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TRANSFER PRICING: CONCEPT AND DIMENSION

1.0 INTRODUCTION

Goods and services are traded in the open market for a consideration. When they do, they are likely to involve parties that are unrelated but happen on one another i.e. the buyer in his search for such goods and service, for purchase, and the seller, in search of his market. However, when this occurs within the context of legally recognized but related persons, it conflates issues, especially for tax purpose, as a result of the tendency of transactions not getting any or part of the tax treatment therein. Thus, we can infer that because of the realities of potential for cross-border controlled transactions distorting taxable income, tax authorities in many countries adjust intragroup transfer prices that differ from what would have been charged by unrelated enterprises when dealing at arm's length. This is one of the major basis for discussions on transfer pricing.

2.0 CONCEPT

Transfer pricing is, therefore, the setting of prices for goods and services sold between or among controlled (or related) legal entities within an enterprise based on defined methodologies. Transfer pricing culminates in the ascertainment of prices among divisions within an enterprise. So, when a subsidiary company sells goods to a parent company, the transfer price is the technical term given to the payment by the parent to the subsidiary for the cost of those goods passed on to the parent company by that subsidiary.

Transfer pricing can also refer to the pricing of international transactions between two related entities as a result of the relationship that exist between related parties. The objective, for tax purposes, is to ensure a transfer price that is not markedly different from the price similar transaction would have commanded, had it been agreed, between unrelated parties at "arm's length".

In taxation, therefore, transfer pricing refers to the rules and methods for pricing transactions within and between enterprises under common ownership or control. When transfer pricing occurs, companies can book profits of goods and services in a different country that may have a lower tax rate in terms allocation of profit before tax, to other countries of operation for Multinational Enterprises (MNEs). This presents tax advantages that regulatory authorities generally frown upon. Therefore, because such potential exists for cross-border transactions that distorts taxable income, locally, tax authorities in many countries are disposed to adjusting intragroup transfer prices to bring it into consistency with what would have been charged by unrelated enterprises dealing at arm's length. For tax purpose, the central focus of transfer pricing is on earnings and ensuring it stays where it is created, before it is eventually distributed.

By implication, Transfer prices serve to determine the income of both parties involved in cross-border transactions, thereby contributing to shaping the tax base of the countries involved in such cross-border transactions. Under such scenario, the three parties involved are the multinational group and tax authorities of the two countries involved in the transaction. When one country's tax authority taxes a unit of the MNE group, it influences the tax base of the other country. In other words, cross-border tax situations involve issues relating to allocation, valuation and jurisdiction.

The Organization for Economic Cooperation and Development (OECD) and World Bank recommend intragroup pricing rules based on the arm's length principle implemented through:

1. Bilateral treaties and domestic legislation,
2. Regulations, or
3. Administrative practice.

Two principal models exist for transfer pricing considerations i.e. the OECD and United Nations' models. Countries, with transfer pricing legislation, generally model after the OECD Transfer Pricing Guidelines for Multinational Enterprises including Tax Administrations, even though there might be differences in vital respects.

Where and when adopted, transfer pricing rules allow tax authorities to adjust prices for most cross-border intragroup transactions, including transfers of tangible or intangible property, services, and loans. For instance, increase in a company's taxable income may be achieved by a tax authority through the reduction of the price of goods purchased from an affiliated foreign manufacturer or an uptick in royalty a company must charge its foreign subsidiaries for rights to use a proprietary technology or brand name. These adjustments are generally calculated using one or more of the transfer pricing methods specified in the OECD guidelines.

Some of the available transfer pricing methods include:

1. The Comparable Uncontrolled Price (CUP).
2. The Resale Price Method
3. The Cost-Plus Method
4. The Transactional Net Margin Method; or
5. The Transactional Profit Split Method etc.

As with every other assessment raised on a taxpayer, the move by the tax authorities may be subjected to judicial review or other dispute resolution mechanisms.

The need for transfer pricing rules cannot be overemphasized as a result of abusive schemes that may target cutting back on taxes payable to government by taxpayers. Such aggressive pricing may be achieved as a result of intragroup pricing – especially for debt and intangibles. Among the measures called by the OECD after its 2015 final BEPS report was for country-by-country reporting and implementation of stricter rules for transfers of risk and intangibles with continued adherence to the arm's-length principle. This call has, however, not been without its criticism.

3.0 DIMENSION

We may wonder, therefore, about the scope and depth of transfer pricing measures. In other words, in what way(s) should transfer pricing be of concern to all relevant stakeholders in the tax system?

Legal entities, for the purpose of transfer pricing, are those falling under the control of a single corporation, which may include branches and companies that are wholly or majorly owned, ultimately, by the parent corporation. Beyond this, entities are considered to be under common control if there are high degree of distribution of family members on their boards of directors, in certain jurisdictions.

A scenario is where taxable entities i.e. one parent and the other subsidiary company engage in a transaction. A certain Company A, in a "low-tax" jurisdiction (Country) manufactures baby diapers and distributes them through subsidiary B in a "high-tax" jurisdiction (Country). The diapers cost N500 for Company A to produce and Subsidiary B incurs N100 distribution cost bringing a total enterprise-wide cost of N600. Company A sets the "transfer price" for the diapers i.e. the price at which Company A sells to Subsidiary B, at N800 and Subsidiary B sells the diapers for N1000 to customers. The enterprise has made an overall profit of N400 (N1000 minus the N600 costs incurred by Company A and Subsidiary B) that will be subject to income tax. Company A will report N300 in taxable income to the tax jurisdiction it is found i.e. N800 price minus N500 cost, and Subsidiary B will report N100 (N1000 minus the N800 price paid for the diapers and the N100 distribution costs) in taxable income to its tax jurisdiction.

However, if Company A sets the "transfer price" at N850 instead of N800 and the retail price remains N1000, Company A would report N350 in taxable income, N50 more in taxable income and more than the initial scenario, while Subsidiary B would report only N50 (N1000 minus N850 price paid for the diapers and N100 distribution costs). By shifting the "transfer price" from N800 to N850, Company A increases the income subject to tax in its tax jurisdiction and decreases the income subject to tax in the other tax jurisdiction, thereby reducing the enterprise-wide tax. This can be presented illustratively thus:

Scenario:

	Income (N)	Tax rate	Tax owed	Income (N)	Tax rate	Tax owed	Country Gain/(loss)
Company A	300	10	30	350	10	35	5
Company B	100	40	40	50	40	20	(20)
Worldwide	**400**	**17.5%**	**70**	**400**	**13.75%**	**55**	

The table above is an illustration of the ramification of the impact of transfer pricing on two tax jurisdictions as a result of the actions of controlled entities. We see that the increase in cost in the parent company in the lower tax jurisdiction implies a higher cost consideration in the books of the subsidiary company in the higher tax jurisdiction just like the practice of earnings stripping used by parent company to move profit to lower tax jurisdiction from higher jurisdiction.

4.0 CONCLUSION

The term transfer pricing is not an abstract state of affairs of entities. To the contrary, the above is an indication that enterprises and government agencies are in constant assessment of taxable entities for transfer pricing risk, tax-efficiency, adequacy of support for transfer pricing policy, intercompany agreements, policy implementation in support of transfer pricing documentation as well as intercompany agreements.

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