

TRANSFER PRICING – A FISCAL ISSUE

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Abstract: Lately a frequently used practice to reduce fiscal costs is the commercial transactions of products between subsidiaries of multi-national entities depending on their actual purposes or strategic objectives. In this context an important role in policy's of such companies have methods available for pricing transfer. Even a relatively late entrant into economical practice, transfer pricing has rapidly emerged because more than a half of global transactions are conducted through multinational companies. In this paper we intend to present some of the situations where use transfer pricing, the consequences of their practice and their fixing methods on the basis of the strategic objectives of companies.

1. Introduction

It is considered that 60% of the world trade is done through multi-national companies because they have a broad range of alternatives regarding some very important issues for having a profitable business. One of these alternative refers to the use of transfer pricing.

On Central and South-East Europe, first country which has adopted the legislation regarding transfer pricing was Poland (1997), then Hungary, the Czech Republic, Lithuania, Slovenia, Latvia, Russia and, finally, Romania.

Transfer pricing refers to the pricing transferred within member entities of the same group or with common shareholders called affiliated companies.

It is believed that two companies are affiliated if one of them holds at the other at least at least 25% of the titles of participation or voting rights or even control.

These prices are subject to laws that these types of companies do not try to transfer profits to countries with lower tax, to reduce the amount of tax.

There are two situations where is used transfer pricing:

1. When multinational company wants to acquire or use financial and other resources at a lower cost and then transfer them on other markets where it works branches / subsidiaries of the group for which resources are hard to be obtained or have a high tax regime or cost prohibitive.

2. When through intra-company transactions, the company wants to transfer profits (income, expenses, or both) from areas with high taxation in areas with a permissive tax regime, so maximizing net profits of the group.

2. Fiscal aspects of the practice of transfer pricing

The most common situation where is used the transfer pricing practice and that one reflects the essence itself of the notion it's the trade of multinational group's products between group's subsidiaries, according to the goals of the moment or strategic objectives, or simply to reduce costs tax.

Beside this there are other situations in which it is recommended the conclusion of transactions at prices on:

a) Penetration of new markets Until using production capacities of a new subsidiary in a new country can import products from the group's other subsidiaries at prices below those charged to third parties, and they are sold with low prices in order to win customers and to enter the market.

This method is often used because it is difficult to prove that these prices just don't aim to promote products on that market.

b) Gain a greater share of market

Through this it can gain a largest share market even in the light of some potential losses resulting from lower sale prices. Especially in markets with high potential it is trying to obtain a more favorable position expecting a further development of that market.

c) Avoidance of legislative barriers. There may be cases when legislation in certain countries where work subsidiaries of multinational group changes, in the meaning of imposing of maximum prices on the domestic market or certain trading restrictions. Therefore becomes much more useful using some outlets from third countries at higher prices, where operates subsidiaries of the mother's company that cannot cover local demand. Also, there may be legislative changes regarding environment protection or other trading restrictions.

Therefore, in order to avoid keeping on stock the products already produced that can not be sold until the adjustment to the applicable rules, these products can be sold at reduced prices compared to the price market toward subsidiaries from other countries.

d) Use of demand fluctuation

It is not something new that the prices of similar products on different markets have different prices, depending on market positioning, objectives or purchasing power. There may be situations when it is more profitable to sell on the external market than on the domestic market by selling products to a sister companies from the group (at preferential prices), which has no capacity to cover the market by itself.

A multinational group can guide sales between subsidiaries and impose certain prices depending on the exchange rate evolution between currencies on international currency market.

e) Using the exchange rate differences and currency exchange rate variation

Thus, it is known that when a country currency depreciates comparing with other country currency / or an international reference currency, exports are stimulated - even more, it can export products to a subsidiary that does not cover demand on the local market.

f) Using transfer pricing as a way of out of business

Obviously, any investment in a new country, especially in emerging markets, involves some risks that large multinational groups want to minimize through a faster and invariable repatriation of profits. It is not surprising that many multinational companies register at the beginning, on emerging markets, constant losses in spite of high turnover.

Through various ways, including preferential sales, transfers funds to areas considered safer in terms of political stability, law, etc.

There may be cases when tries to accelerate the repatriation of profits through sales from countries subsidiaries where funds are consolidated toward emerging countries

subsidiaries; mechanism is quite simple - products are sold at much higher prices than is charged third parties or than market prices.

Therefore, the funds obtained generally in emerging countries, can be transferred directly into safer areas and / or reduced tax.

In choosing the interpretation method of the transactions between affiliated persons we take into account following aspects (compared to a situation of similar transactions, but concluded between independent persons):

a) any obvious difference determined by goods or services characteristics covered by comparable transactions, but only to the extent that these features influence the market price of that transaction object;

b) positions of people involved in these transactions

In order to obtain a conclusive information as a result of analysis of persons functions who participate to a transaction will be considered: the economic importance of the functions performed by each participant, sharing risks and responsibilities between the parties that participate in the transaction, volume of resources committed, machinery and equipment, the value of intangible used assets.

In determining the market price for transactions between affiliated persons use one of the methods stipulated by the Tax Code. In order to determine the most appropriate methods take into account the following elements:

a) The method that close most with the circumstances in which prices are settled, submitted to a free competitions on comparable markets from commercial point of view;

b) The method for which are available data as results of the effective functioning of affiliated persons involved in transactions subjected to free competition;

c) The degree of accuracy with which can make adjustments in order to obtain comparable basis;

d) circumstances of individual case

- the type, condition, quality and novelty degree of goods and transferred services;
- market conditions where goods, wares or services are used, consumed, treated, processed or sold to some independent persons;

- activities and production stages and distribution chain of involved entities;

- stipulations from transfer contracts, regarding : obligations, deadlines for payment, rebates, discounts, guarantees granted, assuming risk;

- in case of long term relationships transfer, their benefits and risks

- compétition spécial conditions

e) The activities of different affiliated persons;

f) The method used must match the circumstances of market and taxpayer activity;

g) Documentation that can be offered by the taxpayer

Companies that operate at international level discover the fact that their approach on transfer pricing may be contradicted by some fiscal authority, even when their position is well sustained and accepted by other tax authorities which also operates under the umbrella OECD principles of transfer pricing.

3. Transfer pricing – an alternative for growing the company performance

Tax inspectors can review through various methods the transfer pricing in case they do not have the same value as the price formed on the free market, according to the guidelines of the Organization for Economical Cooperation and Development on Transfer Pricing:

- Price comparison
- Cost-plus method
- The resale price method
- Method of sharing profit
- Net margin method

The first of the methods that can be used by the authorities is that of price comparison. To determine the market price, it is compared the price of the analyzed transaction with prices of other independent entities when comparable products or services are sold.

For the transfer of property, goods or services between affiliated persons, the market price is the price that would be agreed independent persons, in the existing markets, comparable in terms of trade for the transfer of goods or identical or similar goods, in comparable quantities, at the same point in the chain of production and distribution and in a comparable delivery and payment conditions.

The methods used to determine the actual value of the market are:

a) Compare prices settled between persons affiliated with the prices agreed in relationships with independent persons for comparable transactions (internal comparison of prices)

b) Compare prices agreed between independent persons, for comparable transactions (external comparison of prices).

In order to apply price comparison method, the market price of the transaction is determined by comparing the selling price of identical or similar goods and services, sold in comparable quantities, with the selling price of goods and services subject to evaluation. If the quantities are not comparable it can be used the selling price for identical or similar goods and services, sold in different quantities. To do this, the selling price is corrected with plus or minus differences that could be caused by the difference of quantity.

The second method stipulated by law, according to that tax authorities have the ability to interpret and adjust transactions between affiliated persons (of which at least one being Romanian) is known as the cost-plus method.

Cost-plus method aims also to be established by the tax authorities of a market price in order to apply later of a fee or tax which to reflect reality. The method is based on the increase of main costs with a profit margin accordingly to the taxpayer field of activity.

To use successfully this method in the case of transfer of goods or services between affiliated persons, it is going from the cost of producer or service provider. These costs are determined using the same method of calculation on which the person making the transfer bases also the pricing from policy for independent persons.

The added amount to the settled cost will take into account a profit margin which is according to the taxpayer field activity. In this case, the market price of the controlled transaction is the result of adding profit to the costs above.

If goods or services are transferred through a number of affiliated persons, this method will be applied separately for each stage, considering the role and current activities of each affiliated persons. The cost plus supplier's profit in a controlled transaction will be set up adequate by reference to the cost plus profit of the same supplier in comparison with uncontrolled transactions.

In addition, the method that can be used is cost plus profit that was earned in comparable transactions by an independent person. The third method of those fiscal

authorities may use in order to interpret the transactions between affiliated persons (of which at least one being Romanian) is known as the resale price method.

In this case, the market price is determined based on the resale price of products and services to independent entities, less cost of sales, other expenses of the taxpayer and a profit margin.

In applying of this method it starts from the price at which a product bought from an affiliated person is resold to an independent person.

This price (the resale price) is decreasing then with a corresponding gross margin (the resale price margin), representing the value from which the last seller in the group is trying to cover its sales expenses and other operating expenses depending on the operations performed (taking into account the used assets and risk assumed) and to achieve a suitable profit.

The market price for the transfer of property between affiliate entities is thus the price that remains after decreasing gross margin and after adjustment with other costs associated with buying product.

Margin of the resale price of the last seller in a controlled transaction may be determined by reference to the profit margin for resale, which the same last seller won for purchased and sold goods in the comparable uncontrolled transactions.

It can be also used the profit margin of the last sale achieved by an independent person in the comparable uncontrolled transactions.

In determining of the resale price margin value should take into account the following aspects:

a) Factors relating to period of time between of initial purchase and resale, including those relating to the changes occurred on the market in terms of expenses, exchange rates and inflation;

b) Changes occurred in the status and usage degree of goods subject to the transaction, including changes in technological progress in a particular field;

c) The exclusive right of reseller to sell certain assets or rights, which could influence the decision on a change of the margin of price.

Usually, the resale price method is used when an entity that doesn't resell won't increase substantially the value of product. This method can be used even when, before resale, the goods are processed and, in these circumstances, it may be set up the adequately margin.

Net margin method involves calculating net profit margin, obtained from a person after one or more transactions with affiliated persons, and estimating of this margin based on the level achieved by the same person in transactions with independent persons or based on the margin obtained in comparable transactions performed by independent persons.

Net margin method involves making a comparison between some certain financial indicators of affiliated persons and the same indicators of independent persons, which work in the same field of activity.

In order to use the net margin method it should be taken into consideration the differences between people whose margins are comparable. In this regard will be considered following factors: the competitiveness of other contributors on the market and equivalent assets, efficiency and management strategy, market position, the difference in cost structure and level of experience in business.

Sharing profit method is used when the transactions made between affiliated persons are interdependent, so that is not possible identification of comparable transactions.

This method involves estimating the profit obtained by persons affiliated after one or more transactions and share these profits between affiliated persons in proportion to the profits that would have been obtained by independent persons, sharing of profits should be done through a proper estimate of obtained revenue and costs involved after one or more transactions by each person.

Profits should be divided so that to reflect the functions performed, risk assumed and assets used by each party.

Although Romania is not yet a member of OECD, the rules require that application of transfer pricing, tax inspectors will take into consideration the OECD Guide regarding transfer pricing.

Multinational companies that operated in Romania, set up their prices which transactions were made within the group with no obligation of checking tax implications.

Now, when transfer pricing are legal settled, these companies may have trouble adjusting fiscal outcome as a result of checking pricing transfer. Therefore it is now necessary not only to review and set up the companies' policies regarding transfer pricing at group level, but also preparing the paper with specific documentation for transfer pricing.

In Fiscal Procedure Code is stated that those companies that make transactions with affiliated parties can address to the tax authorities in order to obtain an agreement for advance pricing. Agreement for advance pricing (AAP) is an agreement for a certain number of years through which are settled the determination methods of transfer pricing for future transactions between affiliated companies. The price charged by ANAF is between 10,000 euro and 20,000 euro, and for changes of the agreement between 6000 euro and 15,000 euro. Transfer pricing are settled at the market value, which represents the price paid in transactions made between independent companies for the same product or service. The problem is that still have not specified which documents are required by tax inspectors in order to justify the pricing transfer.

Among the "warning signs" (red flags) taken into account, by the tax authorities from the entire the world, as possible reasons that would lead to a more detailed analysis, include the following: unusually large amounts of profits and losses at a company belongs the group; reorganizations in the group that involves closing operations (liquidation) or reducing of some companies activity; significant fees paid for management services provided by companies within the group; transactions with companies within the group located in countries so-called "tax paradises"; location in a country where costs are reduced (such as low wage costs).

Companies within the group should adopt a systematic approach of the determining and documenting transactions process that take place between companies within the group, identifying those transactions that might attract the attention of tax authorities, preparing for them the necessary documentation and detailed studies regarding the pricing transfer policy and setting up their objectives.

Developing an internal control system is the first step in the understanding of risks related to transfer pricing. This system involves performing a list of intra-group transactions ranked according to the size of transaction, describing the policies used to

determine pricing and the way in which these policies have been applied, and also estimating the financial results of these transactions for each country.

Once intra-group transactions have been identified it can be established which of them might arouse suspicion to the authorities.

Knowing risky situations for the company in connection with the tax authorities allows the development of some control policies of these risks. Armed with these instrumental, the taxpayer may decide what position to adopt and what solutions are available for any problems that might arise. One of the first things it should be considered is whether that problem can be solved locally or it is necessary the negotiations between the tax authorities involved.

Local option may be less expensive, may set precedent for future disputes (which can be good and bad for the payer company) and, usually, the solution is found out more quickly. This is why the majority of disputes relating to transfer pricing can be solved locally. On the other hand, the advantage of a negotiated solution between the tax authorities of two or more countries is that the danger of double taxation is eliminated.

A priority of any company within a group could be limiting conflicts with the tax authorities, improving predictability of the amounts indicated in the financial statements, effective management of effective tax rates or the fulfillment of objectives regarding cash and available cash flows. The company will try to balance a number of these objectives. It is important to have a clear and well-supported justification regarding the decisions that are taken. The regulations on transfer pricing documentation were recently introduced in the Romanian legislation.

Their violation attract fines and penalties and increase the risk of tax adjustments in the event of a fiscal control as a result of consideration that prices are not at the market . It also may appear further difficulties for companies that cannot provide precise information regarding their policy of transfer pricing.

One of the most powerful constraints that exists in Romania consists in the fact that any tax inspection made in order to repay the VAT is suspended until the company is preparing the file for transfer pricing.

Sometimes the tax authorities investigate only certain transactions of the Romanian company with affiliated persons, but in any case, t must be prepared a complete file of the transfer price that will cover all transactions with affiliated persons.

4. Conclusions

There are four main reasons to consider very carefully the risk management of transfer pricing. The first one is that tax authorities around the world realized that transfer pricing is a null game (extra money collected as tax in a jurisdiction are lost in another jurisdiction) and therefore their vigilance increase, fact proved by the dramatic growth in recent years of the quantity of documents required by many tax authorities.

A second reason is related to the fact that lately the views of the tax authorities in various countries differ increasingly more. Although most of these authorities adhere to the set of principles formulated by the Organization for Economic Cooperation and Development (OECD) in order to assess the transfer pricing, the interpretation of these principles varies greatly.

A third reason to consider very carefully risk management of transfer pricing is related to the novelty of the subject in the legislation of some nations. This can create

uncertainty, but in the same time can affect trust of contributors in the manner in which the competent authority to resolve the problem of double taxation.

Finally, the fourth reason is that many multinational companies have noted that the tax authorities proceed, sometimes even with a large dose of suspicion, to the more rigorous controls and a more detailed assessment of the rules related to certain tax with positions that aren't extremely clearly defined.

That force companies to invest more time and effort to deal with those problems, in terms of the risk related to the emergence of divergent between taxpayer and tax authorities (especially if the company is present in many jurisdictions) is not totally removed. However, this risk may be kept under control by applying of some efficient principles of risk-management: the development of an internal control system, which allows the company to identify significant transactions intra-group and obtain information related to the identification of potential risks, identifying those transactions which could born suspicions from taxation; identify options for resolving disputes with authorities; keeping specific documentation according to legislation and local requirements (which, however, can prove to be extremely expensive).

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