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TRANSFER PRICING, ITS IMPLICATIONS ON THE ECONOMY

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Outline

1. Introduction

Globalisation presents both opportunities and challenges to the world economy as companies can create assets in more than one jurisdiction, while operating under various regulatory requirements. This ability to operate under different regimes poses a challenge at the time of preparing financial reports for various authorities while presenting an opportunity for a wider and varied market. However, there are associated costs for distribution of goods and services, together with other operational overheads between and within the concerned entities. To determine transactions costs within the company, the Organisation for Economic Co-operation and Development (OECD) recommends transfer pricing, the procedure in which firms set prices for goods and services traded between related legal entities within an enterprise. For instance, a parent company may sell production inputs to the subsidiary, and vice versa. The incurred cost by either forms part of the transfer price.

Therefore, transfer pricing can be one of the avenues through which multinational companies allocate profit to boost profit margins. Transfer pricing involves cost transfers among business entities within enterprises, a common phenomenon in multinational corporations, which use it as a method of allocating profits (earnings before interest and taxes) among various subsidiaries within the organization. Some multinational companies may tend to employ it to keep taxable income low in the operating countries. It may also represent a conduit through which profits are allocated for tax and other purposes between parts of a multinational corporation group in their different operations across the globe to maximise profits at the expense of tax disclosure.

This article, therefore, aims to put the subject under microscopic lens with a view to enhance the general understanding. This will contextualise the topic and raise awareness to policy makers with a view to continuously review and update legal the environment governing industrial development.

2. Approaches to profit allocation

In an effort to ensure profit maximisation, multinational companies have developed a number of interventions to eliminate profit erosions and protect financial positions. Below are some of the popular approaches:

(i) The formulary apportionment method, which is also known as the unitary apportionment method, is one method of transfer pricing invention which consolidates business operations through their functional integration, centralisation of management, and economies of scale. This builds on the established global reputation, such as, the values shared among its constituent parts, such as reputation, good will, customers and other business relationships to infuse market appetite.

(ii) The Separate accounting underlines the overall business only income from sources within a single state, and ignores the value attributable to the integrated nature of the business. This is despite the knowledge that the wealth, power, and profits of the multinational enterprises are attributable to their integrated and unitary nature of their operations.

(iii) Multinational companies set transfer prices to allocate more of the worldwide profit to lower tax countries in order to maximise returns. This makes it difficult for developing countries to force compliance with domestic laws as some of their operations are in sovereign entities.

3. Risks and Benefits of Transfer Pricing

Transfer pricing offers many advantages for a company from a taxation perspective, which may irritate the regulatory authorities as that offers avenues through which taxes are syphoned. The process takes advantage of different tax regimes in different countries and generates more profits for goods and services in countries or economies with lower tax regimes. It reduces income taxes in high tax countries by overestimating prices of goods that are transferred to subsidiary companies in those countries whose tax rates may be comparatively low to yield higher profit margins. Accordingly, it reduces the duty costs by shipping goods into high tariff countries at minimal transfer prices to lower the taxable amounts.

However, it may present a challenge to estimate the right transfer price for services as this is not easy to quantify. As a consequence, it undermines authorities of area managers, and renders decentralisation ineffective. Moreover, it is costly and time consuming for clients because some decisions are to be sourced from head office. This is particularly true with some financial institutions that are operational in Lesotho. Management of a multidivisional firm needs to strike a balance between providing transfer pricing autonomy to divisional managers and retaining some level of control to prevent dysfunctional behaviour.

4. The Difficulty in applying Transfer Pricing

4.1 Understanding Its Operationalisation

Transfer pricing presents challenges to unsuspecting officials in developing countries. This is in part attributable to the fact that governments are desperate to grow industries in majority of developing countries. The multinational companies, therefore, take advantage to exploit them while in the process trying to fill the void. As a result, the OECD developed some guidelines to assist authorities to deal with such and also remain attractive to investment. According to the guidelines, 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 example, a tax authority may increase a company's taxable income by reducing the price of goods purchased from an affiliated foreign manufacturer or raising the royalty the company must charge its foreign subsidiaries for rights to use a proprietary technology or brand name.

This is done under the application of the arm's length principles for taxation and its complications. The arm's length principle dictates that prices should be the same as they would have been, had the parties to the transaction not been related to each other. The OECD argue that Transfer Prices are significant for both taxpayers and tax administrations because they determine, in large part, the income and expenses, and therefore taxable profits of associated enterprises in different tax jurisdictions. However, they continue to advise authorities to apply such with maximum caution as there is high mobility of international enterprises and extremely competitive in terms of offerings.

4.2 Experience in the Regional Blocs

Since business entities operate across domestic boundaries under different regulatory environments, some of those requirements may encourage business expansions, while others are restrictive. As a result, business entities look for innovative possibilities to continue to enjoy maximum profits without necessarily appearing to violate the legal environment. This is can be observed in some firms operating in the region. Majority of firms keep their headquarters in South Africa, where decision are made from, and establish subsidiaries across the region.

This gets complicated where there exists an established regulatory requirement that may not be consistent with those tenable with the block. For instance, the Common Monetary Area (CMA) allows free movement of capital within the membership. Therefore, some companies operating in Lesotho may transfer funds to South Africa, either to access the financial markets that side, given the limited opportunities locally or to capitalise some of their subsidiaries or associated enterprises operating within the CMA. From there, they can then transmit funds to any of their operating agencies throughout the world.

However, this may not be the case with some firms operating in Mozambique. This is because Mozambique operates different set of regulatory provisions, some of which may not favour the status that obtains between Lesotho and South Africa. For instance, there is no capital mobility between SA and Mozambique, which may be a challenge for profit repatriation by SA companies. This could compromise business operational efficacy, and hence lower profit margins. This is despite Maputo have relatively bigger and more competitive markets.

5. Implementation of Transfer Pricing and the Supervisory Oversight

The OECD guidelines become extremely useful for regulatory authorities to play oversight roles in jurisdictions that transfer prices are practiced in. The arm's length becomes the supreme instrument that is of reference while dealing with such. But this is not easy to implement, especially where the parent company retains most of the administrative responsibilities, including those with potential to generate revenue. This is also open to abuse as companies might use it to get around exchange controls and to repatriate profits in a tax free form. This situation compromises countries abilities to negotiate and bargain with the big companies, as the latter can easily disinvest and migrate to countries that have relatively relaxed taxation and regulatory requirements.
There is evidence of this practice in the financial and manufacturing sectors in Lesotho. The financial sector, on the one hand, is dominated by institutions from South Africa (SA) that maintain administrative decisions in their headquarters. This somehow affects regulatory/supervisory role played by the Central Bank. They usual transfer any excess over regulatory requirements to their respective parent companies, and source any shortfalls from the same. As a result, the Bank finds it difficult to implement some policy instruments to manage liquidity. They also mobilise, through placements, portion of their revenue from earnings they get from their placements in SA financial markets. This is to the detriment of Lesotho's financial sector development.

The manufacturing industry, on the other hand, is dominated by foreign owned firms that source most of their inputs through their parent companies. These firms are also in the CMT categories that work on order with predefined specifications in terms of quantity and quality. Accordingly, there is a possibility of them submitting claims for tax refund that may include items that were destined to other production bases. Therefore, these may use Lesotho to finance their operations while the returns are shipped to their countries of origin.

There is also evidence of "Base Erosion and Profit Shifting (or BEPS)", which is the practice where multinational companies employ the corporate tax planning strategies to artificially "shift" profits from higher-tax locations, to lower-tax locations, thus "eroding" the tax-base of the higher-tax locations. While BEPS strategies move profits to lower tax rate locations, they also try to move expenses to where they are relieved at higher tax rates. The result is a tendency to associate more profit with artificial intellectual property accounting structures such as mobile assets which can be moved to lower tax locations. This practice reduces the share of profits associated with the substantive commercial operations.

Below are some of the strategies employed to shift profits:

a) Exploiting mismatches in tax rules;

b) Using intellectual property accounting;

c) Using loan interest from intergroup loans or more recently, using securitisation of Special Purpose Vehicles (SPVs).

6. Policy Implications

Transfer pricing can deprive governments of their fair share of taxes from global corporations and in some cases, expose multinationals to possible double taxation. It is, therefore, imperative to understand the subject matter in order to prepare enabling environment for attraction of foreign investment to facilitate industrial development, while also protecting own interests. International Companies are often more knowledgeable with international business operations, which they utilise to their advantages to minimise tax remittances. As a result, this may affect country's potential tax collections, or it may chase away potential investment from international market players. It would therefore be in the interest of the Kingdom to have adequately trained personnel both in tax administration, and industrialisation architecture.

7. References

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