Expanding globally: transfer pricing considerations

As your company expands into new countries and markets, it will likely need to assess its transfer pricing. This article explains what transfer pricing is and why it is important to address it when your business expands globally.

What is transfer pricing?

The term "transfer pricing" generally refers to the setting of prices on transactions between related parties. Transfer pricing can apply to any number of related party transactions, including the price on a sale of goods, the fees charged under a services agreement, the interest rate on a loan, or the royalty rate on a license between two related entities. Transactions between related parties located in different countries with different tax regimes create an opportunity to set artificial prices to reduce the overall worldwide tax burden of a company, and for this reason tax authorities may give more scrutiny to your related party transactions. The following example illustrates the impact of transfer pricing on a transaction:

Company X, located in "low-tax" Country A, manufactures shoes and distributes those shoes through Subsidiary Y, located in "high-tax" Country B. The shoes cost $50 for Company X to produce and Subsidiary Y incurs $10 of costs to distribute the shoes for a total enterprise cost of $60. Company X sets the "transfer price" for the shoes, the price at which Company X sells the shoes to Subsidiary Y, at $80 and Subsidiary Y sells the shoes for $100 to customers. The enterprise has made an overall profit of $40 ($100 minus the $60 costs incurred by Company X and Subsidiary Y) that will be subject to income tax. Company X will report $30 in taxable income ($80 price minus $50 cost) and Subsidiary Y will report $10 ($100 minus the $80 price paid for the shoes and the $10 distribution costs) in taxable income.

On the other hand if Company X sets the "transfer price" at $85 instead of $80 and the retail price remains $100, Company X would report $35 in taxable income ($85 price minus $50 cost) and Subsidiary Y would report $5 ($100 minus $85 price paid for the shoes and $10 distribution costs). By shifting the "transfer price" from $80 to $85, Company X increases the income subject to tax in Country A and decreases the income subject to tax in Country B, thereby reducing the total worldwide tax. The table below illustrates the resulting tax advantage.

Scenario 1:	Income	Tax rate	Tax owed
Company X	$30	10%	$3
Subsidiary Y	$10	40%	$4
Total worldwide	$40	17.5%	$7

Scenario 2:	Income	Tax rate	Tax owed
Company X	$35	10%	$3.50
Subsidiary Y	$5	40%	$2
Total worldwide	$40	13.75%	$5.50

What happens if the tax authorities come knocking?

Taxing authorities in various jurisdictions may scrutinize your related party transactions to ensure that they satisfy an "arm's-length" standard (*i.e.*, that the terms of the transaction reflect terms that are consistent with unrelated parties). In Scenario 2 above, the Country B tax authority may try to reduce the price charged by Company X to Company Y to reflect what the Country B tax authority thinks is the price that an unrelated party would charge (and which, not coincidentally, would generate for taxable profit in Country B).

What should you do?

As companies expand their business globally and establish overseas subsidiaries, it is important to develop a global transfer pricing policy that satisfies the arm's-length standard. A key element of such a policy is to perform "benchmarking" studies to identify comparable transactions and profit-levels among unrelated parties. This benchmarking process can help to demonstrate that the transfer prices set between related parties satisfy the arms-length standard and should not be adjusted.

Learn more about our transfer pricing practice.

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