Transfer Pricing

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A transfer price is the internal price charged by one segment of a firm for a product or service supplied to another segment of the same firm.

Selling division: Iron ore mine

Firm

Buying division: Metal foundry

Goods transferred at transfer price

Production of intermediate product

Sales of finished goods to outside market

The transfer price is the selling division’s revenue and the buying division’s cost.
Why does it matter?

Transfer pricing not only determines how the pie (total profit) is divided among responsibility centers. It also changes the size of the pie:

• By influencing managerial behavior.
• Through tax effects, including income taxes, payroll taxes, customs duties, tariffs, sales taxes, value-added taxes.

Over a third of all global trade takes place within firms.
The goal of transfer pricing policy?

$$\text{Min} \ (\text{Agency costs} + \text{taxes})$$
How Transfer Prices Affect Managerial Behavior

Iron ore mine
Extraction
Opportunity cost: $70

$?

Metal foundry
Process further & sell
Total cost: $40

$125

Outside customer
FIAT

1. Does headquarters want the transfer to happen?
2. If decision making is decentralized and
   • the transfer price is $65, what will happen?
   • the transfer price is $90, what will happen?

Depending on transfer pricing policy, this value-generating transaction with FIAT might not happen.
Transfer pricing methods
Absent of tax considerations

The correct transfer price is opportunity cost—the value forgone by not using the transferred product in its next best alternative use.

The problem?
Market-based transfer prices

- The standard transfer pricing rule according to most textbooks: **If a competitive market exists for the product, it should be transferred at the external market price.**

- Market-based transfer prices align the selling and buying division to make correct make-or-buy decisions.

- However, external prices ignore synergies. This is why firms often produce in-house even if the product or service can be purchased externally.

- Also, producing internally can provide greater quality control, more timely supply, and better protection of trade secrets.

- And in most companies, such prices can’t be found, or at least in a cost-effective manner.
Cost-based transfer prices

- Transfer price is based on the costs of producing the intermediate product. Examples include:
  - Variable production costs
  - Full costs (variable and fixed)
  - Full costs (including life-cycle costs)
  - Usually a markup is added

- Useful when market prices are unavailable, or inappropriate (e.g., “distress pricing”), or too costly to obtain. This approach is far more common than market prices.
Variable-cost transfer prices

• Variable cost represents the value of the resources forgone to produce one more unit. But what critical assumption is being made here?

• Another problem is that the producing division doesn’t necessarily recover its fixed costs.

• A possible solution: Price all transfers at variable cost while also charging the buying division a fixed fee. The fixed fee can cover the selling division’s fixed costs plus a return on invested capital.

• But there’s another problem: Variable-cost pricing creates incentives for the selling division to distort variable cost upward, perhaps by misclassifying fixed costs as variable costs or by changing their production process.
Full-cost transfer prices

- Relatively easy to implement.
- Avoids wasteful disputes over measuring variable costs.
- But full costs typically overstate opportunity cost, especially if manufacturing has excess capacity.
- Also, full cost allows manufacturing to transfer inefficiencies to distribution. What can be done to mitigate this problem?
Negotiated transfer prices

• Transfer prices are negotiated directly between the selling and buying profit-center managers.

• Works only if both managers have some bargaining power (i.e., have the option to sell or source outside).

• Problem: The outcome depends on the negotiating skills of the managers involved.

• It’s costly (in management time), accentuates conflicts between profit-center managers, and often requires corporate management to intervene.
Transfer pricing is the most controversial issue in international tax

Example: GlaxoSmithKline (GSK)

In January 2004, the IRS filed a $5.2 billion claim (including $2.5 billion in interest) over the transfer prices attributed to Zantac (ulcers), Zofran (nausea), Ceftin (antibiotic), etc.

The R&D had been undertaken in the U.K. The products were produced in the U.K., and shipped to the U.S. The drugs were then marketed and sold by the U.S. subsidiary.

The price charged by GSK in the U.K. for drugs exported to the U.S. included a charge for services related to the costs of R&D.

The IRS claimed that (1) the charges were excessive, and (2) GSK ignored the contribution that heavy marketing and sales efforts in the U.S. made to the drugs’ success.
Transfer pricing is a contentious issue

- At the firm level: Because transfer prices affect performance evaluation and, hence, the rewards managers receive, disputes between divisions are inevitable.
- At the country level: Transfer prices allocate taxable income across borders within multinational businesses. And this income tends to be allocated to relatively low-tax jurisdictions.
Recent developments

• In 2013, the G20 asked the OECD to produce reforms aimed at curbing abusive transfer pricing.

• The principle: multinationals should be taxed “where economic activities take place and where value is created.”

• The result:
BEPS

Base Erosion and Profit Shifting
Examples of profit shifting

- Toothbrushes imported from the UK for $5,655 each.
- Cotton dishtowels imported from Pakistan for $153 each.
- Car seats exported to Belgium for $1.66 each.
- Missile and rocket launchers exported to Israel for just $52 each.

"Double Irish with a Dutch Sandwich"
Want a Lower Tax Bill? Just Google It

Google’s elaborate international network allowed the company to cut its overseas tax rate to just 2.4% between 2007 and 2009.

1. Google can’t easily send money to Bermuda without incurring Irish taxes. Instead, the cash takes a brief detour through the Netherlands.

2. The Netherlands has generous tax laws, so Google can transmit about 99.8% of its Dutch revenue to the tax haven of Bermuda.

3. The overseas subsidiaries pay Google a licensing fee, but the company tries to keep the fee low since it’s subject to high U.S. tax rates.

Google Ireland

Google Netherlands Holdings

Bermuda

Google Inc.

88% of Google’s overseas sales

Technically an Irish company with management in Bermuda

GNH is a shell company with no employees

$3.1 billion in tax savings
CUP
The transfer pricing method of choice for tax authorities

• CUP = comparable uncontrolled price
• Usually the first question from tax authorities: Did you use CUPs?
• The problem: it’s very hard to find true comparables.
• Cost-plus has become the default after CUP.
TNMM
Transaction Net Margin Method

• This approach uses profit indicators, such as operating margin, as a test to determine if cost-plus meets arms-length criteria.

• Here’s how it works:
TNMM
Transaction Net Margin Method

- First identify some comparables—e.g. 10 companies.
- Rank order them from lowest to highest.
- Exclude the outliers: e.g., the top 2 and the bottom 2.
- The middle-6 is known as the “arm’s length range.”
- If your operating margin is within this range, you’re almost certainly OK.
Transfer pricing red flags
When tax authorities get suspicious

• Persistent losses or low operating profits.
• Lack of sufficient documentation.
• High royalties with licensee exhibiting low profits or operating losses.
• Royalties charged for soft intangibles (i.e., those that are not legally protected, such as business systems/methods).
• Significant inter-company management fees.
• Transactions with group company in tax haven.
• Significant asset impairment charges, restructuring charges, inventory write-offs.
• Significant year-end adjustment to inter-company prices.
Transfer pricing: The future

• Companies will be required to do more country-by-country reporting of where they really earn their revenues, hold their assets and employ people, and where they book their profits. This will give tax authorities (though not the public) a clearer picture of how much profit is being shuffled around for tax purposes.

• The “double Irish” game is disappearing, and will likely disappear completely.

• Despite the OECD guidelines, there will always be loopholes.