

- We consider that the advantages for this solution is bigger in the case of small and medium companies, rather than the bigger companies regarding the relation expenses (costs)-benefits;
- In the process of choosing this option we must consider few essential factors like: external and internal environment where the company activates, the dimension of the company, domain of activity, the management experience.

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TRANSFER PRICES: MECHANISMS, METHODS AND INTERNATIONAL APPROACHES

Pop Cosmina Mădălina

University of Oradea, Faculty of Economics, Finance-Accounting Department,, Oradea, str. Universităţii nr. 1, e-mail: cpop@uoradea.ro, tel:0259/408401

Pop Valer

University of Oradea, Faculty of Economics, Finance-Accounting Department,, Oradea, str. Universităţii nr. 1, e-mail: vpop@uoradea.ro, tel:0259/408401

Balaciu Diana

University of Oradea, Faculty of Economics, Finance-Accounting Department, Oradea, str. Universităţii nr. 1, e-mail: dbalaciu@uoradea.ro, tel:0259/408401

Abstract: Transfer prices are considered the prices paid for the goods or services in a cross-border transaction between affiliates companies, often significant reduced or increased in order to avoid the higher imposing rates from one jurisdiction. Presently, over 60% of cross-border transfers are represented by intra-group transfers. The paper presents the variety of methods and mechanisms used by the companies to transfer the funds from one tax jurisdiction to another in order to avoid over taxation.

Key words: transfer pricing, intra-firm transaction, tax jurisdiction

Introduction

Globalisation of the economic activity and the rise of the multinational corporation has determined the necessity of management to adapt to the new conditions and to define new operational and financial strategies; these strategy should create an advantage to the multinationals as being an global player through the reductions of the costs, exposure or resources acquiring difficulties. Presently, when more than 60% of world trade takes place within multinational enterprises³⁹², the importance of transfer pricing becomes clear.

Multinational companies are acting in different countries and benefit from advantages as fiscal, foreign exchanges, capital repatriation or others offered by these countries. This way the chances to get a higher profit, on the whole increase, compared with the situation of developing operations within one country.

Multinational companies operate inter-corporate flows, through diverse mechanisms, taking advantages of the law's niches from different countries in order to benefit from the most favourable conditions. This came out under international financial markets' and shareholders' pressure for higher profitability rate, that can be obtain only by maximum exploiting of the corporations' synergies, transfer pricing or legislative niches specific to each country.

Transfer pricing refers to establish prices for goods, services, know-how and intellectual property transferred across borders within corporate networks and especially between foreign affiliates and parent corporations.

Transfer pricing mechanisms

In order to obtain higher profitability, a multinational company transfers its revenues and expenses, or parts of them, using a variety of methods from one tax jurisdiction to another, in order to reduce the tax liabilities. These methods suppose the maximum exploiting, and sometimes up to the limit, of the law's stipulations.

The most used transfer pricing methods are:

a. Intra-firm loans

³⁹² John Neighbour, Transfer pricing: Keeping it at arm's length, OECD Centre for Tax Policy and Administration, 2002;

Multinational companies often refer to intra-firm loans in order to finance their new established or liquidity difficulties affiliates from different countries, taking advantage of the quick financing from parent company, but also of the reduction of the taxes, due to the use of this mechanism.

a.1. The mechanism of conversion the liabilities/loans in shares is used when the interest rates in the market are high; these generate for affiliates prohibiting financing possibilities from financial institutions. So, the parent company will lend the affiliate at a very low interest rate comparing to market's rate. Generally, all over the world, the interest expenses up to a limit are deductible in calculation of the tax on profit. Such a transaction generates for the affiliate a competitive advantage, because it benefits from a capital infusion that afford the costs' reducing, the opportunity to invest in business developing and winning new market shares. The affiliate has many alternatives regarding the way and the moment of loan's reimbursement, including the debt - equity swap, that assure an almost cost free financing.

a.2. The interest rate mechanism suppose the significant funds transfer from tax jurisdiction where the tax level is high to affiliates in the countries where the tax level is low using by granting a very high rate loan. Generally the taxation method for the interest revenues is withholding tax in the country where are obtained. If there are conventions for avoiding double taxation, these prevail over national law system, and this way, important amounts can be transferred to jurisdictions with low level of taxation.

b. *Royalties' mechanism* is the mechanism used by the parent companies to sell the rights to use patents, licences, trademarks and similar rights to the affiliates of the group, the amounts paid being in accordance with tax level. Royalties represents payments made in order to have the right to use a patent, a trademark, licenses, know how, franchise activities, manufacturing procedures, software and any other cable, relay or satellite transmission, industrial, commercial or scientific equipment, including the right to use information and knowledge regarding to commercial or business activity.

b.1. High royalties are used by the parent company by lending or selling to the affiliates the right to use licences, patents, know how at important rates, significantly higher than the royalties applies in transactions with independent parties. The target of this mechanism is the funds transfer from the countries with high tax level to the company of the group where the tax level is low, saving important amounts.

b.2. Low royalties are used by parent companies to sell the right to use patents, trademarks, licences at lower rates comparing to the rates used in uncontrolled transactions. This way the affiliate that buy at such a low rate these right, realizes important benefits against the competitors, and transfer the resources almost free of charges, where the countries have a convention for avoiding the double taxation.

c. *Commissions' mechanism* – between the companies belonging to a multinational group may appear monetary flows as compensation for the brokerage service, financial intermediation or other services perform within the group. The volume of the paid amounts depends on the tax level in the country where the company develops its activity.

d. *Performed services mechanism* – represents one of the preferred methods for intra-group funds transfers towards more favourable tax jurisdiction. The reason for intensive use the easy way to proof the performance of the service, most of the time there is a simply contract between the parties implied in transfer, for the consultancy, technical assistance or other similar services. Most of the times, these services are invoiced with significant prices, due to the high rates of the experts implied, representing the pretext of important funds transfer toward favourable tax jurisdiction.

e. *Preferential prices selling* – suppose the use of preferential prices in the intra-group transaction, significantly different from market's prices or the prices used in relations with independent customers. Using the preferential prices for any type of intra-firm transactions (sell-buy, loans, assistance, advertising, etc.) targets two advantages:

e.1. Competition advantages

Within the multinational companies the management of individual plants and divisions is often carried out on a decentralized basis, and accounts are made out for each "profit centre", the group enterprise as a whole may require a centralized financial strategy, to ensure an efficient co-ordination of the group's multinational business operations. In this respect, a multinational company may set the transfer pricing of intra-firm flows of goods, services or other assets on a centralized basis, thereby taking control over pricing policy away from individual profit centers. This requires a mechanism for setting prices in a rational way that ensures the setting of optimal prices that create the opportunity to enter new markets, to exploit the demand's fluctuations or foreign exchange volatility.

e.2. Reduction of the fiscal debts represents the target, directly or indirectly aimed, for all the transfer pricing.

International approaches regarding transfer prices

During the last 30 years, as a consequence of economic activity globalisation, the number and the role of multinational companies have exponential increased. The increase of multinational companies leads to increase of taxation complexity issues for firms and governments, due to the fact that tax rules can not be isolated, but considered in a larger international circumvention.

The difficulty for multinational companies consists in the necessity to operate within the law that differ from country to country, but for the governments, to calculate the expenses and the revenues for a affiliate – part of a transnational group.

Most developed countries derive their transfer pricing regulations from the Organization for Economic Co-operation and Development (OECD) transfer pricing guidelines (OECD, 1995; 1996). According to them, transfer pricing methods which are currently acceptable to most tax authorities are based on the arm's-length principle.

Arm's Length Principle (ALP)³⁹³

According to OECD 9th article, 1997a, when conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Methods used in transfer pricing

Cross-border transfers may be priced using any of several traditional transactional and transactional profit methods, all of which adhere to the arm's-length principle. The methods can apply to both "tangibles" and "intangible property". Tangibles include any goods, whether finished products or intermediate inputs, such as raw materials or components, that are transferred between affiliated enterprises. Intangible property includes such diverse categories as:

- Patents, inventions, formulas, processes, designs or patterns;
- Copyrights, literary musical or artistic compositions;
- Trademarks, trade names or brand names;
- Franchises, licenses or contracts;
- Methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
- Other intellectual property not listed above.

The traditional transactional methods suppose the comparison of the prices used in controlled transactions between affiliated enterprises with prices used in transactions with independent companies. This is the most direct method and can be considered a benchmark, but in reality is very difficult to use, making necessary the use of less direct methods as gross margins reflected in traditional transactional methods.

A. The Comparable Uncontrolled Price (CUP) method seeks to determine the ALP by comparing the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted. This method is basically applied to concerns engaged in the manufacturing and selling of the product and hence to be applied to manufacturers. Typical transactions in respect to which this method may be adopted are: transfers of goods, provisions of services, intangibles, loans and provisions of finance. It seems very easy, but in reality, any minor change in the circumstances of trade, such as billing period, branding or amount of trade, may have a significant effect on the price and its makes extremely difficult to find a sufficiently comparable transaction.

³⁹³ OECD Committee on Fiscal Affaires, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2002;

B. The Resale Price (RP) method compares the gross profit realized when an company re-sells goods to a affiliate enterprice to the gross profits realized by comparable entities in uncontrolled transactions. Comparable profitability is determined by calculating the ratio of the initial purchase price of comparable tangible goods to their resale price to an unrelated party. This ratio, expressed as a percentage, is then used to calculate the value of the goods in a related-party transaction. The resale price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale; in their view, packaging, repackaging, labelling, or minor assembly do not ordinarily constitute physical alteration.

C. Cost Plus (CP) method evaluates whether the amount charged in a controlled transaction is arm's length by comparing the gross profit markup realized in comparable uncontrolled transactions. This method is generally used for the trade of finished or semi-finished goods, by adding an appropriate markup to the costs of materials, labour, manufacturing, and so on incurred by the selling party in manufacturing/purchasing the goods or services provided, with the appropriate markup being based on the profits of other companies comparable to the tested party. Cost based method calculates transfer price on the cost of the goods or services available as per the cost accounting records of the company. The method is generally accepted by the tax customs authorities, since it provides some indication that the transfer price approximates the real cost of item. Cost based approaches are however not as transparent as they appear. A company can easily manipulate its cost accounts to alter the magnitude of the transfer price. This method probably is most useful where finished goods are sold between affiliates and these have concluded joint facility agreements or long term buy/supply arrangements.

The most common used *non-traditional transactional profit methods* are the Profit Split method, the Transactional Net Margin method and the Comparable Profits method..

The *Profit Split (PS) method* is applied when the businesses involved in the controlled transactions are too integrated and cannot be evaluated separately for the purpose of determining the arms length of any one transaction, and so the ultimate profit derived from the endeavor is split based on the level of contribution of each of the participants in the project.

The *Transactional Net Margin Method (TNMM)* focuses on the arm's length operating profit earned by one of the entities/affiliates in the transaction. It stipulates that relative operating profit (relative to sales, costs, or assets to allow comparisons between different companies or transactions) may be a more robust measure of an arm's length result when close comparables, as required for the traditional methods, are not available. This may lead to very different gross margins (and hence the resale price method may not be easily applicable). However, the operating margins would not be expected to be materially different since the margins reflects a competitive return only.

The margin is measured pre-interest since the level of interest expense is a function of how a company decides to finance its operations and unrelated to the transfer pricing.

The *Comparable Profits Method (CPM)* determines an arm's length result using the amount of operating profit that the examined company, part of a multinational group would have earned on related party transactions with other affiliate entities if its profit level indicator were equal to that of an uncontrolled comparable transaction.

As it was shown, the transfer pricing method mostly depends on the allowance of the expenses' and revenues' treatment, but the mechanism depends on the business domain, the size of international network, the complexity of the transactions between companies of the group being able to counteract any change in a tax jurisdiction, that may dramatically affect the affiliate's or group's results. The pressure of realizing the assumed budget is quickly fined by the stock exchange investors and may have positive or negative training effects in transfer pricing policy.

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