

Transfer Pricing: Headache to Corporate Governance

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Abstract. Fixations of transfer pricing (TP) is problematic to corporate governance (CG) as there are various constraints such as legal issues, pricing methods, documentation, penalties influence and are applied differently across the globe. The aim of the paper is to locate such constraints through literature review and comparative analysis of management of TP in various countries. The research confirmed TP as headache to CG and hence suggested to incorporate TP guidelines in the respective country's Company law and OECD to act as "International Court of Justice" in the area of TP conflicts.

Keywords: Transfer pricing, Corporate Governance

1. Introduction

TP is a system of charging price by an enterprise that enters into international cross boarder transaction with an associated enterprise. For tax saving, TP is manipulated that resulted in revision of TP system in US [1]. "New TP rules require more proof that internal transactions at multinational companies are conducted at arm's length price (ALP)" [2], a price that is available to any unrelated party in open market conditions. Internal Revenue Service (IRS) of US, OECD and many countries across the world issued many complicated "regulations" on how TP is to be handled. The lack of harmony in TP regulations created headache to CG to administer them, more so in the areas dealing with legal issues, method of pricing, documentation and penalty. The old regulations didn't require much documentation whereas the revised regulations require pricing at arm's-length [3] with or without a markup and the connected documentation. Revenue agencies and CG stand at opposite ends in dealing with TP as the former desires to secure more revenue through taxes and the later tries to save more through dodging taxes so as to secure more profit after tax to declare dividend.

2. Literature Review

The TP Guidelines for Multinational Enterprises and Tax Administrations provide guidance on the application of the ALP for the valuation, for tax purposes, of cross-border transactions between associated enterprises [4].

New CG is a broad spectrum that covers many practices which are not compatible with the formal rules of CG more so in areas of TP, share dilution, asset stripping, limiting shareholder' voting rights and bankruptcy [5]. TP in the CG takes lead when a company is having its branch outside of the country. Through TP "billions of dollars related to tax heaven, flow across borders" [6]. Australian Taxation Office (ATO) noticed the abuse of TP to avoid tax through "corporate restructures" [7]. The application of a specific method of TP out of many methods [8] [9] adds headache to CG. Though TP system is designed to be consistent with accounting theory but it is not in operation [10].

Almost every corporate scandal of recent years, from Enron to Parmalat, has involved tax-dodging in one form or another. There is a bull fight between the Revenue Authorities and CG. It is aptly said TP is a global headache and is very tricky. Most countries set ALP but the practice is complicated particularly companies are increasingly service-oriented and rely more on brand, intellectual property and other hard-to-price intangibles. Haishun [11] noticed in China the headache created by TP on CG and recommended to further liberalize the economy and develop a well-defined legal system to govern business operating environment which includes fixation of TP.

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Bernard [12] identified that CG behavior has a powerful effect on market value in a country where legal and cultural constraints on corporate behavior are weak and thereby there will be further headache when dealing with the TP. Suppliers of finance to corporation require return and the return could be available from the balance profit after tax. This system added to the problems of CG as less tax (no tax), more return and vice versa [13]. Chong et al. [14] and Porta et.al. [15] supported several theoretical predictions that the legal approach is a more fruitful way to understand CG and its reform than the conventional distinction between bank-centered and market-centered financial systems. Han [16] investigated the impact of CG on the choice of TP methods in China and concluded that the ownership has an impact on the choice of TP methods.

Martine [17] is of opinion that cross-border TP is difficult to fulfill the fiscal requirements which created headache to the CG. Still CG plays a “key role” in fixation of TP to establish a balance with various good reasons, while playing different roles at different levels to reflect strategic goals.

The prescribed methods where CG can choose under ALP such as (a) Comparable Uncontrolled Price Method (CUPM) (b) Resale Price Method (RPM) (c) Cost Plus Method (CPM) (d) Profit Split Method (PSM) and (e) Transactional Net Margin Method (TNMM) further created headache in the areas of documentation (exhaustive & requirement of various certificates), burden of proof (rested on the corporation) and heavy penalty (in case of understatement of income).

In addition to the above each country may have different laws, for example in India, Income Tax Act, 1961, Customs Act, 1962, Central Excise Act, 1944 and Accounting Standard 18 varied their approach in dealing with TP issues. Divergent approaches in defining a transaction, associated enterprise and basis of determination of price etc. further added salt to CG headache.

3. Constraints adding headache to CG in the area of TP

Among various constraints, this paper concentrates in the areas of legal position, pricing method, documentation and penalty that add salt to headache to CG in handling TP. Legal position deals with the laws of the country that are applied for TP. Pricing Method is the method among various methods such as CUPM, RPM, CPM, PSM, TNMM etc allowed to be applied in TP. Documentation deals with documents that are legally to be provided in TP which include background information on the commercial environment when the international transaction entered into, the analysis carried out to select the most appropriate pricing method in relation to ALP, certificate of an accountant certifying that the ALP has been determined in accordance with the TPR and that prescribed documentation has been maintained [18]. Penalty is the area that attracts if the CG failed in the TP. As stated that TP deals with different countries, it is problematic to CG to follow the contradicting legal system, rules etc of two or more different countries and to satisfy the Revenue Authorities of the various countries. Never the less, it is a wanted headache which requires medicine to prevent or cure the headache. It is always better to analyze the problem creating areas in TP, identify the reasons and apply the preventive or curative treatment which should satisfy both Revenue Authorities and the CG.

4. Headache in fixation of TP at global perspective.

It is seen that fixation of TP has become a great headache across the corporations in the globe. It is ideal to scan through the problematic areas of TP in different countries whether there is uniformity in the problems and approaches in TP. As case study, countries such as Argentina, USA, Canada, U.K., France, Germany, Russia, India, China, Indonesia, Japan and Australia are taken up to pinpoint the divergence in dealing TP issues and presented in the Table 1.

Table 1: Divergent approaches in dealing TP issues by different countries across the Globe

Country	Legal Position	Pricing Method	Documentation	Penalty
Argentina	Tax Act & ARS	Best method out of many methods	Contemporaneous	3% interest monthly for late, 2-10 times fine un paid taxes
USA	IRS	Best from CUP, Resale Price, Cost Plus, CPM, Profit Split	Contemporaneous	20% - 40% underpayment of tax as penalty levied.
Canada	Tax Act & CCRA	Method which provides highest comparability between transactions	Contemporaneous	10% penalty on total adjustment to transaction plus non-deductible interest
UK	Income & Corporate Tax Act; IRD	Transaction based method	Contemporaneous	Up to 100% of any additional tax due
France	Tax Administration	Transaction-Based method.	Documentation audit purposes.	40% for bad faith 80% for fraud
Germany	Federal Ministry of Finance	Transaction based method	No specific provision	No penalty
Russia	Russian Tax Code	CPU method	No specific rule	No specific TP Penalty
India	Finance Act 2001; IT Act, CBDT	Best of CUP, Resale Price, CPM, Profit Split, TNMM, or CBTD prescription.	13 Different types of documents	100% to 300% of the tax sought to be evaded and others.
China	Income Tax Law; SAT	Best out of CUP, Resale Price, Cost Plus	No statutory requirement	2000 to 10000 Yuan and others.
Indonesia	Income Tax Law	Best of CUP, CP M, Sales minus resale price method	No formal requirement	2% to 48% of any tax underpayment discovered.
Japan	NTA & STML	Transaction based	No Statutory but suggested documents	No penalty but general tax penalty provisions apply.
Australia	Income Tax Assessment Act & Taxation Rulings	Most reasonable method among CUP, Resale Price, Cost Plus, Profit Split, TNMM	Contemporaneous	Under TR98/16, provision for penalty.

Notes: ARS= Argentina Revenue Service; IRS= Internal Revenue Service; CCRA= Canada Customs & Revenue Agency; IRD = Inland Revenue Department; SAT = State Administration of Taxation; CBDT = Central Board of Taxes; NTA= National Tax Administration; STML = Special Taxation Measures Law.

Table 1 highlights that there is no uniformity in the applicable variables tested such as legal position, pricing method applied, documentation and penalty. Each country is having its own approach and hence it becomes further headache for CG dealing in fixation of TP applicable (or suitable) in another country. Even, within the same country, the rules and regulations are confusing and contradicting. This confusion has given rise to many court cases. In order to streamline the TP regulations, Government of India appointed an Expert Group which drafted TP regulations.

5. Indian Context

India, since 2001 has been amending its Income Tax Act to catch up strides of the international developments regarding TP issues. The ALP is the core principle followed for computing transfer prices in respect of transactions between related entities. The Assessing Officer can determine the ALP after making adjustment in respect of the price charged or paid. The penalties up to 300% are also prescribed in the law to curb tax avoidance by abuse of legislation [18]. India followed the suit of US and OECD and amended its TP regulations accordingly. Courts also issued specific rulings on TP such as in Maruti Suzuki India Ltd [19] allowed certain expenses in arriving at taxable income on TP system [20]. Re Dana Corporation [21] court case dealt with the application of TP law on capital gains in business reorganizations at international level [22].

6. Conclusion and suggestions

It is seen that Tax Law of the country is most influencing law in TP, still we could locate, other laws within the country and global practices confuse the system of TP. Most of the countries followed ALP, yet identifying the reasonable ALP is severe headache to CG. Documentation varies from country to country yet too many such as 13 in India, definitely adds the salt to CG headache. Penalty is not uniform across the globe; hence CG has to be careful in dealing TP.

The suggestions emanated from the Expert Group in India on TP aptly fit here such as TP guidelines to be incorporated under the Companies Act to ensure the fairness of TP from a shareholder/creditor perspective. "Abuse of CG by violating investor and creditor rights damaged the financial system. On the one hand, the erosion of investor confidence has dealt a body blow to our capital markets. On the other hand, mounting corporate delinquencies have debilitated the banking system. In this situation, it could be argued that there is a case for a regulatory regime to check transfer-pricing abuses" [23]. Further it is suggested a world body such as OECD should be empowered with legal powers as International Court of Justice in dealing with TP issues.

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