Setting Transfer Prices in International Groups of Companies - Methods, Contributing Factors and the Role of Subsidiaries

by Peter Schentler und Matthias Tyssen

Numerous companies have established international subsidiaries in the last decades. There are diverse reasons for that: Raw materials and specific know-how available locally, proximity to customers, a low wage level and logistical advantages. This trend applies not only to big companies and mid-sized businesses, but still more to small and medium-sized companies. **The transnational intra-group cost allocation along with numerous organizational and cultural requirements have gained in importance due to increasing internationalization.** Given the fact that the "right" transfer prices must be determined and because of tax laws and economic reasons, the transnational exchange of internal services is very important:

- As far as tax laws are concerned it is advisable to comply with the national tax regulations in order to avoid the danger of a double taxation.
- From economic point of view an equitable distribution of costs within a company is a fundamental basis for the controlling and success assessment of single company units or subsidiaries.

As a result the external influences (e.g. wage level in the respected countries) as well as internal influences (e.g. the role of subsidiaries in the affiliated group) have a decisive impact on transfer prices. In the scientific and practically oriented literature there are numerous pieces of advice on setting transfer prices. However, there is no one universally applicable solution available.

This article gives an insight into setting transfer prices from scientific and practical points of view; it enables comparison between companies; and gives an incentive to optimize your own transfer prices. Basing on interviews, the authors show how companies deal with the issue of transfer pricing, what kind of challenges the companies may face and which contributing factors determine the process of setting transfer prices.

Aims and Functions of Transfer Prices

Transfer prices denote the monetary value of services which are not offered to external customers - these are services exchanged between independent areas/subsidiaries within a group. Every provision of a service and its transfer generates profit for the service provider and loss for the service recipient. These processes, recognized as profit or loss processes, influence the determination of the income in the whole group of companies and have an impact on the group's output.

The goal of transfer prices is to guarantee a "correct" allocation of services among various independent units. This goal system serves to differentiate between various functions of transfer prices. As it is presented in image 1, there are both internal and external goals pursued.

Internally transfer prices take on the function of *coordination*. Due to strong interlocking it is often impossible and pointless to create independent functions and areas in big companies. Resulting from that requirement for an overall coordination can be satisfied by transfer prices functioning as an all-embracing coordination system.

In addition, transfer prices can serve as incentive systems. In many cases the profits gained in an individual area serve as a basis for the assessment of the respective area within the company. Thus the managers of these areas feel an urge to maximize their profits. This effect is further intensified in companies which have introduced the system of payments depending on results achieved by each respective area. Thanks to the fact that transfer prices create costs transparency and costs awareness they can be used as behavioral management tools.

Finally, transfer prices fulfill the function of an internal performance measuring tool. In such a way services and costs can be calculated individually for each unit (profit center or subsidiary). This can serve as a basis for the strategic and operative controlling of the whole company.

As showed in image 1, transfer prices fulfill also **external functions**. So the external performance measuring tool serves to determine output of legally independent subsidiaries. This provides support for the subsidiaries while balancing an account.

As part of the group's *taxation,* transfer prices have an influence on the income tax of the whole company, especially in international companies with varying tax rates in different countries. Provided there is cross-border goods trade, transfer prices influence the level of the customs duty basis and consequently the amount of the customs duty.

Moreover, transfer prices can be used as price justification for the public law, e.g. when subjected to regulation precesses on certain markets (e.g. post, telecommunications).

Methods of Measuring Transfer Prices

It is apparent from the previous part that transfer prices fulfill a number of functions and you cannot imagine internationally established companies without them. On the other hand, transfer prices can be determined in many different ways. **The most common methods in scientific and their practical use** will be shortly presented in the text that follows:

- market-oriented method
- costs-oriented method
- negotiations-oriented method
- price comparison method
- resale method
- cost-plus (markup) method

The starting point for the *market-oriented method* is calculation of market mechanisms

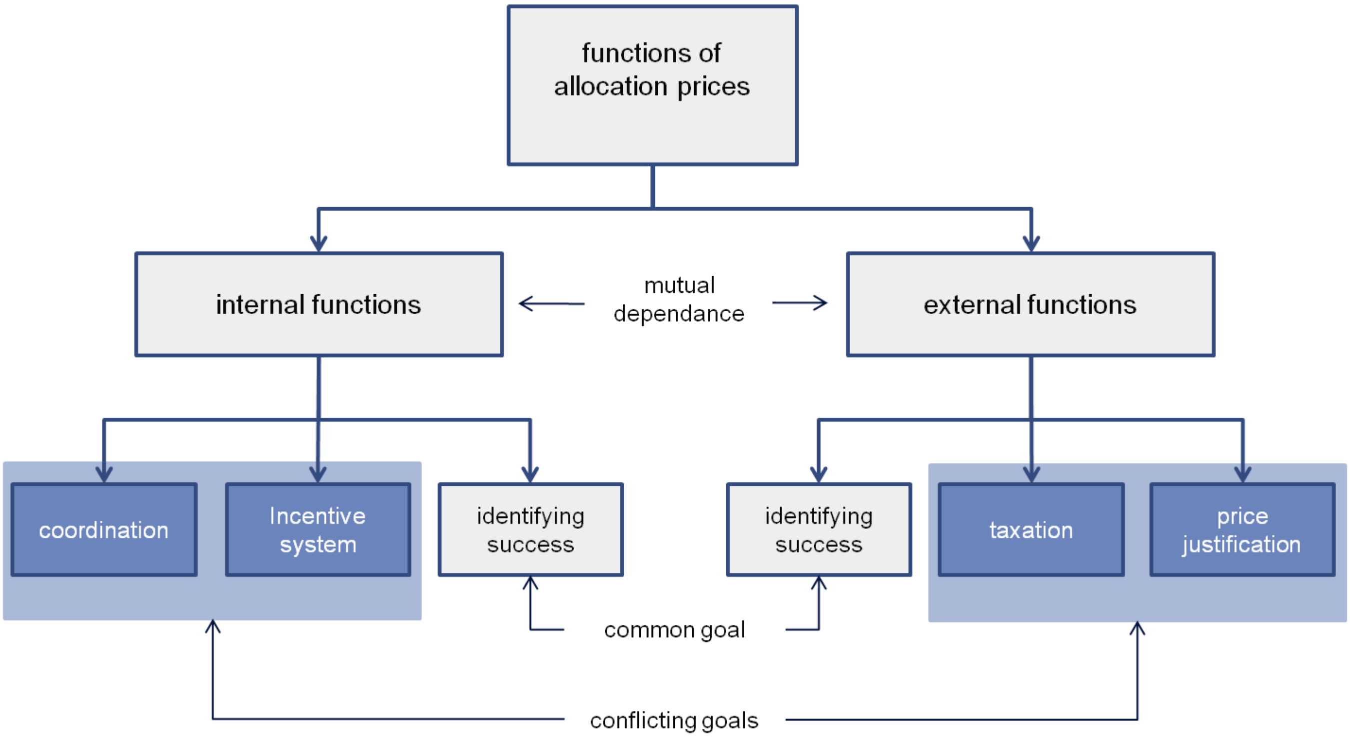

Image 1: Functions of allocation prices 2

which lead as a rule to a subjectively verifiable market price. If the price is estimated as a transfer price, we can assume that the price will be quite realistically established and therefore we can count on a high internal acceptance. Required for the calculation is an existing market for the in-house service which had been transferred.

In case of the costs-oriented method, the companies can choose between the actual, expected, marginal and full costs perspectives. The estimation of actual costs leads to an exact coverage of the service providing area, the service receiving area runs the risk of costs fluctuation. If the budgeted costs estimation is carried out, the service receiving area will become a planning guarantee, whereas the service providing area runs the risk of overloading its capacity. In case of the marginal costs-based approach, the service providing area carries the fix costs. The variable unit costs are covered by the receiver of the service. If you use the full costs perspective, the service receiver bears all costs.

If the transfer prices are not centrally set, we have to do with the *negotiations-based* method. In this particular case both areas decide about the determination of transfer prices. Whereas the level of freedom and the motivation of participating managers are increased, the determination of transfer prices depends on negotiation skills of the managers involved. And justice is done to tax and economic concerns only in a random way.

One more method to determine transfer prices is the *price comparison method.* As oppose to the market-oriented method, in the price comparison method there are no market prices for the service available. As a staring point for determination of transfer prices serve comparable transactions with third parties. This method makes a distinction between the internal and external price comparison. Whereas the internal comparison is based on the price between a company and a third party, the price of the external price comparison method corresponds to the price of two independent third parties on the market. Basic conditions for the use of this methodology are comparable contributing factors (among others, competition and similar products.)

The *resale method* determines transfer price from the difference between the customary market price and a gross profit margin of the service providing area. This method is especially widely applied in marketing. However, basic conditions are here comparable products, functions and business conditions.

In single cases there is no possibility to determine market prices for the services to be calculated. An alternative for such companies would be the *cost-plus (markup) method*. In this method you take the costs basis for a service and add a nett profit markup. The used nett profit markup is based on the customary market markups. It is important however to present the costs basis realistically, and it can prove to be difficult with company's own services.

Empirical Findings for Setting Transfer Prices

In order to obtain findings on contributing factors and requirements for setting transfer prices, the authors had conducted four interviews with German companies. While choosing the companies special care was taken to make sure that the international transfer prices are calculated and active in manifold sectors. That guaranteed a differentiated approach to the issue. Table 1 gives an overview of the interviewed companies.

In the focus of the survey stood first of all the allocation of services which were provided by headquarters to a subsidiary or by one subsidiary to another. Taken into account were among others: IT, marketing, R&D, procurement and other services. Products made for subsidiaries were also partly discussed, but it did not play a pivotal role.

Descriptive Findings on Setting Transfer Prices

Necessity: Overall, the companies see the necessity to cope more intensely with the issue of transfer prices and they provide two main reasons for that. On the one hand transfer prices increase the results and controlling transparency in the company. And on the other hand they point out that in view of tax assessment, transfer prices are even more important and regulatory agencies

Company	Contact person	Business activity	Turnover (2008)	Employees
company A	the head of transfer pricing	pneumatic and electronic automation solutions	€1,700 million	14,000
company B	the head of the controlling department	alcoholic beverages	€550 million	2,200
company C	the director M&A the head of the tax department	sports and sports lifestyle articles	€2,500 million	10,000
company D	the head of the controlling department	pumps, dosing systems, regulation and control engineering technologies	€130 million	700

Table 1: Tasks Spectrum of Controllers at Different Stages of a Radiical Change[2]

control them with increasing care.

Spectrum of Services: The package of services to be allocated is in the examined companies very similar. IT and marketing services are allocated in almost all companies. Some of the companies allocate also the costs for brand management, central procurement and fair participations. To the question why certain services are provided centrally, all interviewed companies gave again similar answers. Securing know-how, costs reduction effects and historically developed motives were the main reasons named by the companies.

Organization: The ways transfer prices were incorporated in the surveyed companies was very differentiated. This issue of transfer prices is incorporated in two companies into the area of controlling , in one company in the area of management, whereas one company has a separate department dealing with transfer prices.

The various organizational approaches to the subject can be partly explained with the company structures as well as performance of services. In that way a company creates, with a separate department for transfer prices, a wide spectrum of services - especially prominent in the sector of R&D services - foreign subsidiaries function as recipients of these services. Therefore for subsidiaries it is of much importance to guarantee a correct allocation of services.

The Role of Subsidiaries: Along the spectrum of services to be allocated, the structure and role of subsidiaries seems to have also a great impact on transfer prices. In almost all companies foreign subsidiaries are self-established and they belong 100% to their parent companies. This creates a close connection between the subsidiaries and regulates at the same time power relation among partners. Whereas two companies describe their subsidiaries to high degree as autonomously acting entities, there is little autonomy in subsidiaries of the third company. On the other hand, the levels of freedom in subsidiaries of the forth company vary widely. Moreover, all companies point out a crucial role of the parent company.

Involvement of Subsidiaries: It was mentioned in all interviews that the subsidiaries show a high level of autonomy in their business activities. Nonetheless they do not take part in the process of setting transfer prices or do it only to a limited extent; transfer prices are determined centrally.

Acceptance Obligation: In two examined companies the subsidiaries are obliged to accept the centrally offered services. The two other companies see only certain services as obligatory for their subsidiaries.

Acceptance: Problems with accepting the services and their prices by the subsidiaries were declared as negligible.

Tax Perspectives: The findings regarding the taxation framework conditions turn out to be unified. All companies had dealt intensively with taxation conditions and they influenced the process of setting their transfer prices.

Tax vs. Controlling Aspects: Three companies stated that tax considerations are important, but there is only one criterion by which they set their prices. In one company

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Aspects	very similar	similar	different
necessity	x		
range of services	x		
organization			x
role of subsidiaries		x	
involvement of subsidiaries	x		
obligation to acceptance		x	
acceptance problems		x	
taxation aspects	x		
taxation vs. controlling aspects			x
selection of methods		x	
country differences		x	
adaptation		x	

Table 2: Unification of Responses According to the Examined Aspects

the optimal arrangement is of the highest priority and it is almost the only decisive criterion for determining transfer prices. None of the examined companies have experienced the negative sides of a double taxation so far, yet they recognize that the topic is becoming increasingly explosive.

Selecting the Methods While choosing the method, all companies rely on the principle of the costs markup method. In some companies they add to this method a negotiations-oriented markup, and in other companies fixed contributions. Overall, we can conclude that (if nec. country-adjusted) group's interests are in the foreground and there are no individual or situational deviations from that.

Country Variations: There is one difference, however, in the determination of transfer prices in individual countries. The country -specific conditions lead as a rule to markups or discounts for the foreign subsidiaries. This reflects the differences in price levels in the country and foreign subsidiaries, but also takes into account specific tax aspects. A basis for that are markups or discounts defined by the company itself or amounts of markups and discounts basing on the OECD data.

Adaptation: None of the companies adapt their transfer prices during the year. While half of the examined companies conduct an annual adaptation, one company does not do it at all; the transfer prices in that company remain fixed over several years.

Table 2 presents the companies' various responses concerning the examined aspects of determining transfer prices.

Where the necessity, range of services, role of subsidiaries and taxation aspects were assessed in all companies very similarly, there are wide differences among the companies in the matter of organization and in the issue of "taxation vs. controlling". There are also differences in the role of subsidiaries, obligatory acceptances, problems with acceptance, selection of methods, differences in individual countries and adaptation. Due to the fact that all companies treat their subsidiaries in the same way and the services to be taken into account, one can suppose that these are not the cause of differences in transfer prices. A much more probable cause of differences in transfer prices may be their objectives. And accordingly in one company the foreground occupies the optimization of taxes, whereas in another company the equitable charging of services is of the highest priority.

Requirements for Transfer Pricing

To sum it up several **requirements** can be defined in the context of transfer pricing.

- **Determining transfer prices that both sides accept as "fair"** poses for companies still a considerable challenge. The parent company pursues in many cases the strategy of transfer pricing that is supposed to cover at least the incurred costs. This creates very often a conflict of interests between the subsidiaries and their parent companies.
- Both the selection of right methods and the **acceptance of subsidiaries are important** for a functional charging of services between the subsidiaries. Gaining acceptance is on the other hand a difficult undertaking, especially if the subsidiaries have not grown organically or belong to the parent company only on pro rata basis.
- Companies, being active in many countries, face an additional challenge of understanding and properly using the **tax frameworks** of the respective countries.
- Even if from financial point of view the focus lies on the optimization of transfer prices with regard to taxes, the accompanying effect of **controlling behavior** shall not be neglected. Otherwise it can have a counterproductive or dysfunctional effect.

Findings and Implications for the Practice

In the process of determining transfer prices the companies face various challenges. Each company is supposed to analyze individually which aspect must be considered in more detail. Yet implications can be drawn which are crucial for many companies in the process of setting transfer prices. Basing on the analysis of conducted interviews and on the approaches from the respective literature, the following pieces of advice have been prepared:

Setting Priorities: Many companies charge for petty services and increase therefore the effort and complexity. It is rather more appropriate to charge for services which are relevant for taxation and/or controlling behavior. Companies should set priorities for the services to be charged and they are also supposed to divide the effort by determining transfer prices according to the level of importance. In such a way more comprehensive analyses and calculation methods can be used for transfer pricing of appropriately categorized services; this guarantees an exact determination of transfer prices. To deal with less important services on the other hand, we can consider using procedures which are simpler and less demanding or there can be no charges for such petty services (e.g. the headquarters cover the costs).

Early Identification of Tax Conditions: Companies have to early identify tax conditions of respective countries. If the taxation aspects are already known in the process of determining transfer prices, they can be taken into account in the discussions phase. A subsequent adaptation of transfer prices

	Suggestions	Status
1.	setting priorities	☒
2.	early identification of tax conditions	☒
3.	internalizing various points of view	☒
4.	limiting the negotiations	☒
5.	considering effects	☒
6.	setting internal standards for processes	☒

Table 3: Suggestions Regarding the Process of Transfer Pricing

with regard to tax relevance will not be necessary or there will be only a reduced adaptation needed.

Internalizing Various Points of Views: In addition, an early internalization of various groups of people presents itself in the process of determining transfer prices: the central management, management of subsidiaries, people responsible for departments/ areas charged for the services, controlling, tax experts and others. A comprehensive discussion enables the consideration of different points of view and also guarantees acceptance of the use as the determination is transparent or the people are involved in the process.

Limiting the Negotiations: The aim is to create a unified price list for all services. Transfer prices are not supposed to depend on the negotiation acumen of individual local managers. The price list should be respectively adjusted to the requirements of various countries according to generally accepted criteria (e.g. the mentioned above OECD regulations). in order to get the economic aspects specific for each country.

Considering Effects: Effects of transfer prices or changes of transfer prices in individual subsidiaries have to be thought through in the foreground. Adaptations of transfer prices can have both a positive as well as negative impact on the achievement of aims in subsidiaries. Considering these changes while defining aims can be helpful here.

Setting Internal Standards for Processes: For companies, which need to charge many services internationally, it is advisable to create unified standards. Especially regarding the differences among individual countries and the numerous possibilities of charging for services, the standards can structure the processes and reduce the effort.

The recommendations are put together in table 3.

Conclusions

It can be stated that transfer prices within internationally active companies is a topic of great relevance. There are internal and external requirements in that context. Externally there lies a central challenge of determining comparable (market) prices and the consideration of tax conditions in individual countries. Internally considered, the subsidiaries' acceptance and the calculation of transfer prices amounts to complex tasks for companies. Due to the increasing globalization of markets and internationalization of companies, acumen in dealing with these challenges also in the future will be of no little importance.

Sources

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