Transfer Pricing in International Markets: Problems of Information Support

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Abstract: The article characterizes the transfer pricing in international markets, analyzes the “arm’s length principle” as the main principle of taxation of interdependent companies, the motivation of transfer pricing participants, the main features of the transfer pricing practice, and the system regulating the transfer pricing at the interstate level. Based on analyzing various aspects of information support for the transfer pricing system, it has been proved that the best approach to improving it is to establish a permanent document flow to substantiate the level of transfer prices and to further draw up management, financial and tax reports. The novelty of the study consists in the recommendations on the sequence of actions to form a unified system of document flow, and management and financial accounting that would provide management with the information on all transactions with affiliates.

Index Terms: affiliates, controlled transactions, document flow, transfer price, transfer pricing.

I. INTRODUCTION

The concept of pricing is a key source of profit in the enterprise. Its formation depends on many factors. The development and evolution of the pricing concept are directly dependent on the economic and technological structure that prevails in the economy. In its turn, the economic environment is transformed under the impact of macroeconomic factors, including globalization that has the greatest impact.

Due to the increase in the globalization of the world economy and the expansion of the activities of transnational corporations (TNC), the number of transactions using the transfer pricing mechanism (hereinafter referred to as the TP) is increasing. Efficient TNC management involves not only the formation of a clear organizational structure of management, but also the development of efficient economic relations between its structural divisions.

However, the TP should not be associated only with the activities of large TNC. This mechanism of minimizing tax payments and international division of capital has started to be widely used even by small participants of international relations that establish their branches or representative offices abroad and use them as participants in transfer operations. This kind of activity has become characteristic of many Russian subjects of the international activity, which makes the study of the TP problem particularly relevant.

Against the background of the need to find an optimal variant of the economic independence of structural units, to clearly define the income and expenses of each unit of the enterprise, and to estimate its impact on the overall result of the activity, the problem of the study and use of TP is becoming more and more important. In this context, the problem of using TP at an enterprise touches on the processes of its information support in order to manage the results of the activities performed by the enterprise, and therefore is relevant.

Despite the fact that the issues related to TP are the object of the study in numerous scientific papers [1]–[6], a number of aspects related to the information support for TP are disputing and require additional study.

The purpose of the article is to characterize TP in international markets, to analyze the problems that exist in the information provision system in terms of TP management as applied to business partnership of enterprises, and as well as to offer recommendations on how to overcome them.

II. PROPOSED METHODOLOGY

A. Characteristics of TP In International Markets

According to the OECD (Organization for Economic Cooperation and Development) Recommendations on TP [7], in the most general form, transfer prices are prices for internal corporate supplies, i.e., the prices that one of the economic centers and/or divisions sets for another center and/or a division of the same company or corporation.

The OECD Guidelines formulated so-called “arm’s length principle”. This is the principle of taxation of interdependent companies. According to this rule, tax liabilities are calculated on the basis of market prices for transactions between interdependent taxpayers, as if companies were independent (“at arm’s length”). This principle has been adopted as a way to protect the state in obtaining taxes.
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W. Cheng and D. Zhang comment on this international legal provision and emphasize that the attempt to regulate profits by specifying the terms and conditions to be achieved between independent enterprises in comparable transactions and under comparable circumstances (i.e., in "comparable noncontrolled transactions") according to the "arm’s length principle" ensures the compliance with the approach to satisfying TNC members as if they were separate entities, and not inseparable parts of a single unified business. This is due to the fact that in such a case, the attention is focused on the nature of the transaction between these members and under the conditions that differ from those that will be recognized in comparable uncontrolled transactions. Such analysis of controlled and uncontrolled transactions is the core of applying the "arm’s length principle" [8].

It is necessary to note that the "arm’s length principle" can be implemented differently in national legislation. Taking into account this fact, there are several variants used by states. Firstly, this is the approach when this principle is explicitly expressed and normatively defined in the national legislation. Secondly, the principle under consideration may be expressed, but formally undefined in regulatory legal acts. Thirdly, there may be the situation when this principle is not expressed in the legislation, but related legal doctrines are applied. Fourth, some states do not legally enshrine the principle under consideration in law, but at the same time they empower tax authorities to adjust the income (profit) of taxpayers in order to display it correctly [8].

The development of TNC as a form of organizing production relations caused a certain transformation of the "transfer price" concept. The concept of "transfer price" is increasingly used to denote the price at which goods and services are transferred between economic entities that are a part of a certain TNC. Thus, the concept of "transfer price" covers international market relations [9].

TP is stipulated by the expansion of TNC international operations. In practice, it is related to pricing goods, services, know-how and intellectual property that are transferred across borders within corporate networks. The prices such assets are transferred at determine the income of both parties and, thus, the tax base of the relevant countries. Theoretically, if the calculated transfer price provides a reasonable distribution of income, the tax authorities of both countries receive a fair share of tax revenues. However, any TNC may want to take advantage of various levels of taxation and "pump over" its income into the country with a lower level of taxation.

It is reasonable to consider the essence of TP in the context of economic interests of various subjects of this process. Depending on their role in this process, these subjects are international and national companies, as well as government bodies. As a result of applying the TP system, companies can get considerable benefits and meet their own economic interests that are not only related to the increase in income, but are more complex.

In general, the main reasons for the companies participating in TP include the following:

1) Optimization of activities: tax optimization (reduction of the tax burden) and efficient distribution and allocation of assets,
2) Control over supply and demand within the company,
3) Keeping trade secrets when transferring technologies within the company,
4) Improving the company competitiveness in target markets,
5) Improvement of the company’s consolidated financial result, in particular, the efficient use of transfer prices subject to applying international accounting standards,
6) Efficient placement of investments and credit resources. State bodies have the following motives related to TP:
   1) Increase in budget revenues by regulating TP,
   2) Protection of national producers,
   3) Creating the same competitive conditions for companies in the national market, and
   4) Avoidance of maladjustments in the payment balance, which may affect the country’s economy, exchange rate, etc.

Based on the concept of TP, this mechanism is referred to the prices at which transactions are concluded between the legal entities that are members of one international corporation. This has an impact on selecting the jurisdiction for income taxation [10].

At the same time, transfer prices can be classified into three groups: 1) the ones corresponding to the market prices, 2) the ones that are higher than market prices, and 3) the ones that are lower than market prices (the last two cases will be accepted as the manipulation of transfer prices). Market prices may differ under the impact of two factors – objective (the lack or difficulty in obtaining information about market prices for certain types of goods, works, and services) and subjective (obtaining additional economic benefits, including as a result of “tax planning”). According to the authors, the manipulation of prices in TP can be the difference in the transfer price from the market one for the relevant goods, works, and services arising under the impact of a subjective factor (obtaining economic benefits).

The analysis of using the TP system in international markets makes it possible to define the following main features:

1) Principles of applying transfer pricing in various international companies differ. They can be based either on the market ones, exceed, or be lower than the market ones for various parties and transactions. Consequently, it does not go about unequivocal overestimation or undervaluation of market prices, but rather about the adjustment of prices to a certain business transaction in order to solve specifically set managerial tasks.
2) The scope of activity of PT extends to companies of all industries and areas – manufacturing, trade and intermediary sector, financial and credit, insurance business and other industries.
3) Use of TP is an efficient instrument for achieving key strategic goals of organizations and groups of companies.
4) Transfer prices can be applied to those types of goods, finished products, works, and services that actually are an intermediate product, or appear as a part of the final product (goods, work, and services) production, etc.

Improper use of transfer prices can cause the removal of weak competitors, barriers for new competitors to enter the market, and the monopolization of certain markets. In this regard, international organizations, home countries and countries that accept foreign direct investments of TNC implement certain mechanisms to control and regulate TP.

TP is regulated at the interstate level in accordance with international requirements set by the OECD TP Guidelines [7]. Most developed as well as developing countries implement OECD principles into their national TP control and regulation systems. It is necessary to note that non-OECD countries are also recommended to follow the Directives. To publicize them, multilateral seminars are held. Here problems of TP are discussed, and the Directives provisions are explained to representatives of tax administrations. The United States do not participate in these events, because their TP regulation system is much older (it is believed that the first regulatory legal act of the United States related to the TP regulation was introduced as early as in 1928 under Section 45 of the Tax Act adopted by the US Congress). That is why other countries either use the US experience or are guided by the OECD principles, although there are also combined variants. Both systems (OECD and USA) are very similar to each other. In particular, both are based on the market price principle and have similar TP methods. However, in the USA the mechanisms for the practical application of regulation standards and provisions are much more developed.

Japan and the United Kingdom are a prime example of developed countries whose national TP regulation systems are based on OECD.

The National Tax Administration of Japan regulates TP on the basis of the law on special taxation measures and the law on special taxation in the context of tax agreements. These rules are also based on OECD principles and are applied to prevent the movement of assets and double taxation. These rules also protect Japanese TNC from audits and sanctions by the Internal Revenue Service.

In the United Kingdom, the Board of Inland Revenue regulates TP according to the Income Tax and Corporate Tax Act adopted in 1998. The standards for the TP regulation for both tangible and intangible assets are similar to the OECD principles.

Despite some differences in various countries from the offered guidelines, in general, it is possible to note that the OECD Guidelines have made the basis for forming a national transfer pricing policy in Russia, Belarus, Kazakhstan and other countries.

It is necessary to note that the use of the OECD TP Guidelines is beneficial not only for tax authorities that now consider operations on TP as a promising object of tax control, but also for companies, because their correct use allows avoiding fines from tax authorities, reducing risks of double taxation and strengthening the positions during the audit.

III. RESULTA AND DISCUSSION

A. Information Support for TP In the System of Business Partnership of Enterprises in International Markets

Now all business entities that use TP systems in international markets face the need in the efficient information support for TP. Therefore, the main thing for such entities is to form a well-adjusted data system for decision-making and control over TP and controlled transactions.

In this case, it means that for the TP system to function efficiently and not to cause permanent risks for the enterprise in terms of the possibility to get considerable fines within the tax control, it is necessary to have a well-adjusted management and financial accounting system in order to provide all departments directly related to concluding and executing contracts with counterparties within the affiliated entities with access to top quality information.

It is better for economic entities to function under the conditions of preliminary, rather than subsequent control of such operations.

In this case one of the most important and at the same time difficult stages is the organization of full-fledged document flow for the purposes of TP and the subsequent analysis of the collected and documented information.

In the system of financial and management accounting, an optimal document flow system should be formed. Its aim is to permanently ensure high quality results of analyzing TP to prevent potential losses from improper application of TP rules (or non-compliance with them) by the enterprise.

It is reasonable to use the list of basic information, including the following minimum as suggestions for creating an optimal document flow system:

- Arrays of data on controlled transactions, as well as transactions that may become potentially controlled,
- List of related persons,
- List of sources of information for the marketing analysis for the purposes of TP,
- Price information about the goods (works, services) that are subject to controlled transactions, and
- Parameters (indicators/conditions) of transactions to be monitored, except for prices, etc.

It is reasonable to create, to a certain extent, unified forms (templates) of in-company documents that would provide a three-tier approach in relation to data formation: Level 1 is the level of a group of companies, Level 2 is a private enterprise, and Level 3 is a controlled transaction. Various aspects related to TP are subject to the analysis. Therefore, it is reasonable to develop templates for the analysis regarding:

- Package of agreements (contracts), including foreign economic that imply controlled and potentially controlled transactions,
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– Schemes (regulations) of standard processes and the use of documents for the benchmark study, functional analysis, TP risk analysis, economic analysis of controlled transactions and TP documents flow, and
– Information exchange on TP issues between structural units of the company, as well as within the group of companies.

The documents regulating the functioning of the TP document flow system in the enterprise are of particular importance in the in-company documents system. They should include:

1) Provision (order) on the regulations (description) of the policy and internal control of the company’s (or group of companies) TP and the requirements and rules for the preparation, authorization, control, and archiving of documents and other information used to further make reports on controlled transactions and TP documentation,

2) Package of job descriptions that specify duties, tasks and functions of individual officials who should participate in the formation, verification, adjustment, maintenance, storage of TP documentation, as well as in the preparation of the Report on controlled transactions,

3) Forms of management reports on regulating the information on controlled transactions, and

4) Schedule for the preparation of Reports on controlled transactions and TP, etc.

The development and continuous testing and evaluation of the effects of controlled transactions in the TC system for the purposes of internal control are of great practical importance.

In general, the conclusion regarding the evaluation of such transactions should be based on:

1) Evaluation of transactions for the compliance with the definition of the term “controlled” in accordance with the tax legislation,

2) Functional and economic analysis of indicators,

3) Substantiation of applying a particular method of determining the transfer price, and

4) Preparation of a reasoned selection of components to form a range of prices (search for comparable transactions and individuals, carrying out a benchmark study), profitability evaluation, etc.

These stages will make it possible to substantiate the conclusion that the terms and conditions of controlled transactions comply with the "arm’s length principle".

In recent years in the economic literature there have been attempts to develop guidelines for forming a system for TP documenting and substantiating controlled transactions.

According to the authors, it is possible to single out a number of basic steps for preparing TP documentation.

The first step is to study information about the related persons of the company and the place of the enterprise in the group of such related persons. In this case, contracts with contractors are subject to the study to determine the relatedness of persons and to develop a substantiated conclusion.

At this stage, it is desirable to study the structure of the company, make a full list of related individuals, describe the company’s activities, make a competitive analysis, describe the market for goods, works and services on certain reviews of transactions that are controlled, and describe approaches to pricing by specifying the method of pricing, costs included in the price, etc.

At the second stage, a functional analysis is carried out. Based on it, in the future methods for determining transfer prices can be reasonably chosen.

In this case, the functions fulfilled by the parties involved in a controlled transaction are analyzed. For this analysis, technological maps, as well as other information sources are used.

The next step is to test prices. At the same time, the following should be implemented as a minimum:

– Price analysis in accordance with internal operations,

– Provision of inquiries to organizations that control prices, and the selection of appropriate information,

– Price research in international databases, and

– Testing according to five methods of TP.

It is necessary to study the possibilities of applying all five methods for calculating transfer prices, as well as to describe and substantiate the reasonability of using each of the methods for the relevant controlled transaction, the reasons and conditions for choosing or abandoning a particular method.

In its turn, the TP method is selected taking into account the analysis of a particular situation. It implies a review of the possibilities of applying well-known TP methods including:

1. Traditional operating methods:

   - Comparative uncontrolled price method,

   - Resale price method, and

   - “Cost plus” method.

2. In this case the methods of profit from operations (net margin, profitability) take into account the following:

   - Standards of comparison that must be applied to the method of net profit from transactions,

   - Selection of net profit indicator,

   - Determination of net profit and its weighing. It is taken into account that net profit can be correlated with sales, expenses, assets and other bases, and

   - Defining the profitability.

3. The methods of distributing profits from operations that require to select various approaches to the profits distribution (analysis of contributions, final analysis) and to determine the total income to be distributed – actually on the calculation basis.

Finally, it is necessary to make a reasonable conclusion about the methods that should actually be applied in a particular case.

In addition to defining the method of TP, it is also important to make an economic and comparative analysis. The task is to find potentially comparable companies. The company should be able to give a detailed description of the actions taken to select such companies, sources of data, and criteria for the selection.
It is necessary to note that this stage is rather difficult, because it is usually not easy to obtain valid data for the benchmarking study. In addition, it is necessary to describe the criteria for determining the comparability of operations.

It is reasonable to carry out the benchmarking study of comparable companies according to a specific pattern by disclosing the company name, its status, date of foundation, a concise description of the activity, functional profile, and analysis of sales revenue.

In the framework of the financial analysis, the profitability indicators are assessed, and the weighted average profitability indicator for each company over a three-year period is calculated.

In conclusion, prices on a controlled transaction are compared with the market prices according to the “arm’s length” rule. Based on this comparison, it is possible to make a conclusion about the need to make adjustments to the income tax.

In order to properly prepare documents on TP, it is very important to have certain prerequisites. According to the authors, they are the following:

1) It is necessary to have deep knowledge of technological processes of the enterprise and to document them in product sheets.
2) It is necessary to rationally organize management accounting in general, and expenses and cost accounting in particular, as well as to obligatorily approve a detailed list of cost items in the annex to the order on the accounting policy of the enterprise.
3) Precise control over the formation of the contractual base of the company with its business partners and the fulfillment of contracts.
4) Permanent monitoring of all controlled transactions and operative accumulation of the information that can be required to analyze them for the purposes of TP.

IV. CONCLUSION

According to the results of the study, it is possible to make the following conclusions.

The transfer price enables managers of responsibility centers to make optimal management decisions, increases their interest in improving business efficiency. That is why efficient administering of TP is of particular importance for top managers. TP creates opportunities for operational control of costs and results of the activity at different levels of the enterprise.

Based on analyzing the aspects of TP informational provision, it has been determined that the best approach to improving it is to create a system of permanent document flow, accumulation, use and archiving data to substantiate the transfer prices used to monitor controlled transactions and to subsequently make reports.

The company must establish a unified document flow system, as well as management and financial accounting system that would provide the management with the information on all transactions with affiliated persons under control. The creation of such system and its work in a constant mode can considerably reduce risks for companies, taking into account the constant expansion of business partnership of enterprises.

REFERENCES