

Kata Inc. International Transfer Pricing¹

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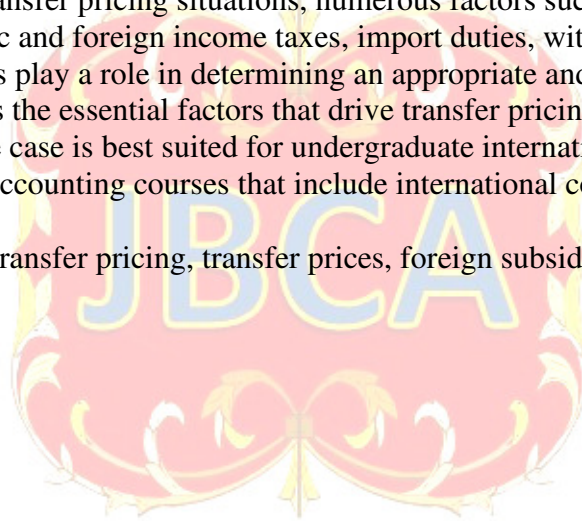
ABSTRACT

Kata Inc. is a U.S. company which owns and operates a subsidiary manufacturing facility in Thailand (ThaiKata PLC). The product is imported from Thailand into the U.S. through two distribution channels. In the primary channel, Kata Inc. distributes the product through their network of independent dealers. However, ThaiKata has excess capacity and sells some product direct to competing U.S. distributors. Because ThaiKata is a subsidiary of Kata Inc., the “sale” of product to Kata Inc. creates a transfer price situation.

In international transfer pricing situations, numerous factors such as allowable transfer pricing methods, domestic and foreign income taxes, import duties, withholding taxes, and foreign income tax credits play a role in determining an appropriate and beneficial transfer price.

This case explores the essential factors that drive transfer pricing decisions in an international context. The case is best suited for undergraduate international accounting courses or advanced managerial accounting courses that include international concepts.

Keywords: international transfer pricing, transfer prices, foreign subsidiary



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THE CASE

Kata Inc.'s wholly owned subsidiary, ThaiKata PLC manufactures electrical transformers having a power handling capacity of between 1kVA and 16kVA. The company has determined that these transformers are found under heading 8504.32.00 in the Harmonized Tariff Schedule of the United States (2022). The production costs for the transformers amount to \$800 per unit. Kata Inc. is expecting to import approximately 500,000 units in 2022 and sell them in the U.S. at a price of \$1,800 per unit. Industry data suggests that Kata's major competitors achieve an average gross profit of 40%.

Kata Inc. pays for shipping to the U.S. that is expected to amount to \$50.00 per unit. Import duties are levied on the invoice price and are deductible for income tax purposes. Kata Inc. is planning to continue to expand ThaiKata's capacity over the next several years. As a result, the company is planning to repatriate, through dividends, only 25% of after-tax income to the each year.

Because of excess capacity ThaiKata PLC also supplies other U.S. distributors with their product, selling them at an average price of \$1,100. Differences in packaging and branding has led ThaiKata to conclude that the value of product sold to these independent distributors has a value \$50 less than the product sold to Kata Inc. Research into industry data indicate a manufacturer's average markup on costs of production at 50%.

The following information relate to income taxes, import duty rate, and withholding taxes:

	United States	Thailand
Headline corporate income tax rate	21.0%	20.0%
Import duty rate	2.4%	n/a
Withholding tax rate on dividends	n/a	10.0%

Recommended Questions

1. What is a transfer price?
2. Briefly summarize the "arm's-length" principle and identify the generally acceptable OECD transfer pricing methods.
3. Are these OECD methods acceptable to Thailand's Revenue Department?
4. Why do countries levy withholding taxes on the distribution of dividends to a foreign parent company?
5. Determine the possible transfer prices under the (a) Comparable Uncontrolled Price method, (b) Resale Price method, and (c) Cost-Plus method.
6. Assume that any of the methods above are acceptable to both the US and Thai taxing authorities. Determine which transfer price would maximize Kata's world-wide after-tax cash flow from the sale of the transformers. Be sure to document your work/calculations.
7. How might changes in assumptions regarding dividend repatriation affect your conclusions in question 4?

TEACHING NOTES

General Discussion

This case explores the fundamental concepts of transfer pricing in an international context. Specifically, the case describes a wholly owned foreign manufacturing subsidiary and its U.S. parent corporation. The product is manufactured in Thailand, imported by the U.S. parent, and subsequently sold to the next stage in the value chain. The imported products are required to have an associated valuation known as a transfer price. Transfer prices between affiliated enterprises must generally follow OECD guidelines and be consistent with the arm's-length principle.

This case is best suited for undergraduate international accounting courses or advanced managerial accounting courses that include international concepts. To prepare for in-class discussion, students should be directed to OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017. Chapter I, sections A, B, and C outline the arm's-length concept. Chapter II, Parts I and II discuss principles of transfer price selection and the traditional transaction methods. Several examples illustrate application of the various transfer pricing methods. Part III of the chapter discusses transactional profit methods which are not explored in this case.

Once the alternative transfer prices have been determined, attention is then turned to analyzing the financial impact of the transfer price. Given that any of the methods are acceptable to taxing authorities, Kata Inc. would presumably choose a transfer price that is financially advantageous. One commonly used metric is expected combined transaction net cash flow. Net cash flow takes into consideration revenue, cost of goods sold, foreign and U.S. income tax, import duties, and withholding taxes.

Use of a template, as shown in Table 1 (Appendix) is recommended to organize the data and assess the financial impact of the choice of transfer price. Organizing the data into an income statement-like format demonstrates the effect that alternative transfer prices have on net cash flow. These are not complete income statements, but rather a means by which to assess the critical variables in the analysis. Readers may contact the author directly to request the template and solution in an Excel workbook.

The discussion concludes with a summary of the three alternative transfer prices and their respective impact on combined net cash flow. The analysis illustrates how transfer price, shipping costs, import duties, foreign and domestic income taxes, and dividend withholding rates all impact combined net cash flow.

Recommended Discussion and Solution

1. What is a transfer price?

Transfer price, also known as transfer cost, is the price at which related parties transact with each other, such as during the transfer of goods or services. In the context of this case, a transfer price is used when ThaiKata, PLC in Thailand “sells” transformers to its parent company, Kata Inc. in the U.S. Goods and services “transferred” across jurisdictions generally must be assigned a value for income tax, import duty, and other purposes.

2. Briefly summarize the “arm’s-length” principle and identify the generally acceptable OECD transfer pricing methods.

When independent business enterprises transact with each other, the terms of the financial relationship are typically determined by market forces. Independent buyers and sellers coming to a mutually agreeable price for the transfer of goods or services is generally known as an “arms-length” transaction. Neither of the parties to the transaction exert undue influence over the terms of the transaction, rather, the terms are the result of overall market forces.

When associated enterprises transact with each other, such as is the case in a subsidiary-parent relationship, conditions beyond market forces exist that could distort a transaction’s price so that it is no longer consistent with an arms-length transaction. This transaction price is known as a transfer price as it represents the assigned value to a product or service that is transferred from one enterprise to a related enterprise. Jurisdictional differences in corporate income tax rates, withholding tax rates, import duty rates, and other factors provide powerful incentives to establish prices that arbitrarily shift profits between associated enterprises for the purpose of minimizing overall taxes or achieving other operational objectives. While it should not be assumed that associated enterprises deviate from arm’s-length transactions, taxing authorities recognize the possibility exists. As a result, the Organization for Economic Cooperation and Development (OECD) have adopted transfer pricing guidelines for member countries.

Additionally, many nonmember countries have adopted the principles and guidelines outlined in OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017.

The arm’s-length principle provides the closest approximation of the conditions of the open market where goods and services are provided between associated enterprises. The OECD guidelines recognize five methods that are consistent with the arm’s-length principle.

The OECD guidelines describe five transfer pricing methods that attempt to emulate an arm’s-length transactions. Traditional transaction methods include (1) Comparable uncontrolled price method, (2) Resale price method, and (3) the Cost plus method. Transactional profit methods include (1) Transactional net margin method, and (2) Transactional profit split method.

Three important considerations must be taken into account by enterprises in their transfer pricing implementations. First, all of the methods listed may not be applicable in specific circumstances. For example, the comparable uncontrolled price method may be applied when the exporter sells substantially similar product not only to its affiliated entity, but also sells to independent (uncontrolled) buyers. The sale to independent buyers is presumed to be guided by market forces. As such, the agreed upon price in the uncontrolled transaction may be used to determine the transfer price between affiliated entities. However, if the exporter sells exclusively to its affiliate, then no such uncontrolled price exists and the method can not be applied. In short, reliable data must be available for any of the methods to be applied.

Second, while all five methods attempt to emulate an arm's-length transaction, they do not do so equal effectiveness in all circumstances. The OECD guidelines specifically identify the traditional transaction methods as the most direct means of establishing a transfer price that meets the arm's-length principle.

Third, countries following the OECD's guidelines generally have implemented legislation granting power to the national taxing authority to adjust profits to achieve conditions which would have been obtained independent enterprises in comparable circumstances. Adjustments to profits will result in modifications to income tax and may lead to additional penalties and surcharges.

3. Are these OECD methods acceptable to Thailand's Revenue Department?

Yes. While Thailand is not currently a member of the OECD, the Thai Tax 2020/21 Booklet (2020, Pwc) notes that Thailand's transfer pricing legislation is generally based on the OECD's arm's-length principle.

4. Why do countries levy withholding taxes on the distribution of dividends to a foreign parent company?

Many jurisdictions require enterprises paying amounts to nonresident entities to collect a withholding tax and remitting the tax to the local government. Such charges are generally referred to as withholding taxes. In a subsidiary-parent type relationship, payments are most commonly made in the form of dividends, royalties, or interest payments. Different tax rates are often applied to these different types of payments. The rates are also subject to tax treaties whereby foreign entities in specific countries are subjected to reduced withholding tax rates.

Countries often implement withholding taxes as means by which to generate revenue to support economic development. Developing nations in particular use such revenue to expand transportation, communications, energy infrastructure, and other public goods.

5. Determine the possible transfer prices under the (a) Comparable Uncontrolled Price method, (b) Resale Price method, and (c) Cost-Plus method.

The computations for the three alternative transfer prices follow.

(a) ThaiKata sells substantially similar transformers to independent buyers at a price of \$1,100. This forms the basis for an uncontrolled comparable price. Substantially similar product is sold in comparable circumstances. However, differences in packaging and branding has led ThaiKata to conclude that the value of product sold to these independent distributors has a value \$50 less than the product sold to Kata Inc. Thus, the transfer price to Kata Inc. would be adjusted upward to \$1,150.00.

(b) The resale method, sometimes referred to as the comparable gross profit method relies on market data to essentially force the importer's gross profit to be comparable to that which would be expected in an arm's-length transaction. Kata's major competitors achieve average gross profit of 40%. This gross profit is considered to be the result of market forces for substantially similar product. Thus, Kata can target a 40% gross profit in the controlled transaction. Kata Inc. expects to sell the transformers in the market for \$1,800 and thus would expect a gross profit of \$720, or cost of goods sold equal to \$1,080. Cost

of goods sold consists of the cost of the product itself (transfer price) plus shipping costs (if paid by the importer) and import duties. The transfer price is determined as follows:

$$\begin{aligned} \text{Cost of goods} &= \text{transfer price} + (\text{import duty rate} \times \text{transfer price}) + \text{shipping cost} \\ 1,080 &= \text{transfer price} + (0.024 \times \text{transfer price}) + 50 \\ \text{transfer price} &= \$1,005.86 \end{aligned}$$

- (c) ThaiKata, LLC is not the only manufacturer of these transformers. Industry data suggest that other manufacturers, in uncontrolled transactions, achieve a markup on cost of production of 50%. Thus, the cost plus transfer price is \$1,200, consisting of the cost of production (\$800) plus 50% (\$400).

The three possible transfer prices meeting OECD guidelines are summarized in Table 2 (Appendix)

Each of these transfer prices has the effect of apportioning revenues, costs, and profits between ThaiKata LLC and Kata Inc.

6. Assume that any of the methods above are acceptable to both the US and Thai taxing authorities. Determine which transfer price would maximize Kata's world-wide after-tax cash flow from the sale of the transformers. Be sure to document your work/calculations.

Given that any of the methods are acceptable to taxing authorities, Kata Inc. would presumably choose a transfer price that is financially advantageous. One commonly used metric is expected combined transaction net cash flow. Net cash flow takes into consideration revenue, cost of goods sold, foreign and U.S. income tax, import duties, and withholding taxes. Table 3, 4 and 5 (Appendix) illustrate the financial impact of each of the three alternative transfer prices respectively.

Organizing the data into the recommended income statement-like format demonstrates the effect that alternative transfer prices have on net cash flow. These are by no means complete income statements, but rather illustrate the critical variables in the analysis. Table 6 (Appendix) summarizes the results of the analyses.

We can see that in this case, lower transfer prices lead to greater combined transaction net cash flow. A lower transfer price effectively shifts income out of the Thai subsidiary and into the U.S. Parent. The higher U.S. income tax rate, vis-à-vis the Thai income tax rate, is offset by lesser amounts of import duties and expected dividend repatriation withholding taxes.

Although the net cash flow differences may not seem significant on a per unit basis, when scaled to expected volume, the annual impact is nearly \$2.8 million between the lowest transfer price (resale price of \$1,005.86) and the highest transfer price (cost plus of \$1,200.00).

It should be emphasized that the lowest transfer price will not be the most advantageous in all cases. Differential income tax rates, import duty rates, shipping costs, repatriation rates, and withholding tax rates all contribute to the determination of transaction net cash flow. The financial impact of the variables is summarized in Table 7 (Appendix).

7. How might changes in assumptions regarding dividend repatriation affect your conclusions in question 4?

The amount of dividends repatriated is entirely within the control of Kata Inc. and will impact the combined net cash flow. As more dividends are repatriated, more Thai withholding

taxes will be paid, thus reducing the combined net cash flow. Kata Inc. will need to make decisions regarding the benefits and costs of retaining ThaiKata's earning in Thailand vs. repatriating the earning back to the U.S. If Kata's management is concerned about potential devaluation of the Thai Bhat, the benefits of minimizing foreign currency losses may be sufficient to offset the additional withholding taxes paid.



APPENDIX

Table 1

TRANSFER PRICING ANALYSIS TEMPLATE - US Operation as Importer			
	Foreign Operation	US Operation	Combined
Sales			
Cost of sales: product cost			
transportation cost			
import duty			
Transaction gross profit			
Less: income tax			
Transaction after-tax income			
Less: withholding taxes			
Transaction net cash flow (per unit)			
Transaction net cash flow (total)			
INPUT VALUES			
Resale price			
Transfer price		TP Basis:	
Cost to produce			
Transportation cost			
Transportation cost paid by			
Volume			
Expected dividend repatriation rate			
Import duty rate			
US income tax rate			
Foreign income tax rate			
Foreign withholding tax rate			

Table 2

Method	Transfer price
Comparable uncontrolled price	\$1,150.00
Resale Price method	\$1,005.86
Cost-Plus method	\$1,200.00

Table 3

TRANSFER PRICING ANALYSIS TEMPLATE - US Operation as Importer			
	Foreign Operation	US Operation	Combined
Sales	\$1,150.00	\$1,800.00	
Cost of sales: product cost	800.00	1,150.00	
transportation cost	0.00	50.00	
import duty	0.00	27.60	
Transaction gross profit	350.00	572.40	
Less: income tax	70.00	120.20	
Transaction after-tax income	\$280.00	\$452.20	\$732.20
Less: withholding taxes	7.00		
Transaction net cash flow (per unit)	\$273.00	\$452.20	\$725.20
Transaction net cash flow (total)	\$136,500,000	\$226,098,000	\$362,598,000

INPUT VALUES	
Resale price	\$ 1,800.00
Transfer price	\$ 1,150.00
Cost to produce	\$ 800.00
Transportation cost	\$ 50.00
Transportation cost paid by	US Operation
Volume	500,000
Expected dividend repatriation rate	25.0%
Import duty rate	2.4%
US income tax rate	21.0%
Foreign income tax rate	20.0%
Foreign withholding tax rate	10.0%

TP Basis:	Resale method
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Table 4

TRANSFER PRICING ANALYSIS TEMPLATE - US Operation as Importer			
	Foreign Operation	US Operation	Combined
Sales	\$1,005.86	\$1,800.00	
Cost of sales: product cost	800.00	1,005.86	
transportation cost	0.00	50.00	
import duty	0.00	24.14	
Transaction gross profit	205.86	720.00	
Less: income tax	41.17	151.20	
Transaction after-tax income	<u>\$164.69</u>	<u>\$568.80</u>	<u>\$733.49</u>
Less: withholding taxes	4.12		
Transaction net cash flow (per unit)	<u>\$160.57</u>	<u>\$568.80</u>	<u>\$729.37</u>
Transaction net cash flow (total)	\$80,285,400	\$284,399,747	\$364,685,147

INPUT VALUES	
Resale price	\$ 1,800.00
Transfer price	\$ 1,005.86
Cost to produce	\$ 800.00
Transportation cost	\$ 50.00
Transportation cost paid by	US Operation
Volume	500,000
Expected dividend repatriation rate	25.0%
Import duty rate	2.4%
US income tax rate	21.0%
Foreign income tax rate	20.0%
Foreign withholding tax rate	10.0%

TP Basis:	Resale method
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Table 5

TRANSFER PRICING ANALYSIS TEMPLATE - US Operation as Importer			
	Foreign Operation	US Operation	Combined
Sales	\$1,200.00	\$1,800.00	
Cost of sales: product cost	800.00	1,200.00	
transportation cost	0.00	50.00	
import duty	0.00	28.80	
Transaction gross profit	400.00	521.20	
Less: income tax	80.00	109.45	
Transaction after-tax income	<u>\$320.00</u>	<u>\$411.75</u>	<u>\$731.75</u>
Less: withholding taxes	8.00		
Transaction net cash flow (per unit)	<u>\$312.00</u>	<u>\$411.75</u>	<u>\$723.75</u>
Transaction net cash flow (total)	\$156,000,000	\$205,874,000	\$361,874,000

INPUT VALUES	
Resale price	\$ 1,800.00
Transfer price	\$ 1,200.00
Cost to produce	\$ 800.00
Transportation cost	\$ 50.00
Transportation cost paid by	US Operation
Volume	500,000
Expected dividend repatriation rate	25.0%
Import duty rate	2.4%
US income tax rate	21.0%
Foreign income tax rate	20.0%
Foreign withholding tax rate	10.0%

TP Basis:	Cost plus method
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Table 6

Transfer price method	Transfer price	Combined transaction net cash flow (per unit)	Combined transaction net cash flow (total)
Comparable uncontrolled price	\$1,150.00	\$725.20	\$362,598,000
Resale price	\$1,005.86	\$792.37	\$364,685,147
Cost plus	\$1,200.00	\$723.75	\$361,874,000

Table 7

Variable	Impact of higher price/rate on Exporter net cash flow	Impact of lower price/rate on Exporter net cash flow	Impact of higher price/rate on Importer net cash flow	Impact of lower price/rate on Importer net cash flow
Transfer price	increase	decrease	decrease	increase
Local income tax rate	decrease	increase	decrease	increase
Import duty rate	not applicable	not applicable	decrease	increase
Shipping cost	decrease	increase	decrease	increase
Withholding rate	decrease	decrease	not applicable	not applicable

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Other Resources

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