How transfer pricing complicates tax control

On engaging with the subject of transfer pricing, it is obvious that the tax angle plays a dominant role. Current buzzwords include ATAD (Anti Tax Avoidance Directive) and CbCR (Country-by-Country Reporting). Prevalent discussion topics include avoiding compliance breaches, fines and even double taxation. The impact on operative controlling is soon forgotten when implementation focuses on the tax angle.

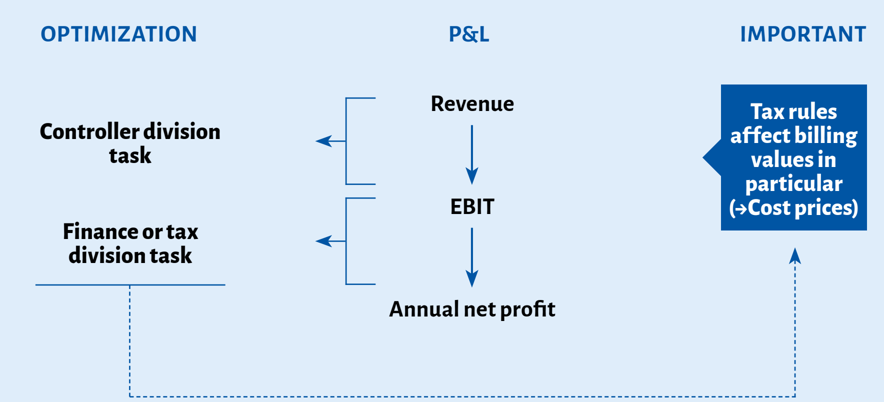

Figure 1: Tax law affects the amount of operating profit of individual entities

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The following example was chosen because it shows a situation in which the tax logic is not sufficient, but requires additional information from the controller division. Point of departure is a typical tripartite value creation structure, see Fig. 2.

In the initial situation, the principal is left with €23. Both routine entities, i.e. the manufacturing contractor in the production function and the LRD (limited risk distributor) in the sales function, receive the tax-wise reasonable margin of cost plus 5% and resale minus 15%. Each of the three companies generates a profit from their share in value creation and therefore has an interest in pursuing the business.

Let's assume an increase in production costs, see Fig. 3 with regard to our example. Wastage has increased, also reworking, and the cost of some raw materials has risen. Manufacturing costs rise from €140 to €160. From a tax point of view, the transfer price must be increased to €168. This however presents a problem for the controller. The tax margin of the contract manufacturer rises from seven to eight euros. It is not logical that higher costs (due to raw material costs) should lead to higher margins. And especially not if the contract manufacturer is responsible for the costs (reworking). The cost plus method generates neither an incentive for efficiency nor transparency. Indeed, it may be posited that production should not show a margin at all. From a tax point of view, this is a given: "the margin of any company corresponds to its share in the value chain." In the controller's book however, no turnover with external customers means no profit.

The same applies to the distribution company. It is unable to maintain the price on the market. While the drop in price of €20 is reflected in the lower sales figures, unfortunately it is not taken fully into account. Due to the price drop, the LRD margin narrows from €30 to €27. To be correct, it should have dropped to €10. In addition, return on sales (ROS) remains unchanged at 15%. **This means that sales cannot be assessed either on the basis of return on sales or of absolute profit.** Tax law has made it impossible to use either indicator. The above also applies to gross and contribution margins. After all, mathematically the two factors can each be converted into the other.

"Reporting more profit than there is in sum to distribute is not possible."

In most cases, auditing constitutes another step. Both gross and net margins are audited using the transactional net margin method (TNMM). Usually based on the EBIT, this is aimed at checking whether sufficient profit has been achieved. A typical case would be a shortfall in target sales volumes combined with a reasonable return on sales. After deducting fixed costs, the remaining profit is no longer reasonable from a tax point of view. In anticipation of this scenario, the tax division takes due counteraction such as lowering the transfer price to the distribution company in order to increase the latter's EBIT. To sum up, **the good work of the tax division** destroys all the information required by the two routine entities for controlling purposes.

This applies even more so to the principal. They report a loss of -€15. Without information processed in a different manner, they have **no** interest in pursuing the business venture. The profits reported by the routine entities are not included in the principal's books. It would however be wrong to take this product out of the range. From the group's point of view, the sum of the three sub transactions constitutes a ("consolidated") profit of 20. In the end, the individual companies report the following figures: +8 / -15 / +27. Following the tax logic, this distribution of profit is correct. In the controller's eyes, it is a nonsense. Reporting more profit than there is in sum to distribute is not possible.

In this example, tax law generates figures that run completely counter to controlling logic. As the accounting invoices are not determined by commercial, but by tax law, the data in the inventory, expense and income accounts of the three companies are not usable without additional information. ■

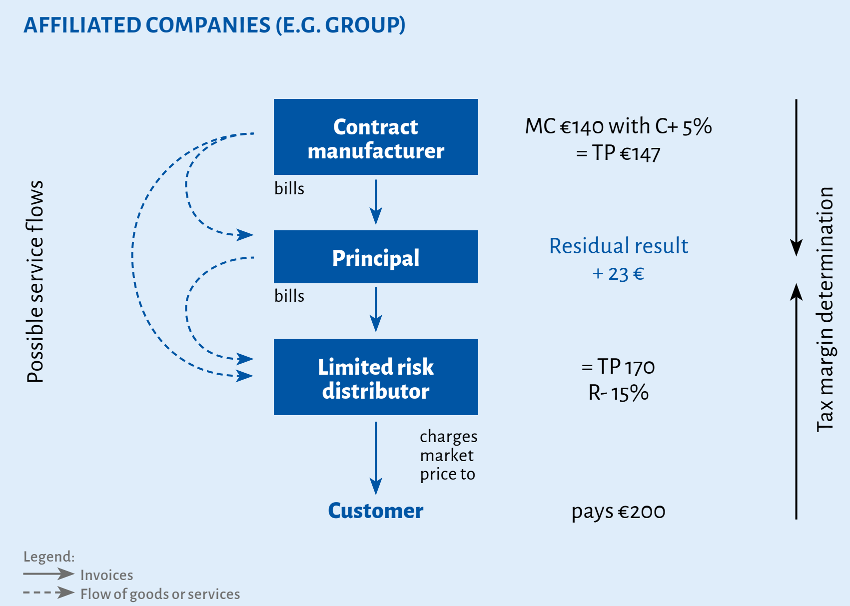

Figure 2: Simplified example of the transfer pricing principle for tax purposes

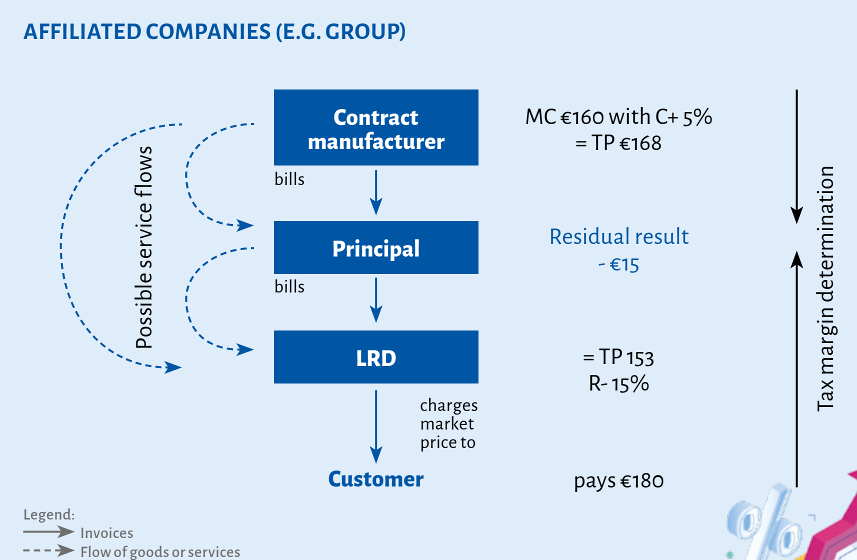

Figure 3: Tax consequences in case of rising MC and falling RP