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## TRANSFER PRICING

### INTRODUCTION:

Transfer Pricing concept attain importance with the accent of global trade. Multinational corporations (MNCs) are devoting more and more attention to intra-firm trade involving different national centers. Historically, MNCs conducted their operations through self-sufficient subsidiaries. With increasing inter linkages in global manufacturing, outsourcing and marketing, the MNCs look at possibilities of optimizing their global profits.

The World Development Report points out that one-third of the world trade takes place within global production networks. American imports and exports between their firms and the foreign affiliates, or parents, account for 40 per cent of the total trade. Similarly, 40 per cent of the US-Europe trade is between parent firms and their affiliates, and in respect of Japan and Europe, it is 55 per cent; with regard to US-Japan trade, it is 80 %.

MNCs are free to charge whatever price they choose to with regard to such transactions concerning the parent firm and their affiliate. The transfer prices arbitrarily set to:

- ▶ Reduce taxes.
- ▶ Reduce tariffs
- ▶ Avoid exchange controls.
- ▶ Optimize global profits by reducing taxes and tariffs to the minimum or nil levels.

According to the Economic and Political Weekly (article)

“The borderline between criminal fraudulent over and under-invoicing and lawful transfer pricing can be thin at times. Transactions through tax-havens showing lower profits in both the exporting and importing countries as well as evading tariffs in the importing countries further complicate things for the tax administrators.”

### **Example of Company**

A domestic company was found over-invoicing the intermediates it had imported from a related company in France to record a loss and escape taxes between 1996 and 1998. The prices of cross-border transactions between the related parties were adjusted and over-invoiced.

Raw materials were imported at a price higher than those offered by other supplier companies, thereby reducing the profits and depriving the shareholders of due dividends. Investigations showed that the domestic company was importing *product* from its sister concern in France at Rs 57,271 per tone when the normal average landed cost of the material was only Rs 22,669 per kg. Investigations by the tax department brought to light large-scale tax evasion through such miss invoicing.

**DEFINITION:**

The price charged for transfer of goods and services from one division to another within the same firm is known as the transfer price.

**OR**

When goods are transferred from one profit center to another, an internal price (“Transfer Price”) is charged.

**OR**

Transfer pricing means the value or price of goods and services, tangible and intangible properties, arrived at between, or, by two taxable entities being related parties or closely-held companies in the course of their internal transactions involving transfer of such goods or rendering of services across different tax jurisdictions worldwide where the “related entities” may be located. The accounting and allocation of costs may be so manipulated as to shift the profit and tax base of the host country such that it might confer undue benefit to the non-resident associate, to the detriment of the host country's revenue.

**OR**

Transfer pricing is the pricing of goods in such a manner that the profits are shifted to the transferee and, consequently, the tax burden on the profits is lightened in the hands of the transferor. The profits may not be parked indefinitely with the transferee, if the transferee is assessed to tax in a high-tax regime. The process may be repeated and the profit-spread continues the same way till the destination is reached in a low-tax regime.

**PRODUCT PRICING DECISIONS**

Companies uses different pricing methods to determine a product’s Selling Price the most frequently used methods are as follows:

- Total Cost Concept or Profit Margin Pricing
- Product Cost or Gross Margin Method
- Return On Assets Pricing

Determining a Product’s Selling Price the following costs were incurred to make 10,000 units of a product.

Variable manufacturing costs	5 per unit
Variable selling and administrative expenses	2 per unit
Fixed factory overhead costs	80,000
Fixed selling and administrative expenses	30,000

This company wishes to price its product so it will make a profit of 27,000 if all 10,000 units are sold.

The selling price of any product can be expressed using the following formula:

$$\text{Selling Price} = \text{Cost} + \text{Markup}$$

**I. Total Cost Concept or Profit Margin Pricing:**

The total cost concept is the most convenient method for determining a product’s selling price if a company includes all manufacturing, selling, and administrative costs associated with the product in its reported cost. A markup is then added to achieve the firm’s desired profit.

$$\text{Markup Percentage} = \frac{\text{Desired Profit}}{\text{Total Costs}}$$

EXAMPLE: PROFIT-MARGIN PRICING

Using the data given above, calculate the total cost to make 10,000 units, and the cost to make one unit. Answers: Total Cost = 180,000                      Unit Cost = 18

- A) This company wishes to price the product so that a profit of 27,000 will be made if all 10,000 units are sold. Determine the markup percentage that will be necessary to achieve this profit, using the Profit margin pricing formula.

Answer: Markup Percentage =  $27,000 / 180,000 = 15\%$

- B) Calculate the selling price of the product if it is marked up 15% above the total cost.

Answer:  $18 \times 1.15 = 20.70$

**II. Product Cost or Gross Margin Method:**

Some companies include only manufacturing costs in the cost reported for a product. In this case the markup added to the product cost must compensate for selling and administrative expenses as well as the desired level of profit. The formula to calculate the markup percentage under the gross margin or product cost method is:

$$\text{Markup Percentage} = \frac{\text{Desired Profit} + \text{Total Selling \& Administrative Expenses}}{\text{Total Manufacturing Costs}}$$

The total cost concept would be used more by merchandising businesses. The product cost concept is better suited to manufacturers. In some cases, companies use the concept of variable costing when reporting a product's costs. Under this concept, all variable costs from manufacturing, selling, and administrative activities are included in determining the product's reported cost. When variable costing is used, the markup added to product cost must compensate for all fixed costs, as well as desired level of profit.

EXAMPLE: GROSS-MARGIN METHOD

Using the data from above determine the Markup Percentage and the product selling price.

$$\begin{aligned} \text{Markup Percentage} &= \frac{27,000 + 2(10,000) + 30,000}{5(10,000) + 80,000} \\ &= \frac{77,000}{130,000} = 59.2\% \end{aligned}$$

$$\text{Product Cost} = 5 + (80,000 / 10,000) = 13$$

$$\text{Product Selling Price} = 13 + 13(0.592) = 20.70$$

### III. Return On Assets Pricing

The goal of Return on Assets Pricing is to price the product so that a specified return is earned on all assets employed in operations.

ROA based price = Total Costs and Expenses per unit + [Desired Rate of Return x (Total Costs of Assets Employed / Anticipated units to be produced)].

Assume, in addition to the previous data, that the asset base is 250,000 and that the company would like to earn a return of 12% on its assets.

ROA BASED PRICE =  $(5.00 + 2.00 + 8.00 + 3.00) + [.12 \times (250,000/10,000)]$

ROA BASED PRICE =  $(18.00 + [.12 \times 25]) = (18 + 3) = 21$