INTERNATIONAL TRANSFER PRICING REGULATION: NIGERIAN EXPERIENCE

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Abstract

Multinational enterprises (MNEs), as any other international business concern, have among other objectives, the reduction of foreign exchange risk, duties or tariffs, foreign and domestic taxes, which ultimately maximise the enterprises' profitability. The use of international transfer pricing strategy by MNEs remains on the surface, a justifiable management tool for achieving acceptable corporate objectives, only to the extent permissible by relevant tax laws; otherwise, creative transfer pricing strategies could be subject to abuse, manipulation, exaggeration and sometimes lead to monumental loss of tax revenue through the unethical movement of one nation's tax revenue to another. This paper discusses the common transfer pricing strategies employed by multinational enterprises, and the realities of emerging economy like Nigeria in the use of appropriate legislation in controlling the abuses of unwholesome transfer pricing strategies. .

Keywords: International transfer pricing; foreign exchange risk; exaggerated transfer pricing

Introduction

A Multinational Enterprise, MNE, by its inherent nature has portions of operational facilities of many types located in many locations in the world. Transfer pricing is a field of analysis that reflects the determination of profits of each of such portion of the enterprise. The profits of each portion of the business are most typically structured through intercompany transactions, including intercompany sales, leasing, licensing, and the like. Transfer pricing is a practice that reflects the price of goods, services, or intangible transfers between different entities of the same organisations, or, as an alternative, the determination of profits of entity or division within the enterprise.

Transfer pricing has dual impacts, first on the businesses that may have to pay the taxes and government revenue agents that expect to collect the taxes. Curiously, transfer pricing by design rules across international borders and are much more similar than they are different. These differences, however, result in substantial tax consequences which is manifest in most double taxation and which occasionally lead to tax-saving opportunities to the MNCs and tax losses to the government.

Nigeria, a leading African emerging economy has a growing number of local companies in the telecommunication and financial industries extending their businesses across international borders, particularly to the West African sub-Region. The sorry state of basic industry supporting infrastructure such as electricity, good road networks etc are among the motivating factors of local industries to extend their operation bases to other African countries such as Ghana and South Africa. Examples of such erstwhile wholly local enterprises include the Glo Telecom Company, United Bank Nig. Plc; Access Bank Nig. Plc including others in the manufacturing and entertainment industries that are in the process of establishing their operational bases in some African countries.

Multinational Enterprise and International Business.

Multinational enterprise (MNE) otherwise known as multinational corporation (MNC), Trans-national corporation,(TNC) or International corporation,(I.C), (Pitelis, Christos; Sugden, 2000), is an enterprise or corporation that manages production or delivers services in more than one country. The International Labour Organization (ILO) defined an MNC as a corporation that has its management headquarters in one country, known as the *home country*, and operates in several other countries, known as host countries.

Multinational corporations have various motives for establishing operating presence in other countries and one of such motive is a desire for growth. A corporation may have reached its maximum limits meeting domestic demands with little little prospect for additional growth and extending to new foreign markets could be the only window of opportunities for new growth. Another motive could be the desire to avoid the protectionist and restrictive policies of an importing country. Through direct foreign investment, an enterprise can bypass high tariffs that could prevent its goods from being competitively priced. When for example, the then European Common Market (now European Union) placed tariffs on goods produced by outsiders, U.S. corporations responded by setting up European subsidiaries of its home corporations.

Two other motives are perhaps, more uninviting while at the same time controversial. One is the prevention of competition, and the most certain method of preventing actual or potential competition from foreign businesses being the acquisition of those competing businesses. Another motive for establishing subsidiaries in other nations is the reduction of costs, mainly through the use of cheap foreign labor in developing countries. A transnational corporation can hold down costs by shifting some or all of its production facilities abroad. This practice in contemporary international business is known as *outsourcing.*

Another concern with multinational corporations is their ability to use foreign subsidiaries to minimize or avoid their tax liabilities.

International business is a term used to collectively to describe all commercial transactions (private and governmental, sales, investments, logistics, and transportation) that take place between two or more nations. Usually, private companies undertake such transactions for profit; while governments undertake them largely for political reasons. It refers also, to all those business activities which involve cross border transactions of goods, services, resources between two or more nations.

Nigeria and multinational corporations

Foreign/international businesses came into Nigeria following the onset of colonialism as commercial interests are considered to have primarily motivated the colonial exploiters. Fubara, (1986). One of the earliest of those MNCs was the Royal Niger Company (RNC), the grandfather of UAC Plc. Nigeria has a long history of international companies' right from her pre-independence era. These international companies were largely trading companies that operated as trading posts in Nigeria with their headquarters in Western Europe, notably United Kingdom. Examples of such early international companies are:

GBO; Cadbury; Leventis Motors, etc. Later to establish their foreign subsidiaries in Nigeria were the Motor Vehicle assembly plants- Volkswagen plant (of Germany) Peugeot Assembly Plant (of France).Multinational Enterprises in the Oil and gas sector to establish their presence in Nigeria include the Dutch- Shell Company, French-Agip Company, Exxon-Mobil, and the American Chevron Company among others. Early foreign pharmaceutical subsidiary companies in Nigeria include the U.S based Pfizer, Glaxo-Smith companies etc. These companies share the common features of having their corporate headquarters in their countries where transfer pricing decisions are taken.

Nigeria, like most developing or emerging economies of the world, had her concerns geared more towards providing incentives for direct foreign investments than the making of rules to checkmate the excesses of foreign companies in the use of transfer pricing for tax avoidance However, with increasing pressure to broaden her revenue base due to the uncertainties surrounding the international oil market, greater emphasis has to be placed on non-oil sector and by implication, the enlargement of the tax net to cover such areas as international companies activities.

International transfer pricing and multinational enterprises

A transfer price is the price charged for intercompany goods or services transferred from one division to another of the same divisions. A company's profit, Return on Investment (ROI) and the residual income for the segments of a company can be significantly impacted by the price charged. The goals of transfer pricing within multinational enterprises, however, differ from those of strictly domestic transfer pricing. This is primarily because of the benefits involved. While this can get complex when the two divisions are in the same country, it becomes much more complicated when the divisions are based in different countries.

In multinational companies, there are inherent tax implications, as well as profit manipulation, and fraudulent activities. For example, Multinational companies may use transfer pricing to shift costs to high-tax countries and to shift revenues to low-tax countries. A multinational corporation (MNC), as a body, has at least two divisions, the parent division which is located in the home country and at least one subsidiary division that is located in a foreign country. This arrangement makes possible vertical trading of at least one product (or service) internally between the upstream division and the downstream division at an internal price called the "transfer price". The transfer price would be the price that the parent (selling) division charges the subsidiary (buying) division for the intermediate good that is traded between them. In some other cases, the selling division could be a subsidiary that sells to another subsidiary. This results in horizontally integrated MNE, where the subsidiary would sell the same finished good as the parent division.

Implications and complexities of international transfer pricing

The goals of transfer pricing within multinational enterprises can either be internally or externally. The internal reason include motivating managers and monitoring their performance, while external reasons would be to reduce taxes, duties or tariffs, reduce the foreign and domestic tax bill and strengthen the foreign subsidiary. Transfer pricing can also reduce foreign exchange risk and put the company in a better position to relative to its competitors. However, transfer pricing could be subject to abuse and which in many cases could involve transfer pricing manipulation. This involves shifting accounting profits from high tax to low tax jurisdictions. This is done by exaggerating the amounts involved in the transfer in an effort to pay only minimum taxes and increase the overall income of the corporation. This effectively translates to the movement of one nations' tax revenue to another. In a number of cases, the amounts of these exaggerated transfer prices may be material, both at the transaction level, and significantly from a global economic perspective with respect to the total amount of intra-firm trade across national borders.

Cost/income tax minimization

Profits of divisions involved in an intercompany transaction are directly affected by transfer pricing. Some performance evaluation systems are based on divisional profits and the effectiveness of these performance evaluation systems is influenced by the fairness of transfer prices. So also does the effectiveness of performance evaluation systems affect the satisfaction of managers.

Profit maximization and, by extension, cost minimization are common and important corporate objectives. Manipulating transfer prices between countries is one way for multinational enterprises to achieve cost minimization. This is referred to as discretionary transfer pricing. The minimization of costs through the shifting of profits to lower tax rate jurisdictions is the most common transfer pricing approach.

Minimization of worldwide import duties

Transfer prices can reduce tariffs as import duties are normally applied to intracornpany transfers as well as to sales to unaffiliated buyers. If the goods are transferred in at low prices, the resulting tariffs will be lower. This same pricing strategy may be used when a country places a ceiling on the value of goods that may be imported. By valuing at low transfer prices, a subsidiary may be able to import a larger *quantity* of goods and services; however, where a country had a low tariff on imports, a higher transfer price could be charged.

Tariffs interact with income taxes. Low import duties are often associated with a country with high income tax rates. The opposite may also be found—-high import duties with low income tax rates. The MNC must have to deal with the customs officials and income tax administrators of the importing country and with the income tax administrators of the exporting country. A higher import tariff would result in a lower remaining profit for determining income taxes. The MNC has to evaluate the benefits of a lower (higher) income tax in the importing country against a higher (lower) import tariff as well as the potentially higher (lower) income tax paid by the MNC in the exporting country.

Avoidance of financial restrictions

To mitigate the impact of foreign government restrictions on the operations MNC, transfer prices can be a handy tool. Where a Country for instance, restricts the amount of cash that may leave its boundaries in the form of dividend payments, setting a high transfer price on goods imported into the country may facilitate the desired movement of cash because the importing subsidiary must remit payment. However, cash transfers are not easily accomplished in a country that watches import and export prices closely.

International transfer pricing can also be used by MNC to manipulate profitability figures to their advantage. When an MNC desires to show lower (higher) profitability, high (low) transfer prices on imports to subsidiaries may be used. An MNC may want to appear less profitable to discourage potential competitors from entering the market. Higher profits may cause the subsidiary's employees to demand higher wages or even to request some type of profit-sharing plan. Takeover by highly profitable foreign-owned subsidiaries may also be avoided if they appear less profitable.

Managing currency fluctuations
A country may decide to devalue its national currency as a result of balance-of payments problems. Losses from such devaluation may be avoided by using inflated transfer prices to transfer funds from the country to the parent or to some other affiliates. Balance-of-payments problems often result from an inflationary environment and inflation erodes the purchasing power of the MNC's monetary assets. Using inflated transfer prices on goods imported to such an environment may offer the MNC a timely cash removal of cash from the system.

Other cost minimization objectives includes the avoidance of withholding taxes on dividends through the setting of favorable transfer prices. The same can be done to avoid profit repatriation restrictions. This essentially changes cash flows from dividends to intercompany revenues and expenses.

Transfer pricing choices
A good number of transfer pricing systems in use today are based on either external market prices or internal costs. The use of market prices is consistent with the concept of operating subsidiaries as decentralized profit centers. When transfers are recorded at market prices, divisional profitability approaches the real economic contribution of the subsidiary to the total MNC. On the whole, using market prices ideally creates the sense of competition that would normally be present if the subsidiaries were independent corporations transacting business at arm's-length market prices. If the transfer price does reflect market conditions, then the subsidiary may be fairly evaluated on its own performance. Market prices also appear less arbitrary to government tax authorities who are watching for manipulation of profits and, therefore, are usually less scrutinized.

Using market prices implies that subsidiaries are autonomous profit centers and that their managers have the authority to make autonomous decisions. However, this is rarely happens in multinational corporations. It may be difficult to establish a free competitive market price if no intermediate market exists for the transferred goods. Finally, using market prices does not afford the MNC much flexibility with which to manipulate profits and cash flows to accomplish the various objectives as discussed earlier.

Comparable uncontrolled price method

Comparable uncontrolled price method is generally considered the most reliable measure when a comparable uncontrolled transaction exists. Transfer price is determined based on reference to the company's sales of the same product to an unrelated buyer. For this purpose, reference to transactions between two unrelated parties for the same product is acceptable. Where an uncontrolled transaction is not exactly comparable, an adjustment is allowable.

Governments are aware of the risk that Multinational Enterprises will use transfer pricing to cheat by avoiding or completely evading paying income and other taxes. Consequently, most governments publish guidelines regarding acceptable transfer pricing. These guidelines typically use the notion of an arm's-length price. Arm's-length price is the price that would be agreed upon by unrelated parties.

International transfer pricing guidelines

The code and underlying regulations are based on the principle that transactions between related parties should be evaluated on arm's length basis. This principle creates transfer pricing issues when one of the related parties is offshore.
The United States and Canadian rules are similar in many respects to OECD guidelines, with local differences. The rules of nearly all countries permit related parties to set prices in any manner, but permit the authorities to adjust those prices where the prices charged are outside arm's length range rules. Prices charged are compared to prices or measures of profitability for unrelated transactions.

International transfer pricing and Nigeria
Nigeria has increasingly share of world trade consisting of cross-border transactions within groups of affiliated, particularly with the advent of foreign. Nevertheless, there are no hard and fast rule in either Nigeria's broad Legislations or its tax laws that are clearly indicative of whether specific of whether specific intercompany transactions relating to their pricing terms are carried out in variance to the open market price of goods and services. Onyeukwu, (2007). Under the Nigerian tax laws, the basis for charge to tax of transactions between related companies is provided in section 13 (2) (d) Companies Income Tax Act (CITA) Cap C21 Laws of the Federation 2004 (section 11 (2) (d) CITA Cap 60 LFN 1990) as follows: (2) The profits of a company, other than a Nigerian company from any trade or business shall be deemed to be derived from Nigeria – (d) Where the trade or business or activities is between the company and another person controlled by it or which has a controlling interest in it and conditions are made or imposed between the company and such person in their commercial or financial relations which in the opinion of the Board is deemed to be artificial or fictitious, so much of the profit adjusted by the Board to reflect arm's length transaction. The Act has empowered the Federal Inland Revenue Service (hereinafter called "the Revenue") to make adjustments in order to reflect arm's length transaction in situations where in its opinion it deems the trade or business or activities between related parties to be artificial or fictitious.

The thrust of this provision is that the Revenue shall disregard any disposition, which in this effect means any trust, grant, covenant, agreement or arrangement that would reduce the tax payable and direct any such adjustments in order to counteract the reduction of liability to tax. By implication, the tax authority is conferred with the responsibility to make adjustments where the internal pricing mechanisms of the related parties tend not to reflect the open market prices. The implication of the above sections seems to place issues of determining transfer pricing within the Nigerian context as an exercise of subjective judgment by the tax authority. The Revenue's duty of making adjustments to provide for arm's length treatment of intercompany transactions is based on where it is of the 'opinion' that there are threats of tax avoidance by virtue of the transaction. The above provisions simply portray the determination of transfer pricing in the Nigerian context as an exercise of subjective judgment and personal opinions of tax authorities. The apparent paucity of regulations to guide the tax authority in appropriately determining transfer pricing issues has created a need for Nigeria's legislations to be updated to incorporate such emerging trends. Onyeukwu, (2007).

Conclusion and Recommendations
International transfer pricing is a common practice employed by Multinational Corporations justifiably to meet core international business objectives that include, worldwide income tax and import duties minimization, avoidance of financial

restrictions, management of currency fluctuations, etc. MNCs are not able to accomplish all of these objectives with a single worldwide transfer pricing strategy. In fact strategies employed could vary depending upon the host country of operation. MNCs report several environmental variables as having an influence on setting transfer prices and these variables are nevertheless country specific. These variables make the process of international transfer pricing to be complicated.

Developing countries like Nigeria, in order to avoid tax-revenue losses, must of necessity take a cue from developed countries like the U.S in developing its tax rules to reduce to the minimum, the avoidable tax by Multinational corporations through creative international transfer pricing practices. The Nigerian tax laws should be more specific in its provisions on Transfer pricing as well as providing unambiguous, clear- cut guidelines on how to treat specific cases objectively.

Nigerian tax practitioners and law enforcement agencies should adopt the Arm's Length Standard (ALS) as basis for apportioning tax liabilities. Nigerian legislators must also enact laws that mandate increased disclosures about the magnitude and effects of transfer pricing on subsidiary income and tax liabilities in the financial reports of transnational corporations engaging in cross-border transactions. Appropriate use of these laws will increase Nigerian government's revenue

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration should be adopted as part of Nigeria's domestic legislations. However, country-specific requirements should be incorporated into the Model to make it completely domesticated and address issues in accordance with our macro and microeconomic objectives. This would remove the cloud of ambiguity which besets both the tax authority and the tax payer in resolving issues of transfer pricing and intercompany related transactions. The adopted Model would set the rules clearly and enhances certainty which is an attribute of a good tax law.

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