umbrellas to the subsidiary which is subject to income tax while export profits from the subsidiary sales to foreign buyers is not subject to the US federal income tax unless distributed to the parent firm in the form of a dividend (Burman & Slemrod, 2013).

Litchfield Corporation's ambitious expansion certainly will have to handle and manage the risks that are associated with exportation so as to ensure maximum profitability and limits losses. The risks likely to be encountered include;

Credit risk; this might affect the parent company since the credit worthiness of the offshore subsidiary may be questionable. The credit worthiness limits the risk of late payments, non-payments hence minimizes the risk of reduced profits.

Transportation and logistics; the company faces the risks associated with movement of goods over long geographical locations. This increases the costs of operation since more is invested in risk transfer and profit margins are likely to be reduced.

Exchange rate risk; the risk of exchange rate fluctuations that reduces the business' profits is likely to be affected by different economic climates.

Therefore, the risks that might likely to affect the business need to be identified and proper steps undertaken so as to minimize the risk of loss of profit. Some of the risk management options include; insurance that covers country risk cover, credit risk cover, and transit risk cover ensuring that Litchfield competes profitably in UK.

The methods of transfer of prices for international subsidiary companies include;

Market based; the transfer price imposed to a customer is either based on the price charged on other customers by similar businesses. This is based on the prevailing market prices of commodities

Cost-based; this is transfer price based on the cost of production of material. This determination is set to include a profit margin for the producer. However, the simplicity of application of the cost based transfer price method, two problems arise such as the measure of cost to use and the other one is one unit inefficiency may be transferred to other units limiting profit maximization.

Negotiated price; this is the price set by a business after a bargain between the buyers and the sellers. This allows the offshore subsidiary managers to set free thee prices after interaction with their customers.

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