MULTINATIONAL TRANSFER PRICING: ISSUES AND EFFECTS ON THE NIGERIAN ECONOMY

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Abstract

Multinational transfer pricing is becoming a global issue. This is as a result of several activities engaged in by multinational firms to reduce their corporate tax burden. This paper therefore, focuses on the general issues surrounding multinational transfer pricing. A conceptual approach was taken at reviewing several literatures to identify the methods and effect of Multinational Transfer pricing on the economy. Also, several recommendations were made to aid transfer pricing policy in Nigeria.

Introduction

Organizations due to growth sometimes decentralize their activities. This decentralization may be within the country of their domain or across the boarders of their domain. When such subsidiaries are established across the boarders they are managed separately from their parent companies. This leads to the term "multinational corporations". Omoye and Okafor (2004:69), refers to Multinational Corporation (MNC) as "a large company with foreign branches and its corporate office in a developed economy".

Despite the fact that the branches of MNC are managed separately, they have common corporate objectives to achieve. One of such objectives is "good profit". To achieve this, MNCs engage in international trade among the various units of the MNCs, such as between the parent company and its foreign subsidiaries or between its subsidiaries in different countries. This "trade" among the various units of MNCs is normally carried out at a price referred to as 'transfer price".

Kayode (2003:252), describe transfer Price as "a price attached to goods and services being exchanged among divisions operating under the canopy of a central management". One could make a distinction between intra-corporate transfer price and inter-corporate transfer price by using the former to refer to transactions among divisions of a single corporate entity and the latter to refer to transactions among different corporate entities of one large company. In this paper, inter-corporate refers to any transfer made within a global corporate family. Inter-corporate pricing is also used synonymously with transfer pricing. The objectives of this paper therefore are: to create awareness on the issues associated with multinational corporate transfer pricing policy, identify the various conditions that facilitate transfer pricing, identify the methods adopted in transfer pricing, show the effect of international transfer pricing on the economy and recommend a general guideline for determining a minimum transfer price in transfer pricing situations.

The term "transfer price" has been defined variously by different authors. Okoye (1997:462), in his own view, defines transfer price as "a price used to measure the value of goods or services furnished by one division to another division within a company". Adeniji (2005:211) defines it as "the monetary value attached to goods manufactured by a particular decision making unit and then transferred to another division for the purpose of being utilized for the divisional final product". While Dean, Feucht and Smith (2008:12), are of the view that it is "pricing of goods and services that are transferred between members of a corporate family including parent to subsidiary, subsidiary to parent and between subsidiaries".

From the above definitions, multinational transfer price could be referred to as the price used to measure the value of goods and services being exchanged among the different units of the MNCs. Inter-corporate transfers are important to most MNCs not just because of the profit motive but for the going concern of the MNCs. This of course may be the reason why most MNCs are engaging in inter-corporate transfers despite stringent measures put in place by governments of host countries of their subsidiaries to checkmate them. Adediran (2006:12) cites some reasons why MNCs will continue in inter- corporate transfers.

Firstly, raw materials not available or in short supply for an MNC unit in one country can be imported for sale or further processing by another unit of MNC located in a different country. For example, Reynolds metal company, a subsidiary in Jamaica exports Bauxite to Reynolds U.S for subsequent processing into aluminum.

Secondly, some stages of an MNC's production process can be conducted more efficiently in countries other than that where the MNC has its headquarters. For example, to minimize total production cost, many MNCs produce or assemble components in lower labour-cost countries. They can then ship these components to their subsidiaries in another country for final assembly.

Thirdly, many MNCs operate sales offices in some countries but do not manufacture there. To sell their product, the sales offices or subsidiaries must import products from manufacturing affiliates in other countries.

Fourthly, many services for MNC units are rendered by MNC headquarters or other affiliates of an MNC. For example, headquarters may conduct research and development for the benefits of all units, develop advertising campaigns for them or provide them with management consulting.

Fifthly, there are many international financial flows between units of MNCs. Some are payment related to goods or services, some are loan repayments, some are dividends and some are designed to lessen taxes or financial risk.

Despite the reasons necessitating transfers among units of MNCs stated above, MNCs must also take note of certain factors and criteria before setting transfer prices. Adediran (2006:4) also cites some criteria and they include: "Goal congruence, divisional autonomy, and performance evaluation". Furthermore, he stressed those factors to consider for domestic transfer pricing to include; performance evaluation, managerial motivation, pricing driven and market driven.

Also, Omoye and Okafor (2004:71) are of the opinion that "the objectives of MNC transfer pricing are not exactly the same as that of domestics transfer pricing". This therefore means that the factors to consider in both MNC transfer pricing may be different from that of domestic transfer pricing. Citing Tang (1982),

Multinational transfer pricing decisions are based on some consideration such as given below in order of importance: Over all income to the company, the competitive position of subsidiary in foreign countries, performance evaluation of foreign subsidiaries, restrictions imposed by foreign countries on repatriation of profit or dividend, the need to maintain adequate cash flows in foreign subsidiaries and maintaining good relationship with host government.

Generally, there are many transfer pricing methods practiced by MNCs. The method chosen will depend on their policies or objectives they want to achieve. The methods are: Market based transfer price, Negotiated price and cost based transfer price (Omoye and Okafor, 2006)

Market price is simply the price at which the goods and services are offered at the open market. It is recommended for economic evaluation performance and where different buyers and sellers exist.

There are also some drawbacks to using a transfer price based on the market price and they include: there may be problems if the goods transferred do not have a ready market price. Also, in today's regulated economy, perfectly competitive markets are very rare and that can affect the market price rendering it inapplicable as an effective price.

Furthermore, there is no guarantee that the market price of a product is strictly comparable in terms of grade and other relevant characteristics and a situation may arise in which the market price is a distress price (Adediran, 2006).

Negotiated price describes the transfer price established by agreement between the supplying and receiving responsibility centres for their mutual benefit. This system is considered well enough for performance evaluation purpose if both parties have equal bargaining power.

Under the **Cost based** method, transfer price is equal to the unit cost of production to the selling and responsibility centre department. Cost could either be variable, standard or total cost. This method is good for its simplicity in getting cost information.

According to Horngren (1996:914), as cited by Adediran (2006), "The most popular methods around the world are the market price and cost based price. Some authors are of the view e.g. (Adediran 2006), that organizations can be at optimal situation and enjoy great advantages by employing a "Dual price". The dual price system allows the selling division to sell at a market price creating a profit motivation for them to sell and allows the buying division to buy inside the company at variable cost. The advantage to be enjoyed by the MNCs is that it motivates both the buying and selling divisions to operate in the best interest of the company as a whole.

However, the method to be adopted by MNCs will depend on their transfer pricing policies and the objectives they hope to achieve through such policies. Omoye and Okafor, (2004), are of the view that MNC will adopt methods as a result of the peculiarity of their objectives. Similarly, Mueller et al (1991), as cited by Omoye and Okafor (2004:71) classifies objectives of MNC International Transfer Pricing as: Minimization of worldwide income tax, import duties, financial restriction avoidance, currency fluctuation management and winning support approval of host countries.

Worldwide income tax minimization could be achieved by setting high transfer prices for goods and services entering the country with a high tax rate and low transfer prices for countries with low tax rate. The result is that the recipient countries with high tax rate will have high cost of goods sold and low profit and hence low corporation income tax for the recipient unit country. Since some profit have already be preserved in units countries with low tax rate the total profit of the MNC would be high but tax liability would be low.

Worldwide import duties minimization: Import duties are normally based on the values of goods and services (advalorem tax). When goods with high value are under valued and transferred at low prices, the resulting tariffs will be lower. MNCs could use this transfer pricing strategy to send goods to subsidiaries where there is import restriction through high tariff in the host country of the subsidiaries. By using low transfer price, a subsidiary may be able to import a large quantity of goods and services at very low tariff.

Avoidance of financial restrictions: It is not uncommon for government of host countries to place economic or financial restrictions on MNCs operations. MNCs more often than not circumvent this restriction through transfer pricing. If for example a country restricts the amount of cash that is legally allowed to leave its boundaries in form of dividend payment, by using a high transfer price on goods imported into the country; MNCs would move more cash from subsidiaries companies. This is possible because the importing subsidiaries must remit payment. Similarly, financial restriction on MNCs could be mitigated when the “home countries” of the MNC allow a tax credit or subsidy on the value of goods and services exported. In this regard, high transfer price on export allows for a larger subsidy thereby reducing the corresponding tax liabilities. Currency fluctuations management: When foreign subsidiary countries devalue it’s currency to address balance of payments problem resulting from inflationary environment, a high transfer price could be used to counter the effect such devaluation will have on its monetary asset. During inflationary period, the purchasing power of monetary asset is eroded. Therefore, using inflated high transfer price on goods and services to subsidiaries in countries with inflation will facilitate timely cash removal.

Winning the support and approval of host countries’ Government: The activities of MNCs in respect of manipulation of transfer prices to the detriment of host countries have not been unnoticed. As a result of the tax implication, governments of host countries are more concerned about transfer pricing related transactions. It therefore means that MNCs must co-operate with governments by not frequently changing or manipulating transfer price to its advantages. This is necessary to maintain goodwill from the host country.

Transfer pricing seems to be more beneficial to MNCs than to the host countries of their units. Dean et al (2008:7) are of the view that MNCs will continue to engage in MNC transfer pricing because of the several economic benefits. According to them, “transfer pricing assists MNCs in evaluating the financial performance of different parts of the company. Also, it may help reduce their consolidated company’s tax burden”

The Effect of MNCs Transfer Pricing on the Economy

Tax authorities and government officials all over the world pay close attention to taxes paid by foreign corporations operating within their boundaries. Adediran (2006:14), cites how, in 1993, the US Internal Revenue Service (IRS), investigated and concluded that Nissan motor company had minimized US taxes by setting transfer prices on passenger cars and trucks imported from Japan at unrealistically high levels. Eventually, Nissan agreed to pay the IRS, $170 million. Also, in May 1994, Japan’s national Tax Agency (NTA) alleged that coca-cola corporation had deliberately under recorded profits earned in Japan by charging excessive transfer prices to its local subsidiary for materials and concentrates imported. The NTA imposed taxes and penalties of $150 million

In Nigeria, the situation is more serious with multinational companies that usually over-invoice materials to the country. Arbitrary prices are usually used to transfer goods and services to Nigeria to increase cost and thereby reduce the profit and eventually reduce taxes to be paid. Despite the lame effort of government officials at curbing this, a substantial amount is being lost annually due to MNC transfer pricing manipulation.

According to Adediran (2006:15), "No Indian companies in Nigeria have come out with meaningful profits. Instead they would be posting losses as a result of over-invoicing of the transferred goods and services". This of course is not healthy for our economy because it reduces the revenue accruable to the government. According to Baistrocchi (2006:950),

> *Transfer pricing manipulation produces two major consequences. Firstly, it puts national tax jurisdictions under stress because it is an income shifting system that allows MNCs to maximize after-tax profits by channeling taxable income to jurisdictions with lower taxes. Secondly, it raises horizontal equity issues because it provides substantial advantage to MNCs over non-MNCs; only the former can use this type of international tax planning strategy.*

The issue of transfer pricing is becoming a global problem. This led to the development of the Organization for Economic Cooperation and Development (OECD) model Tax Convention on Income and Capital. The central role of the OECD is to minimize international double taxation by establishing some structural legal fiction to guide the division of international income tax base (Baistrocchi, 2006)

The OECD is to audit MNCs transfer pricing to determine whether such transfer prices meet the Arm's Length Standard (ALS). If any organization is found defaulting, the regulating tax authority can assign an appropriate transfer price and recalculate the new tax liability (Dean et al, 2008).

The United States in their IRS code provided a section (section 482) to deal with the issue of MNC transfer pricing and determine whether it conforms to the ALS. Also, the Australian Tax Office mandates that; transfer pricing review must take place regularly to effectively monitor MNCs transfer pricing.

While a lot can be said of other countries, not much can be said of our country Nigeria. Apart from measure put in place to check the standards of goods and collection of import duties at our ports, nothing is being done to checkmate the transfer prices placed on some of these goods for subsidiaries of MNCS. The Federal Inland Revenue Service (FIRS) should put measures in place to conduct value for money audit on some of these goods transferred. Also, the professional associations (e.g. The Institute of Chartered Accountants of Nigeria – ICAN) should play a vital role here. This they can do by educating their members auditing MNCs to carry out special audit in transfer pricing related transactions. We can not continue to accept that we must borrow to finance budget deficits when millions of naira are manipulatively carted away under the auspices of transfer pricing. We must wake up to the challenge like other countries and come up with a reasonable policy to rightfully take what belong to the nation in form of adequately assessed corporate tax.

Conclusion

The economy stands to benefit from transfer pricing related transactions. MNCs can not continue to milk the Nigerian economy for its sustenance because this will bring about an imbalance in the economic system. It is pertinent therefore that all hands be on deck to ensure the nation gets its rightful share of revenue in form of tax from MNCs indulging in transfer pricing related transactions. Also, tax officials should know that they owe the nation a duty by ensuring that MNCs taxes are adequately assessed and remitted to the government treasury.

Recommendation

Based on the foregoing discussion, it is hereby recommended that;

- Adequate and enforceable legislation be made to curb the menace perpetrated under the game of MNCs transfer pricing.
- The FIRS should embark on periodic review of MNCs transfer pricing related transactions.
- The Nigerian Accounting standard Board (NASB), on their part should come up with a standard on transfer pricing related transactions.

- Also the government should come out with a white paper on its transfer Pricing Policy (TPP) through any of its approved agencies.

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