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INTRAFIRM TRADE AND TRASNFER PRICING

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Abstract—Intrafirm trade, i.e. intrafirm exchange between parent company and its subsidiaries abroad primarily occurs on the basis of transfer pricing that do not correspond to market value of goods. Height of these prices is determined according to the needs of transnational company, because transfer pricing are, on one hand, significant from the standpoint of transnational companies because they provide them with a possibility to adapt tax base to their goals (profit increase), and on the other hand, from the standpoint of tax authorities of host country. Today, a big part of trade takes place on global level, where transnational companies dominate and which, through transfer pricing, increase net gain, as well as on reduction of income, which flows into the budget of host country in the form of taxes.

In this paper we analyze: 1) manners of determining transfer pricing and factors that influence their choice; 2) transfer pricing in the function of avoiding the taxes and high tariffs; and 3) Normative solution of transfer pricing in the Republic of Serbia.

Keywords—transfer pricing, transnational companies, intrafirm trade, taxes, thin capitalization, motives.

I. Introduction

TRANSNATIONAL companies (TNC) significantly influence directions and the scope of international trade, and their interests and significance overcome national framework, and thus they encourage globalization of international economic relations through their actions. However, through the establishment of subsidiaries, they create the systems of their own, closed and internal markets and thus the number of rich people constantly decreases, and the number of poor people increases and they are poorer and poorer.

TNCs acquire competitive advantage owing to organization of production in cases where production resources are the cheapest and where the possibilities for profit are the biggest. Such a commitment is motivated by main business goal of each company, to provide as higher as possible added value for capital owners.

Activities of TNC can be monitored through their presence: 1) in external trade of parent countries; 2) in external trade of host countries of subsidiaries abroad; 3) in international trade in certain products and 4) in internal, closed, intrafirm markets.

Subsidiaries outside the parent country of TNC match classical export in terms of value and structure, and their high share in global export determines the control of international trade in certain products (e.g. in 1980’s, 90% of global turnover of wheat, cotton, tobacco, iron ore and some other primary products was under their control). However, in the 1990’s, the third of international trade has developed through intrafirm exchanges between parent company and its subsidiaries.

Very important factor of the business of multinational companies are the prices by which products and services are transferred between the subsidiaries, i.e. transfer pricing. Very important factor of multinational companies’ business are the prices at which transfer pricing include prices of products, services, intellectual property and other compensations that are calculated between connected entities.

The most significant issue in defining TNC strategy is the selection of the manner of determining transfer pricing, because in that way economic relations between subsidiaries are defined and allocation of resources within TNC as a whole is directed. Significance of studying transfer pricing, in theory and practice, comes from the fact that their use is, on one hand, in the function of “moving” profits between countries in order to minimize income tax and, on the other hand, their avoidance directly endangers budgets of countries where TNC do business.

To what extent are transfer prices a hot subject in contemporary finances, we can see from the results of numerous studies in which transfer prices are ranged as one of the most interesting fields in international accounting [1].

In order to preserve social, economic and political stability, countries are forced to discover new ways to protect their revenues. In addition to legal regulations in the field of taxes on enterprise’s gain, countries resort to even more strict revisions of multinational companies’ business. Due to lack of respect for the laws of host country, signed contracts, exploitation of natural resources and people by TNC was encouraged by establishment of forums at Economic-social Council of UN for monitoring and studying the work of TNC, and there is a suggestion for adoption of behaviour code for TNC at the level of UN that would be mandatory for these world giants.

II. Manners for determining transfer pricing and factors that affect their selection

Transfer pricing are the prices that TNCs use in intrafirm trade or transfer pricing can be defined as value per unit of product that is transferred across the borders of at least two countries from one subsidiary to another [2]. Transfer pricing can be determined as “opportunity cost for product or service, i.e. neglected value due to not using the transferred product in its next best use alternative” [3].

Concept of transfer pricing can be observed from narrower and wider standpoint. According to wider standpoint, transfer pricing exists, strictly on relation parent company – majority-owned subsidiary, where the possibilities of manipulation are the biggest. According to a wider standpoint, concept of transfer pricing also includes the prices that figurate in the exchange between parent company and subsidiary in so-called minority ownership, so the possibility of the impact on these prices in relation to criteria valid in official market is smaller.

There are two categories of transfer pricing: 1) pricing that affects the price of end product, where higher transfer pricing causes higher sales price and 2) determined prices that do not affect sales price of the end product.

In economic theory and practice, there are many different methods for determining transfer pricing. OECD (Organisation for Economic Co-operation and Development) recommends member countries to apply the following methods of determining transfer pricing 4] : 1) comparable profits method; 2) costs-plus method; 3) comparable uncontrolled price method and 4) retail price method.

Comparable profits method implies the comparison of profitability of the company that deals with the same or similar activity and the profitability of subsidiary that uses transfer pricing, and it is most frequently used in combination with previously described methods of determining transfer pricing.

Costs-plus method implies adding appropriate amount of profits to the costs of producing the goods. It is mostly used in the exchange of final products. Amount of profit is always when possible determined by comparison to appropriate uncontrolled price. As it is based on real costs, costs-plus method is recommended by tax authorities because it suits the best to the market price from previous classification [5].

Comparable uncontrolled price method can be applied in cases when a good that is a subject of transfer among subsidiaries is simultaneously also the sales subject of multinational company in external market, or if the same good is a sale subject of two independent companies.

Retail price method implies the subtraction of a particular amount of profits of sales sector (or distributor) from retail price. However, if retail sector largely creates the sale of certain product, it is difficult to determine the appropriate amount of profits that should be subtracted from final sales price in order to determine adequate transfer price.

When defining the borders among which transfer pricing can move, it is necessary to start from the level of utilization of the existing capacities. When a subsidiary that sells products operates at the level of complete utilization of capacities, opportunity cost of a product unit represents market price. It is the upper border for transfer pricing, because subsidiary that buys products has not interest in paying products at a price that is higher than market price. In case that subsidiary works at the level lower than complete utilization of capacities, opportunity cost per product unit equals its marginal cost.

In addition to transfer pricing based on market prices or marginal costs, there are many possible alternatives. Thus, it is possible, in case of complete utilization of subsidiaries’ capacity, to sell products at price that is market price from which acquired saving from intercompany procurement is subtracted. Such a choice of transfer pricing leads to profits reallocation to subsidiary that sells, while for subsidiary that purchases, it is still more favourable alternative than purchase in external market, unlike transfer pricing and market price 6].

For subsidiary that sells, the same effect as in selling in external market will be achieved, while the subsidiary which purchases will be provided with the purchase at a price lower than market price. When utilization of capacities is lower than complete, subsidiary can sell products at prices that are above marginal costs. For which of the mentioned two models of transfer pricing will the multinational company decide it will entirely depend on whether the company is oriented on accomplishing short-term and long-term goals.

Finally, choice of transfer pricing depends on the set goals of multinational company. If we start from generally accepted attitude that primary goal of business of the corporations is accomplishment of long-term value for capital owners, then transfer pricing based on market price is imposed as a choice. It enables the formation of long-term value for shareholders and provides sufficient funds for future investments that are a source of future inflows of cash and initiator of further growth of the company. Transfer pricing that do not reflect transaction costs between subsidiaries in a realistic manner, as in case of profit centres of multinational company, do not provide an adequate image of subsidiaries’ profitability, and thus they influence the motivation and commitment of their executive managers.

When considering transfer pricing, it is necessary to distinguish the goals of their application and motives that lead to manipulation of transfer pricing. Primary goals of international transfer pricing are: 1) providing economic locations of resources between company's affiliations located in various countries, i.e. to maximize criteria for profitability measurement for particular affiliations.

However, there are also primary goals of transfer prices, such as: increased market share, increased competitive advantage, realization of the economies of scale, reduction of domestic and foreign restriction etc. Secondary goals are actually additional path to accomplishment of primary goal, which is profit maximization [7].

As key factors for the selection of models of transfer pricing in multinational companies that operate in developing countries, we can mention the following: 1) Differences in rates of income tax; 2) customs minimization; 3) interests of local partners; 4) exchange rate control and risks related to it; 5) limitations in relation to repatriation of profits; 6) risks of expropriation and nationalization and 7) good relations with local government.

1) Through definition of transfer pricing, multinational companies use differences in rates of income tax in different countries for minimizing profits after taxation. As income tax is considered as increasingly significant variable from the part of managers, transfer pricing is increasingly used as means of its reduction.

2) One of the fields where we can, by applying appropriate transfer pricing, directly influence business result of corporations are the customs. As in the majority of developing countries relatively high customs rates are applied, using of lower transfer pricing can influence the reduction of customs in nominal amount.

3) Higher participation of local partners in the capital of multinational company simultaneously implies smaller share of foreign investors in the capital of the same. It directly leads to the transfer of smaller amount of profits outside national borders and retaining of higher profit in the country of origin. Accordingly, in order to protect their interests, local partners need to actively participate in creating the policy of transfer pricing, which reduces the impact of foreign investors. If the management of corporation believes that the role of local partners is significant, he will even more strive for the reduction of conflicts between the two parties, using market transfer pricing.

4) Control of the exchange rate that is applied in developing countries is an encouragement for the application of transfer pricing and its use for transferring profits. Use of transfer pricing enables exchange rate risk management through the reduction of the level of liquid funds in subsidiaries that operate in countries in which there is exchange rate control.

5) In order to provide a faster progress, developing countries mostly apply rather strict limitations when it comes to capital repatriation. As limitations of capital repatriation, limits for the amount of profit that can be transferred to the country of origin are usually applied, as well as high tax rates on all types of transactions with capital towards the country of origin. Such limitations prevent multinational companies to achieve their goals.

6) Multinational companies in developing countries often face with political risk, and a possibility of expropriation and nationalization that is related to it. Precisely that is the reason why multinational companies strive to achieve as rapid as possible return of invested funds, for which purpose they use transfer pricing. However, as much as the possibility of expropriation or nationalization is reduced to minimum, countries always retain the right to exceptional circumstances in which it is possible. For that reason, multinational companies tend to transfer as much as possible funds from subsidiaries located in developing countries, where political risk is, as a rule, more expressed. As efficient mechanism in accomplishment of that goal, transfer pricing based on costs is imposed.

7) in order to avoid various bureaucratic obstacles and in order to be in a position of negotiating and influence state measures by which business conditions in a country are created, multinational companies strive for maintaining as better as possible relations with local government and its organizations. If the companies attribute higher significance to this factor in relation to others, they choose market transfer pricing as more objective and fair alternative by which they prevent possible conflicts with state institutions.

III. Transfer Pricing in the Function of Avoiding Taxes and High Tariffs

One of the ways to increase the value for capital owners is to minimize income tax. In order to accomplish this goal, TNCs use different mechanisms such as:

1) they can influence international allocation of accountingly expressed profits through arranging financial structure by subsidiaries. The aim is the financing through loans by higher interest rates in subsidiaries that operate in the regime of high tax rates, which results in minimization of total paid taxes at the level of a group,

2) reallocation of common costs to the countries with high income taxes is also possible, by which profit for taxation in subsidiaries that operate in that countries is reduced,

3) mechanism of transfer pricing also serves for the transfer of profits from countries with high tax rates into countries with low tax rates, through the maximization of costs in former and incomes in the latter. In this way, minimization of income tax, maximization of profits after taxation at the level of multinational company as a group.

Therefore, transfer pricing provides for the profit to be transferred from a country with high tax rate to the country with a low one. Possibility of transferring profits from countries with high to those with low rates comes from the "freedom" to determine transfer pricing, which exists owing to subjectiveness that the costs and their allocation bring along with them. Each country independently decides on the height of tax rates. They are significantly different from country to country, so the income tax rate in the USA is 35%, in Great Britain 28%, in Germany 15.8%, in Ireland 12.5% etc.

There is a correlation between the size of multinational companies and intensity of using transfer pricing in order to minimize paid taxes [8]. Analysis shows: 1) which companies more intensively transfer profits due to lower taxes, which can direct states and tax authorities towards the solution of this problem and 2) points to the ability of companies to react to the changes in tax rates depends on their size, which needs to be taken into consideration when estimating the impact of new legal solutions to the future fiscal income. Transfer of profits between subsidiaries determined internal performances of subsidiaries, and thus the height of bonus for managers.

Income tax represents one of the most significant state incomes and avoiding it directly impairs the balance of state budget. Transfer pricing are not only an accounting technique, but a method of resources allocation that directly influences distribution of income, welfare, risk and thus determines life quality.

The fact that profit is transferred from a country with high interest rate into countries with low interest rate through transfer pricing can also be represented by the example: from country A, with tax rate of 50% products are transferred to country B, with tax rate of 25% at the lowest possible price. In that way, part of profits is transferred from country A to country B, and total income taxes paid in both countries together is reduced. In the reverse case, if export goes from country (C) with a low tax rate to the country with a high tax rate (A), transfer pricing is determined at the highest level.

If we observe country (A) as a country with the highest tax burden, we can conclude that import at the highest prices is included in its economy, and export at the lowest prices, due to which tax authorities of that country are deprived of significant tax incomes. On the other hand, if country A, host country of TNC, developing country remains deprived of a significant part of profits acquired in its economy, with additional negative consequences in the relationship of exchange and trade balance, due to high prices of import products. However, developing countries have lower nominal rates of corporate taxes that developed countries, which is one of the mechanisms by which they attempt to attract foreign direct investments.

However, there is also the case of countries with extremely favourable tax conditions where tax rate is zero or minimum, so TNCs strive to extract profits from other parts of the system to the affiliations located in such countries through transfer pricing manipulation. For that reason, legislation of the majority of countries that export the capital introduces restrictions to the possibility of using tax havens location and, on the other hand, there are some countries in development that introduce punitive taxes to repatriation of dividends, interests and royalties. [9].

In establishing the relations between taxes and transfer pricing, the most difficult task is to determine a price that is sufficiently low, that will not cause a reaction of host country and which will provide minimization of paid taxes of a corporation as a whole. Low transfer pricing lower profits in areas of high tax burden and increase profits in the areas of low tax burden, while reverse situation is valid for high transfer pricing [10].

Introduction of restrictions to repatriation of profits by host country will be an encouragement for TNC to assume the manipulation over transfer pricing, in the form of overestimation of goods that is sent to the affiliation and underestimation of goods that it sends to others in the system, in order for a bigger as possible part of acquired profits on that location to be extracted and transferred on some more favourable place.

In order to avoid high tariffs on imported goods in a host country, TNC can minimize the price of goods that are the subject of exchange and thus reduce the amount of paid customs duties to minimum. However, transfer pricing are an efficient mechanism of avoiding customs barriers only when it comes to so-called ad valorem customs duty. In case of fixed customs rates, it is not possible to achieve desired effect.

Country-importer will thus be deprived of potential income from customs duties that it hasn’t achieved, but there will come to the improvement of exchange ratio, having in mind low costs of imported goods. In addition, profits will move from parent company into affiliation, which carries additional risk: 1) risk for host country to have high tax rates, when it comes to conflict of two goals that need to be achieved by transfer pricing and 2) financial risk of possible instabilities in the rate of host country or introduction of control of repatriation of entered profits.

Having in mind that tariffs for end products are higher than those for raw materials and semi-products which are further developed and exported, usually by affiliations, we can conclude that higher underestimations of invoices, i.e. lower transfer pricing is obtained when affiliation provides for parent company, than vice versa.

Non-tariff barriers, such as quotas and subventions, also vary from lower levels for semi-products and raw materials, to higher levels, for finished products. If we are talking about non-tariff barriers of exports on a certain value, as lower as possible import prices are desirable. In addition, limitations of export on certain value will condition as lower as possible export prices.

Use of transfer pricing by TNC is influenced by different social and political pressures. In table 1, reactions of MNCs to various types of pressures of host countries are presented.

Table 1: Types of pressures that encourage the use of transfer pricing

TYPES OF PRESSURE	REACTION OF TNC
Syndicate looks for bigger share in affiliations' profit. Government of host country threatens by nationalization due to high profits that TNCs achieve	TNC extracts profits by overestimation of goods that it sells. TNK extracts profits through overestimated export in that affiliation.
Host country abolishes import protection that TNC had	TNC overestimates semi-products that it sends to the affiliation in order to provide previous level of protection
By high profits, TNC encourages host country to introduce higher taxes or to look for higher share of domestic shareholders so that higher part of profits would remain in country	By transfer pricing, TNC extracts profits of the given location
By high profits, TNC attracts the other TNCs or local companies to enter the competition	By mechanism of transfer prices, TNC attracts profits and makes entrance in the branch more difficult.
High unemployment, inflation, corruption, tendency towards nationalization and generally bad political and economic situation of host country	TNC applies high prices in order to save acquired profits

Source: Grinwade. N. "International Trade: New Patens of Trade, Production and Investment" London, 1989.

However, in the application and use of transfer prices by TNC, there are also certain constraints that can be of external or internal nature.

Among external constraints, the most frequent are reactions of governments on the application of transfer prices, both due to extracting profits from host country and customs and tax authorities that remain deprived of significant incomes. In order for state authorities to properly react, they need to determine the height and existence of transfer pricing in relation to prices that would exist in conventional manner of trading, and for that reason TNCs tend not to use transfer pricing in an open manner, in order not to attract the attention of authorities.

When it comes to internal constraints, we need to say that they refer to significant share of local ownership or common investments with local partner, which limits the possibility of manipulating transfer pricing. Transfer pricing imply high level of integration and centralization of control within the company, when affiliations are subjected to the decisions of parent company, and maximization of local profits is subjected to the goal of maximization of entire company's global profit.

One of the possible ways to calculate transfer pricing is so-called systemic approach in order to achieve synergic results. The system implies taking into consideration all the elements such as: marketing, distribution and production in order to reach adequate price for certain product. If each affiliation applies that approach, it will come to efficient solution on transfer pricing from the aspect of a system as a whole.

IV. NORMATIVE SOLUTIONS OF TRANSFER PRICING IN THE REPUBLIC OF SERBIA

Application of transfer pricing is regulated the Republic of Serbia by the Law on Corporate Income Tax (Official Gazette of the Republic of Serbia no. 25/2001, 80/2002, 43/2003; hereinafter Law). According to the Law, related persons performs the correction of expenditures on the basis of transfer pricings based on difference (if it exists) between calculated costs by transfer pricing and calculated costs by market prices. This correction, which aims at preventing the reduction of tax basis, influences the taxable income only if transfer pricing is higher than market price. It is defined by Law that person related with taxpayer is the physical or legal entity in whose relations with taxpayer appears the possibility of control of more significant impact on business decisions. Owning more than 50% or individually the biggest part of shares is considered as provided control over taxpayer.

The Law prescribes that taxpayer is obliged to present transactions among related entities in his tax balance, by entering calculated costs on the basis of transfer prices in the appropriate row of the pattern Tax balance. In addition, taxpayer is obliged to present in tax balance the transactions with related entities according to prices that would be achieved in the market of such or similar transactions if it wasn't for related entities (principle "out of the arm's reach").

Calculated costs by market prices are entered in an individual row. Difference between calculated costs on the basis of transfer and market prices, if it is higher than zero, it is presented in appropriate row of Tax balance. In case when difference is not positive, which happens when transfer pricing is lower than market, it is not presented in the balance [11].

The Law also prescribes the correction of incomes based on transfer pricing, on the basis of difference between incomes calculated by market prices and incomes calculated by transfer pricing. This correction, which also aims at preventing the reduction of tax basis, affects the taxable gain only if we start from the assumption that calculated incomes on the basis of transfer pricing are lower than incomes that would be calculated if transactions were realized by market prices.

The law requires for incomes on the basis of transfer pricing and incomes based on market prices to be separately presented in tax balance, as well as their difference, if the incomes by transfer pricing are smaller than incomes by market prices.

Multinational companies in Serbia also use transfer pricing for the exchange of products and services between their units. Dominant forms of exchange include the exchange of semi-products on relation production unit-production unit and exchange of finished products on relation production unit-commercial unit. Commercial units are entities specialized in sales of products outside the group and they are the only ones dealing with the sale of products in external market.

As main principle when determining transfer pricing, arm’s length pricing is respected. In order to determine transfer pricing of companies, we can use costs-plus method, which implies for transfer price to be calculated on the basis of products costs with calculated profits of 10%.

Transfer pricing is calculated within the framework of the financial plan creation process for the following year (e.g. transfer pricing for 2011 are calculated in the period August-September 2010). Accordingly, transfer pricing will be based on costs that will be found in planned income statement for the following year. It is strived for the costs projection to be as realistic and precise as possible.

Calculation of costs is performed on the basis of latest assumptions regarding all the elements that determine costs, available at the moment of determining transfer pricing.

Key elements are sales and production volume, exchange rates (of all currencies in which production inputs are obtained), prices of production materials, prices of energy, planned operating mode etc. Therefore, basic measure of performances of production units is cost price, i.e. transfer pricing, and not profits. Greater the difference between transfer pricing, at which commercial unit purchases a product, and production unit and market price, at which commercial unit sells the product in external market, higher the profits will be achieved by commercial unit and group as a whole.

Transfer pricing adopted in financial plan are fixed and their application starts from the January the 1st of the following year. They cannot be changed during the same business year, even under condition of radical changes of initial assumptions. If transfer pricing would be changed during a year, it would cause a lot problems in balance consolidation at the level of a group. In case that during business year it is started with the production of a new product whose production wasn’t planned at the moment of creating financial plan, transfer pricing is calculated immediately prior to the beginning of production and, also, it remains unchanged until the end of the year. If it comes to changes in a product that result from marketing activities (e.g. changes in design for small series of products), that product is treated as existing, i.e. transfer pricing calculated for basic variant of product is used.

V. CONCLUSION

By expanding business outside the borders of one country, multinational companies tend to overcome all limitations specific for local markets. Owing to high financial power, multinational companies become a significant factor of international economic relations.

Transfer pricing is not market category, so it is often independent from the impact of market flows. There are many methods for determining transfer pricing, of which most widely present are those recommended by OECD. Selection of methods for determining transfer pricing is one of the most important steps in defining financial strategy of multinational company. If the companies are strategically determined towards the maximization of profits in the short run, they apply transfer pricing based on marginal costs, while in case of orientation towards profit in the long run, the companies resort to market transfer pricing.

What qualifies transfer pricing as one of the biggest challenges in international accounting is its use in order to transfer profits into countries “tax havens” in order to minimize income tax and maximize profits after taxation at the level of a group. Multinational company thus makes local companies completely uncompetitive and through the reduction of state incomes directly endangers social welfare and life quality in certain countries. Countries fight this problem by adopting new legal solutions by which they authorize the tax authorities to additionally verify purchase transactions between subsidiaries and charge of evaded taxes.

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