TRANSFER PRICES

AN IMPORTANT INTERNATIONAL ISSUE

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TAX LAW VERSUS PERFORMANCE MEASUREMENT?

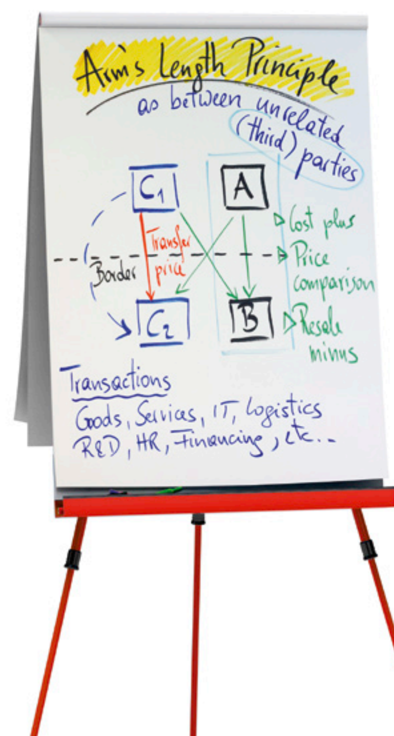
One of the focal points in our 5-level diploma programme is performance measurement. In discussions with our clients we have found that tax-based transfer prices in international corporations dilute transparency about the company's actual performance. Indeed, in some cases management metrics still in use today are even made completely obsolete. This is a new challenge for us controllers.

Alternatively, in my most recent Stage II seminar I learned about a case where a controller knew about activities abroad, but not (yet) anything regarding the corresponding tax consequences. Unfortunately, the tax department was informed much too late about the activities, and this delay resulted in high penalty payments.

In order to achieve fairness in taxation between countries, the OECD (Organisation for Economic Co-operation and Development) states that transfer prices must meet certain requirements, including a comparison with third parties. This approach, also called the arm's length principle, is described by the OECD in its Transfer Pricing Guidelines as follows:

“The arm's length principle requires that compensation for any intercompany transaction shall conform to the level that would have applied had the transaction taken place between unrelated (third) parties under similar conditions.”

If so-called “related companies” conduct business with each other across national borders, they must observe these fiscal rules. Permanent establishments (place of business) are a particularly important problem in this regard. While controllers are informed about operational projects and the activities of employees in foreign countries, they are often unfamiliar with the tax rules governing these new places of business and “permanent” establishments. On the other hand, the tax department is easily able to determine whether a permanent establishment exists under domestic (or foreign) law, but it is too far removed from the operational business to become aware of the events that might lead to a permanent establishment. According tax authorities a permanent establishment is quite often founded based on the number of days that an employee spends abroad. The limit in many countries is 183 days. If an employee is authorised by the company to conclude business agreements – often called signature authority – this, too, usually leads to the foundation of a permanent establishment. In such cases it is generally irrelevant whether this authorisation is based on legal or commercial rules. Tax law focuses on an activity's economic substance, which has individual phases (negotiations about the type and scope of the performance, pricing, payment and delivery conditions, contract signature, etc.) within the overall process until an agreement is concluded. Legal tricks to circumvent this signature authority are thus fundamentally invalid from a tax perspective.



Furthermore, we convey to our seminar participants that, in contrast to what the title “Transfer Prices” suggests, it is not just the prices that are relevant, rather all commercial conditions associated with a transaction, such as the payment term, the delivery conditions (“Inco-Terms”) and other ancillary services. The term “transaction” is broadly defined in this regard: besides commodities, products and services, it also includes, for example, assigning clients, IT support, marketing support, brand usage, licensing or other know-how transfers.

A so-called function and risk analysis of the two participating companies should be performed for every transaction. This analysis determines the relationship between the individual group companies. Companies that perform (relatively) few functions or are exposed to limited risks are called routine companies. In contrast, if the functions and risks are strongly pronounced, the company in question is a strategy carrier.

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Routine companies are awarded a limited, but stable profit. In other words, transfer prices must be designed so that routine companies generate a guaranteed profit, but are only marginally profitable. This also means that in the case of a looming loss (or if it appears likely that the minimum margin for tax purposes will not be achieved), adjustments to the transfer prices need to be made during the year. This improvement in the earnings of the routine company is made at the expense of the strategy carrier. Of course, this rule also applies when the opposite occurs, namely when the forecast indicates that the earnings of the routine company will be too good. In this case, the transfer prices must be increased.

The strategy carrier receives the remaining group profit, i.e., minus the shares attributable to the routine companies. The functions and risks are most pronounced in the strategy carrier, and its profit therefore fluctuates the most. It is a “residual profit” in the truest sense of the word.

Apart from some special circumstances, this means that the EBIT (Earnings Before Interest and Tax) of the routine company is not suitable as a performance metric or for variable compensation purposes. After all, the company always achieves a profit, even when the company's business is poorly managed. On the other hand, great success is penalised by increases in the transfer prices. From a local perspective, EBIT therefore loses its appeal as a motivational metric. This applies analogously to the strategy carrier. Other metrics must therefore be found for both sides, or there needs to be an additional internal transfer price in the form of a “shadow price”. This price would be tracked only for internal management reporting purposes; in other words, it would have no relationship to external financial reporting. From the perspective of internal management, i.e., the view of the controller, this issue must be addressed.

More than 50 nations have already adopted requirements for transfer pricing documentation at companies in order to understand the approach the companies have taken and to provide a basis for tax auditors to audit them. It must be readily apparent that the documentation reflects a serious effort by the company to enable a knowledgeable third party to obtain an insight into the company's transfer pricing policies within a reasonable period of time. Otherwise, in the worst case, the tax auditor might reject the documentation, which could cause serious financial consequences. Investment (subsidiary) controllers should therefore insist on “complete” and current documentation for all internal transactions, something that should never happen without close contact with the tax department!

In light of the high penalties, it is not surprising that many companies today focus on the tax aspects of transfer prices. But that should not obscure the fact that although penalties reduce profits, the avoidance of penalties does not create them. Avoiding penalties, i.e., compliance with tax legislation for transfer pricing, is an important sub-responsibility, but it does not achieve good returns per se. The issue, therefore, is not about tax law versus performance measurement, but rather the merging of the two. As controllers, we must accept this new challenge.

In a dialogue with our seminar participants we show that tax-based transfer prices and the question of reliable measurement of internal performance can be connected.