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THE INCREASING IMPORTANCE OF TRANSFER PRICING AND THE TAX STRATEGIES OF THE TRANSNATIONAL CORPORATIONS

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Abstract *Pricing policy of intra-group transactions can have significant effects on competitive advantage and profitability in terms of fiscal costs of companies with international activity. The trend in transfer pricing developments in many countries reveals a growing interest of the national tax authorities towards transfer pricing, which is one of the main areas of tax investigation. The paper deals with issues of increasing interest of companies to transfer pricing, and tax measures taken by the authorities towards the regulatory framework for transfer pricing. In this context, are presented aspects about transfer pricing, the implications of their use, specific legal rules and procedures applicable in Romania.*

Key words:
Transfer price, taxation, multinational companies OECD Guidelines, EU, Romania

JEL Codes:
F23, H25, K34

1. Introduction

Planning transfer pricing strategies support companies' business activities and tax return position and transfer pricing practices on a global basis. Lately, more companies have become more and more interested in the issue transfer pricing and as a result the tax authorities have sought to ensure legal frameworks in terms of awareness that is facing a new problem. Consequently, in most countries, transfer pricing rules have gone beyond the simply theoretical approach. As if many years ago, a contract signed was enough to prove that the transfer pricing tax authorities were charged at a market level, now companies need to ensure not only that transfer pricing may be justified to the tax authorities but to demonstrate that they reflect market prices. Under these circumstances, multinational companies are recommended to pay close attention to the arm's length of their related party transactions and their documentation so as to be prepared in case of any transfer pricing disputes with the tax authorities.

Transfer pricing, prices for transactions between subsidiaries, such as sales of goods or services, transmission of intellectual property rights or making any other transactions, represents a characteristic increasingly significant for multinational companies to establish tax planning. Currently, approximately 60% of world trade takes place between subsidiaries of transnational corporations extended internationally.

With the increase of multinational corporations engaged in cross-national activities, tax authorities seek to increase vigilance on duties and taxes collected from the economic activities of multinational corporations. In this context, it is necessary that companies apply prices set at a market level in transactions carried out between subsidiaries, following which the OECD has defined as the "Arm's Length" (the market price). Otherwise, multinationals may transfer artificially profits from a country with high taxation, for example, in a country with a tax-friendly regime, by changing the price of goods and services applied to transactions carried out between subsidiaries.

Transfer pricing problem is complex for both tax authorities and the transnational corporations, considered to be the most important current fiscal problem they face. This is because infringement of the principle of market value will affect the tax burden in the cluster.

2. Explaining the transfer price

Transfer price is the price at which a person (natural or legal) transfer of tangible or intangible (e.g. know-how, trademarks) and related services to a person. Transfer prices are those *prices charged in transactions between member firms of the same group or the shareholders of both companies called affiliates.* It is considered that the two companies are affiliated if one of them has at least 25% of other equity or voting rights or control. These prices are legally covered for these types of companies not to try to shift profits to countries with lower tax to reduce the amount of income taxes.

Transactions between related persons must be made on the basis of *market value* ("*The Arm's Length Principle*"), as seen in the literature, without being influenced by the relationship of "similarity" between them.

Often, however, market conditions cannot be played in full because it is possible that transactions such as those made by individuals affiliated to not be concluded if the independent companies would be involved, and that just because the transaction object. An example would be the sale of intangible fixed assets - such as patents, trademarks, and brand; in this case, the probability that an independent person to give up in favour of another independent person at some future benefits cannot be measured accurately at the time of conclusion of the transaction is reduced.

According to the Tax Code, tax authorities may reconsider transfer pricing and, therefore, to adjust income or expense of any affiliated persons involved in a transaction if the price at which the transaction took place is not at a market price level, that price the transaction was completed on the same terms or similar conditions by independent persons.

The result of these adjustments can lead to additional income tax expense to the taxpayer declared obligation - where, in the principle of free market, tax authorities conclude that the income recognized by the taxpayer is less than that which would have been recognized or if recognized expenses are greater than those which would have been recognized - a requirement that the income tax less than initially declared, given that this situation would be contrary (recognized income higher than that have been recognized or recognized charges lower than those which would have been recognized).

According to the detailed rules for the implementation of the Tax Code, the transactions concluded between Romanian legal entities are not subject to adjustment by the tax authorities, only those concluded by Romanian legal entities with non-affiliated persons, as well as Romanian individuals.

To conclude, transfer prices are not subject to accurate discipline and therefore their determination is a subjective issue, can give rise different interpretations by tax authorities.

3. Setting the transfer pricing

To estimate the market value can be used several methods by which transactions can be reconsidered. Guidelines on transfer pricing issued by OECD states the following methods for determining transfer prices: *Comparable Uncontrolled Price method (CUP); Cost Plus Method (CP method or C+); Resale Price Method (RPM); Profit split method; Transactional Net Margin Method (TNMM).* These methods are based on complex procedures that require experts and the highest quality of information sources.

Tax inspectors can re-evaluate the various transfer pricing methods if they do not have the same value as the free market price, according to OECD Guidelines on transfer pricing.

Essentially all methods are proposing the same thing, to determine the correct price of a transaction which is suspected to have been carried out in conditions and/or special prices. In this way it will be determined the correct profit that a person would be obtained if the transaction would be carried out under conditions of free market and its taxes.

The reconsideration of a commercial transaction will consider if such a transaction would be conducted in open market conditions (opportunity) and if the transaction price was at the level of the free market (independence).

Guidelines issued by the OECD underlines that there is no best method rule. Thus, a taxpayer is required only to demonstrate that the method used gives a reasonable result (fair price), but not showing the reasons for not using another methods. Regarding "reasonable result", the OECD guide points out that the transfer pricing is not an exact science.

a. *Comparable Uncontrolled Price Method* is based on the comparison of analyzed transaction price with the price or prices of other independent entities, when there are put into discussion transactions of comparable products or services. For transfer of goods or services between related persons, the *market value* is a price agreed between independent entities in comparable market conditions in terms of trade for the transfer of goods or identical or similar goods in comparable quantities in same point in the production and distribution chain in terms of comparable conditions of payment.

To determine the market value, it can be used one of two categories of comparison: *internal comparison of prices* (the comparison of prices agreed between persons affiliated with the agreed prices in relation with independent persons, for comparable transactions); *external price comparison* (the comparison of prices agreed upon between independent persons, for comparable transactions).

b. *Cost Plus Method* take into account the increase of main costs with a profit rate similar to the scope of activity of the taxpayer. The starting point is the cost of the manufacturer or service provider. Where goods or services are transferred through a number of affiliated persons, this method will be applied separately for each stage, taking into account the role and specific activities of each affiliated person.

c. In *Resale Price Method,* market price is determined based on the resale price of products and services to independent entities, less marketing costs and profits. This method is applied starting from the price at which a product purchased from an affiliated person is resold to an independent person. Then this price is reduced by an appropriate gross margin (resale price margin) representing the value at which the last seller of the group will try to cover sales and other operating expenses based on operations and can make a profit.

In applying this method, it should be considered the following issues: the time period between the initial purchase and resale; the market changes in terms of costs, exchange rates and inflation; the changes of the status and degree of wear of the goods subject to the transaction, including technological advances in some areas; the exclusive right of resellers to sell certain assets or rights that may influence the decision on a change in price margin.

d. *Profit Split Method* is used when transactions between affiliated persons are interposed, so that it is not possible to find comparable transactions. This method involves the estimation of the profits obtained by affiliated persons following one or more transactions, and sharing those profits between related persons proportionally to the profits that would have been obtained by independent persons. The division of profits must be achieved through an appropriate estimation of revenue and costs incurred as a result of one or more transactions by each person. Profits should be divided to reflect the functions performed, risks assumed and assets used by each of the related party.

e. *Transactional Net Margin Method* involves calculation the net profit margin obtained by a person from one or more transactions with affiliated persons and estimation of this margin on the level achieved by the same person in transactions with independent persons, or in the margin obtained in comparable transactions made with independent persons. This method involves making a comparison of certain financial indicators of their affiliates and the same indicators of the independent persons working in the same industry.

In applying the above methods there is not a single sequence to determine the market value which applied to all cases. The assessment is based on prices set by the taxpayer. Appropriateness of applying a method depends on: the method that is most closely to the circumstances in which prices are determined under free competition in comparable markets in terms of trade; the method for which data are most reliable on prices; the degree of precision that can make adjustments to achieve comparability; the circumstances of the individual case.

4. Trends in the European Union on the transfer pricing

In the EU countries, tax authorities have begun to recognize the significance of transfer pricing rules as an important source of revenue to the treasury. A British study conducted in the '90s showed that for every pound invested in collecting taxes, to follow the principles on transfer pricing, tax authorities can expect to obtain 230 pounds of collected tax adjustments. This led to the development of legislation on transfer pricing in the coming years. According to one study, 90% of companies polled believed that transfer pricing is the most important tax issue, as the issue price represents a range of risk transfer and risk is both the opportunities and potential losses.

Over 50 countries have already implemented transfer pricing legislation and have been a number of cases assumed billions of dollars in adjustments by tax authorities. Therefore more controls investigate transfer pricing policy practiced by companies.

In an attempt to describe a series of transfer pricing regulations in different countries, it is obvious that *some countries have laws governing documents t*hat companies are required to submit the tax authorities to demonstrate that they respected the "Arms Length". They are the UK, Germany, Netherlands and Romania. In other countries such as France, Italy and Switzerland, there is an *obligation "de facto" for submitting the necessary documents* within the time stipulated by law to justify the charged transfer prices. Thus, based on documentation prepared, taxpayers can benefit from a radical change with regard to *who is the person required to justify the charged prices,* tax authorities became obliged to justify deviations from market prices. Taxpayers who prepare the documentation can reduce the risk of a tax audit. Penalties may apply in some cases: first, if authorities consider that transfer prices are not set at a market level, secondly, for failure to submit appropriate documentation, third, for non-compliance or submission late tax return and, fourth, if adjustments are over a certain threshold level, namely whether a company has established transfer prices wrong either deliberately or by negligence, deviation from market prices exceed a certain level.

There is *a good cooperation between tax authorities from European Union,* including effective exchange of information and mechanisms for disputes resolving between tax authorities from various countries. One of these mechanisms is the procedure for mutual agreement (phase 1), and if it fails after two years, to

switch to invoke the Arbitration Convention (phase 2). One of the major problems that companies may have is in the context in which the tax authorities in different countries can not reach agreement on transfer pricing. This can lead to an adjustment in one country, causing an additional tax for a multinational company, while in another country this considered as a non-deductible expense, thus creating double taxation.

To simplify cross-border transactions and to facilitate the compliance of principles relating to transfer pricing, the European Union introduced the concept of "*Masterfile*" (main file) that multinationals can prepare a single file containing documents that will prove the principle "Arm's Length" across the EU and the concept of "*Countryfile*" (country-specific file) representing a file that will contain country-specific documentation.

In the *Central and South-East Europe*, the first country that has adopted legislation on transfer pricing was Poland (1997), then Hungary, Czech Republic, Lithuania, Slovenia, Latvia, Russia and, eventually, and Romania.

In legal practice the legal system and tax system are similar to those in force in most countries, as 80-90% of transfer pricing rules in *Romania* are similar to those of other countries. Romania is based on the OECD transfer pricing principles. However, tax authorities have no experience and this led to a certain inconsistency in approach, causing a state of uncertainty for multinationals. Consequently, companies must be prepared for examination of transfer pricing. Services provided by non-residents in Romania have already done the subject of checks. It's just a matter of time before authorities will focus on transactions, including goods, financial services and royalties. In this respect, is shown playing a clear picture of how the calculation of transfer pricing, which can be ensured by the following: the contract should specify the type of service provided and its cost, the bills would have to comply with the provisions of the contract or the existence of best transfer pricing policies as a group.

5. Setting the transfer pricing in Romania

Transfer pricing has become increasingly a significant subject matter for multinationals having a business presence in Romania, as the number of transfer pricing audits have increased significantly since 2008 (the year of accession to the Arbitration Convention). Legislation in Romania has experienced lately a real improvement and development. The Romanian transfer pricing legislation follows the *Organisation for Economic Co-Operation and Development (OECD) Guidelines*, the *EU Code of Conduct on Transfer Pricing* and requires that transactions between related parties be carried out at market value.

Tax Code contains the definition of affiliated persons, the principle of market value and the methods for determining transfer prices, and the right of tax authorities to adjust the amount of income or expenditure of any persons, as necessary, to reflect the market price of goods or services in transaction. The implementing rules of the Tax Code detail the scope of the rules on transfer pricing, and provide specifically that in the application of transfer pricing rules, the Romanian authorities will take into account the OECD Guidelines on transfer pricing. Tax code requires taxpayers to prepare a file of transfer pricing, documenting the method used to determine prices charged in transactions between affiliated persons (associated).

In case transfer prices are not set at arm's length, the Romanian tax authorities have the right to correct the taxpayers' revenue and expenses so as to reflect the market value. Profit adjustments on transactions between related parties can be performed within the domestic statute of limitation period (i.e. six years). In Romania, setting the transfer pricing is made, in general terms, *by comparison* with the prices that independent person in comparable circumstances would agree to comparable transactions. To make the comparison, taxpayers will have to assess whether there are significant differences from comparable transactions or persons and, if any, to adjust transfer prices on a functional analysis basis. Achieving functional analysis aims to identify and compare the activities and responsibilities undertaken or which could be undertaken by independent entities and affiliated entities.

Although the tax code and rules for the application leaves the taxpayer's application to the nearest of the methods described above, Order no. 222/2008 of the President of National Agency of Fiscal Administration, regarding the contents of the transfer prices file, states that any application of other than the traditional methods and *the application of any method than the price comparison would be justified by the taxpayer.*

Beginning with 2010, related party transactions carried out between two Romanian legal entities also fall within the scope of transfer pricing investigations, whereas in the past only transactions with non-resident related parties were scrutinised by the tax authorities.

6. Conclusions

While globalisation and the sustained increase of international trade have made inter-company pricing a daily requirement for many businesses, the rhythm of

new regulations, audits, enforcement actions, and sharply higher penalties continues to grow louder.

Transfer pricing is set to become an increasingly important topic as well in Romania. The Romanian transfer pricing legislation is largely similar to the regulations applied by developed countries.

There is expected the next few years to be dynamic and exciting as transnational corporations exercise greater rigor to meet increasingly onerous requirements. Transnational corporations must take a more proactive approach to transfer pricing, since, in their quest for more revenues, tax authorities have become better at auditing, with higher hit rates for adjustments and higher levels of penalties.

In a time of fiscal shortfalls, tax authorities from more and more countries are implementing new transfer pricing documentation requirements. At the same time, transfer pricing strategies are more and more the subject of debates, with the phrase *transfer pricing* regularly used in the same sentence with *tax evasion* on the business pages of newspapers or on the text of national regulations.

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