Transfer Pricing Justification and Impact on Corporate Tax

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Abstract. Transfer pricing represent the prices for goods and services transfer between affiliates. In order to reduce incomes deficit coming from taxes, fiscal authorities search for more incomes, so they are looking more attentively to transfer pricing. Unfortunately, several international disputes arise between fiscal authorities because of increasing divergent national rules. If the authorities do not manage to reach an agreement, they may settle unilaterally the tax base in their own country. As a consequence, a multinational entity shall face the burden of a double taxation. Fiscal authorities began to investigate aggressively transfer pricing determination policies of multinational companies and every time they are striving to make sure that profits are allotted accordingly to each affiliated unit so as to avoid tax reduction by reducing the tax base. That is why, multinationals should implement efficient instruments for risks identification and measurement and they should always be aware of the latest technical and procedural means for solving issues concerning transfer pricing. Romania is not a member of Organization for Economical Cooperation and Development, and this make not possible for taxpayers to claim the Romanian courts, but also fiscal, the official interpretation of double taxation conventions. In Romania, along with the consolidation of fiscal legislation in the field, focused attention has been given to transfer pricing, the means to justify them and their impact on corporate tax.

Keywords: profit, taxation, affiliates, authorities, conventions.

INTRODUCTION

Transfer pricing are used in transfers between branches of a multinational company whose object is the sell of goods, provision of services, collection of lease incomes and collection of interests resulted from intra-company loans. These issues are administratively settled depending on the economical and fiscal interests of the company.

There are several situations that may occur during the transfer pricing set process: the transfer pricing equals the full competition price and the net consolidated profit comes from following the full competition principle; the transfer pricing is set at market price level, so in other words it equals the full competition price, yet the full competition principle is not being followed (Popa, 2008).

In the case where the multinational company seeks to transfer the profit of the mother company to its branches in order to benefit from a lower taxation that the one in its origin country (Mazerolle, 2006). The transfer pricing is then set to breach the full competition principle, thus resulting in fiscal fraud.
MATERIALS AND METHODS

In the conditions of a perfectly competitive external market for the good intra-company transferred, the neoclassical economic theory mentions that the transfer pricing should equal the market price for the optimal situation to exist.

The external market for the goods subject to intra-company trade is imperfect, while the market price assessment may be undertaken without ensuring the optimal situation, for all involved branches. Thus, the transfer pricing equals the market price minus a current technique fee, if the buying branch is a trade department, and the selling one is a manufacturing unit, which distributes its products through the trade department. The buying branch shall trade the product on the external market, at the market price and shall pay to the selling branch a collected market transfer pricing, minus a fee including trade expenses and a profit rate.

This method not always is in the company’s interest. When the company’s turnover decreases, the trade department fee also decreases, yet not a lot. The department may bear this loss, without its global performance to be significantly affected. As far as the manufacturing branch is concerned, as its result is strongly influenced by the accomplishments of the trade department, the decrease of the turnover has significant negative effects on its performances. This method allows the branches of multinational companies to operate as profit centres, their managers being responsible for their own performances. This may generate an increase of branch managers’ motivation, and in the same, an easier real assessment of mother company of its branches’ operational performance (Huizinga and Luc, 2008).

But, it is difficult to use the market price as a mark for setting the transfer pricing. For this purpose, the existence of a competitive market is necessary, to ensure a comparable price to equal transfer pricing. For certain goods, there may not be an external market, while for others the prices may be distorted by monopoly elements. A definitive market price may be hard to determine, since the prices for the same good may considerably vary from one country to another, depending on the demand and offer ratio, the currency exchange variations, the transport costs level, the local taxes and the afferent customs taxes. All together these factors back up the idea that it is highly unlikely that a unique market price exists, for the multinational company to take as a mark to determine the transfer pricing for a product. In the conditions where the supplying branch, considered a profit centre, doesn’t work at its full capacity, taking the market price as mark for the transfer pricing could determine both branches to undertake intra-company transactions (Parker, 2010).

When working at full capacity, when the supplying branch may sell externally all its products at the market price and when the buying branch may purchase the products externally, for the same unitary price, then apparently the intra-company transfer provides no benefit to the involved branches.

By choosing a market price different from the one ensuring the maximum profit, according to the marginal theory, the company’s performance is being achieved, by contraction of supplying branch autonomy for the temporary satisfaction first of the company’s internal demand and then the external one. Thus, the performance assessment and objectives harmonization criteria are met for the entire company. The buying branch thus manages to purchase at a transfer pricing which, although equals the market price, doesn’t include a range of supplementary expenses, being able to provide discounts for the final product sold on the external market of the company, and so to re-distribute the income, in the favour of the multinational company.

When the object of transfers between autonomous branches of a multinational
company represents different goods, with high value and fluctuant market price, it is recommended to negotiate transfer pricing (Mazerolle, 2006). The same for the unique products sold internally in large quantities, as well as for the standard products, if the transfer pricing requested goes above their market price.

In the case where there is no external market for the product traded inter-branches, or there is no directive of the mother company regarding the use of specific methods, the transfer pricing depends on the negotiation ability of the involved managers, which may distort the performance of the branch and the company. Usually, transfer pricing tend to reach the standard costs levels for transferred merchandise, plus the margin for invested capital recovery, which shall generate the disadvantage of passing the fix costs of internal supplier into the variable costs of the buying branch, through transfer pricing (Huizinga and Luc, 2008).

In the case of a decentralized company, when negotiators have access to all data concerning the supplying sources and alternative prices, they may set competitive transfer pricing through direct negotiations, or they may search out of the company, if they do not reach satisfying prices. So, transfer pricing setting methods may be used, based on the market price or negotiation, in certain circumstances, ensuring the adequate fulfillment of transfer pricing functions.

RESULTS AND DISCUSSION

Regulations regarding transfer pricing were limited in the past to a restricted number of industrialized countries. It may be noticed that during the last years, fiscal authorities from the Central and Eastern Europe became significantly more concerned about this field. A range of fiscal jurisdictions (such as Slovakia, Greece and more importantly Romania) introduced new requirements for tax payers in order to create and maintain certain arrangements concerning the documentation of transfer pricing (Parker, 2010).

Considering that fiscal authorities are more vigilant, multinational companies are forced to justify more rigorously, with documents, the basis for their policies regarding transfer pricing. Yet, companies shouldn’t become the victims of structural increase of double taxation arising from the fact that each fiscal authority imposes its own criteria.

Because of divergent proliferation of national rules, controversies concerning transfer pricing between fiscal authorities of different countries shall enhance, leading to the unwanted situation of double taxation of multinational companies, which may concern huge amounts of money. Through transfer pricing – used and invoiced prices between the companies within the same multinational company – the multinationals actually determine where they generate value and what the proper amount of taxes is for each of the involved countries. So, fiscal authorities undertake periodical checking to make sure these internal agreements regarding prices are adequate (Bhat, 2009).

The Organization for Economical Cooperation and Development (OECD) adopted a series of guidelines regarding transfer pricing (OECD, 2009). The basic principle of these guidelines is the market price principle; the internal price should correspond to the external price used by thirds in transactions between them, respectively. Nevertheless, there is a gap between theory and practice. Because Romania is not yet a member of OECD, taxpayers can not claim the official interpretation of double taxation conventions. The issue of transfer pricing has been left aside for a long period of time by both fiscal authorities from Romania and by multinational companies operating in Romania. The principle according to which transactions with affiliated parties should be undertaken at the market value was introduced in
Romania for the first time in 1994. Later on (2004), the Fiscal Code established in a systematic way the definition of affiliated persons and stated the principle of market value and transfer pricing setting methods, while in July 2005 the Advance Price Agreement (APA) concept was introduced; a year later, through the changes of the fiscal procedure Code, new requirements were introduced regarding the official documentation concerning transfer pricing that needs to be handed when requested by the fiscal authorities. The norms regarding the issuing procedure and afferent documentation needed by a tax payer requesting an APA were issued in June 2007, and in February 2008 the detailed national regulations were published regarding the content of the transfer pricing file.

With the consolidation of fiscal legislation in the field of transfer pricing, more attention has been given to the means of justification of these prices and their impact on the corporate tax. Starting from the half of year 2008, multinational companies began to face a series of fiscal audits undertaken by the newly created department of National Agency of Fiscal Administration - “Transfer Pricing Department” whose aim is to analyse transfer pricing files. This checking is meant to find out the physical existence of the file, as well as how much this file follows the principle of market value. The inability to present concrete arguments to support the intra-group prices used may draw significant adjustments of the company’s profit, and implicitly, adjustments on the corporate tax (as well as fines and late payment penalties). The lack of such file or handing over an incomplete file is being punished by amend.

Romanian legislation concerning transfer pricing is greatly similar with the regulations applied by other developed countries, referring to the OECD doctrine and the EU Code of conduct, as regards the transfer pricing documentation. According to Romanian legal stipulations, any type of over-border transaction between affiliates is subject to certain transfer pricing determination regulations. Some of the most frequent types of transfers between affiliates are: loans given by the mother company to affiliates; delivery of goods and services to/from entities of the group; fees received for management services.

Lately, there has been a significant increase of the number of demands addressed by fiscal authorities to tax payers to present the transfer pricing documentation; it is foreseen that this trend shall enhance, because authorities become more and more sophisticated regarding this matter, having specialized teams created within the control fiscal authorities. As a general rule, according to Romanian legislation, in the case of a fiscal control, Romanian entities should have the possibility to prove the market value of transfer pricing set with its affiliates, with both parties’ agreement, for the undertaken transactions.

Romanian law stipulates that two juridical entities are affiliated if: one entity, directly or indirectly, owns participations of the affiliated entities, at least 25% of the number/the value of the shares or the rights to vote in another entity or if it actually holds the control over the other entity, or if a third entity, directly or indirectly, owns participations of the affiliated entities, at least 25% of the number/the value of the shares or the rights to vote in another entity or if it actually holds the control over the two entities.

One controversy concerns the preparation of the transfer pricing file between two or more affiliates in Romania. Thus, in the case of transaction between Romanian legal persons, transfer pricing between affiliated Romanian legal persons are not adjusted, and so transfer pricing file should not be requested. Nevertheless, when determining the corporate tax, fiscal authorities may not consider a transaction that has no economical purpose or they may register into another category the form of a transaction in order to reflect its economical content. In certain situations, it may be difficult to identify comparable external transactions. For instance, frequently intangible assets are created, through a marketing company.
Transfer pricing represent a controversy matter regarding the closure of a company’s activity as well. For instance, if a company moves its manufacturing unit from Romania to Hungary, the factory in Hungary uses the know-how generated in Romania. In this situation, several disagreements arise such as the one concerning the value of this know-how that the company in Romania actually sold to the one in Hungary and whether fiscal authorities in Hungary admit this amount as a cost element.

Another disagreement regards the period for which the transfer pricing file may be requested; such request of preparation and handing over the transfer pricing file may be formulated during a general or partial fiscal inspection, including the control for a Value Added Tax (VAT) refund, which is considered a partial fiscal inspection.

Also, at international level, there is no consent concerning the array of application of the market price principle. For instance, in the case of a loan between the companies of a same group, fiscal authorities have the right to determine only whether the interest rate follows the market price or they may establish if the respective loan is justified.

In the EU, the Arbitrary Convention forces the member countries to apply the mandatory arbitrary procedures in the case of disputes related to transfer pricing. Unfortunately, there is not organism at global level; there is no trade worldwide organisation for transfer pricing (Bhat, 2009).

Hopefully, some countries not only promise to solve the disputes, but they also began to include in the conventions meant for avoidance of the double taxation stipulations concerning the achievement of a certain result (Riedel and Marco, 2007). Thus, countries force one another to find common points. That is why it is necessary for the countries to strive to seek help at OECD to get to an agreement as far as the interpretation of the market price principle is concerned.

CONCLUSIONS

The increasing interest of fiscal authorities concerning transfer pricing and the proliferation of divergent national rules brought into attention as first priority the assessment and management of risks concerning transfer pricing.

Fiscal authorities become more preoccupied by the fact that multinational entities have the possibility to reduce their taxable profits in their jurisdiction by using controlled transfer pricing in over-border transactions. This led to an increased number of regulations concerning transfer pricing, which makes these prices a significant matter in the field of multinationals’ taxation. Although there are particularities in the specificity of each country, as far as the application of the market value principle is concerned, the fact that they follow the OECD’s guidelines ensures the regulations’ harmonization regarding transfer pricing, as well as the method to set them.

The OECD’s guidelines stipulate that the fiscal assessment of transactions between affiliates are based on the concept of market value, and the transfer pricing should be set so as to reflect the price that would have been used by non-affiliated entities operating independently.

Fiscal authorities throughout the world attack more frequently the transfer pricing setting methodologies and they give even more severe sanctions to companies that they find that do not follow regulations. Because more and more companies expand their activity globally, as well as because of the complex character of international fiscal norms, companies may face a “burden” in transfer pricing.
REFERENCES