

Methods and theories on transfer prices

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Abstract

In the current global economic situation, when multinationals companies are no longer a rarity and the increase of volume and frequency of intra-group transactions are a reality, the transfer prices issue has become a problem for big companies because it significantly affects the fiscal task of the groups.

The transfer price is basically the price used for transfer of tangible and intangible assets between related parties and it should be determined on the basis of market value without being influenced by the relationship of affiliation. However, if for services or tangible assets, the comparison of the transfer price to the market one is relatively easy to achieve, for the intangible ones, quantifying future benefits waived by the affiliated person compared to the situation in which it would be independent is harder to be established.

Keywords: multinational, transfer price, market price, transaction, intra-group transactions

Introduction

In the current context of globalization, the most important actors in the global economy have become the multinationals companies; trade between affiliated persons came to represent about 60% of world trade. Therefore addressing transfer is very important.

In the area of transfer price development in recent years it can be seen that the tax authorities in the region of Central and Eastern Europe have become significantly more concerned with this area. Currently

investigation is carried out by applying an aggressive pricing policy of transfer within multinational enterprises and aiming to ensure that every time profits are properly allocated to each affiliate to avoid reducing taxes payment by minimizing tax base (profits).

In Central and South-East Europe, the first country to adopt legislation on transfer price was Poland (1997), then Hungary, Czech, Lithuania, Slovenia, Latvia, Russia and finally also Roma

Recent developments in transfer prices in Romania:

- 1994 - is first introduces the principle that related party transactions to be carried out at market value;

- 2004 – the Fiscal Code establishes in a systematic manner the definition of affiliated persons, states the principle of market value and methods of transfer pricing;

- July 2005 - was also introduced the concept of Advance Price Agreement;

- September 2006 - were introduced through amendments to the Fiscal Procedure Code, requirements on formal documentation for transfer prices, hat must be presented at the request of fiscal authorities;

- June 2007 - were issued Regulations on emission and the related documentation required to a taxpayer requesting an Advance Price Agreement.

- February 2008 - were published detailed national regulations on the content of the transfer price file.

Transfer prices

The term "transfer prices" is used for transactions between related parties, transactions which are not only subjects to free market rules and, therefore, can be influenced by subjective factors such as company's group policy in minimizing the fiscal cost of the group.

Transfer price is the price at which a person (natural or legal) transfers assets - tangible and intangible (e.g., know-how, trademarks) - and services to an affiliate. Transactions between related parties must be made on the basis of market value - "the arm's length principle", as found in the literature - without being influenced by the relationship of "kinship" between them. Often, however, market conditions cannot be played entirely because it is possible that transactions of the kind made by affiliates wouldn't be completed if the companies were independent and that because of the traded object itself. An example would be the sale of intangible assets - such as patents, trademarks, in this case, the

probability that an independent person to renounce in favor of other independent persons at some future benefits that cannot be accurately quantified at the time of the transaction is reduced.

According to the Tax Code, the tax authorities may reconsider transfer pricing and, consequently, to adjust income or expense related to any of the persons involved in a transaction if the price at which the transaction was effected is not a market price, respectively the price at which the transaction would've been completed under the same or similar conditions by independent persons.

The result of these adjustments may result in additional income tax expense to the taxpayer declared obligation - where, by applying the principle of the free market, tax authorities conclude that the taxpayer recognized income is less than the one that should have been acknowledged or if the recognized expenses are greater than those which were recognized - respectively a tax obligation less than originally stated, given that the situation would present contrary (recognized income greater than the one that should have been acknowledged or recognized charges lower than those that should have been recognized).

According to the Methodological Norms for the application of the Tax Code, transactions between the Romanian legal entities are not subject to adjustment by the tax authorities, only those signed by Romanian legal entities with affiliated non-resident persons as well as with Romanian individual persons.

Revenue and expenditure adjustments made by tax authorities by applying transfer prices provisions are made solely for tax purposes, without affecting the financial situations of affiliated persons.

Setting the transfer prices

In the context of current world trade, when the trend of economic globalization manifests clearly involving expanding multinationals companies into ever more countries and the emergence of transnational corporations, the share of international trade transactions undertaken by them - especially intra - group transaction - had a significant increase in recent years. The problem of transfer prices is complex for both tax authorities and for multinational companies, highlighting it as the most important fiscal challenge that they face today. This is because failure to comply with the market value principle will affect the fiscal task of the group.

Setting transfer prices is done, in general terms, by comparison with the prices in which independent persons would agree to comparable transactions in comparable circumstances.

For comparison, taxpayers will have to assess whether there are significant differences from comparable transactions or persons and, if any, accordingly adjust transfer prices based on a functional analysis. Doing the functional analysis aims to identify and comparing activities and responsibilities undertaken or which may be undertaken by independent entities and affiliated entities. In order to achieve functional analysis, an important element is the structure and organization of the group. Also, functional analysis will be conducted by reference to the following:

- economic importance of the functions performed by each person affiliated in the transactions;
- sharing of risks and responsibilities between related parties involved in the transaction, as an increased risk assumed will be remunerated as such;
- volume, type and nature of assets employed or to be employed by affiliated entities involved in the transaction, such as equipment, intangible fix assets to be used, etc.

Although the Tax Code and the Methodological Regulations of application leaves to the taxpayer the usage of the closest method presented in the box, Order no. 222/2008 of the President of NAFA, concerning the contents of the transfer prices file, states that the application of any other method than the traditional ones as well as applying any other method than the comparison of prices must be justified by the taxpayer.

Provisions regarding the obligation of taxpayers to determine transfer prices based on the methods presented exists since 1999, but the reference to the application of the regulations of the Guidelines for transfer prices issued by the OECD to the choosing of the method for determination of transfer prices was introduced in 2003 with the appearance of the Tax Code. Regarding the requirement to prepare the transfer prices file, it exists since 2006 with the publication of GO no. 35/2006 for the amendment of the Fiscal Procedure Code. However, the provisions on the specific content of the transfer prices file appeared only in February 2008, with the publication of Order no. 222/2008 of the President of NAFA.

To prevent the negative effects of non-compliance to transfer prices provisions, taxpayers can "protect" themselves both by obtaining advance price agreements, as well as preparing the transfer prices file that justifies applying the principle of market price in setting the transactions prices with legal non-resident persons.

Advance price agreement

Advance price agreement is an administrative document issued by the National Agency for Fiscal Administration to address a request from the taxpayer, concerning the establishment of the terms and conditions in which are going to be determined, over a fixed period, the transfer prices for transactions between related parties, as defined in the Tax Code.

Advance pricing agreements can be unilateral – in which case are issued by the tax authorities of one state, bilateral or multilateral - where the agreement is issued jointly by two or more tax authorities in various tax jurisdictions.

The advantage of obtaining an advance price agreement is that it is enforceable and binding to the tax authorities as long as the terms and conditions of that agreement are met by the taxpayer. Advance price agreement may be issued for a period of up to five years or even longer if the transactions are conducted under long-term contracts. Taxpayers may request the amendment of the Agreement, for the purposes of its validity extension, expansion or revision. Getting an advance pricing agreement aims to prevent any adjustments of the tax authorities by obtaining the agreement of the competent tax authority that the method of determining the transaction price of the transaction/transactions that the taxpayer is going to carry out with related parties are at the market price level. The procedure for issuing an advance price agreement was approved by GD 529/2007. From a procedural perspective, to obtain an advance price agreement, the taxpayers will have to submit a request for it accompanied by related documentation of the transaction/transactions for which the issuing of the agreement is requested. Documentation of the taxpayer applying for the issue of an advance price agreement must contain certain information, as provided in the procedures approved by G.D no. 529/2007, including information on transfer prices policy of the group to which the taxpayer belongs, describing the functions and risks undertaken, comparative analysis, describing the methodology of the proposed transfer prices.

Issuing an advance price agreement is conditioned also by the payment of a fee equivalent in RON of 20.000 EUR for large taxpayers, and for other taxpayer's categories if the consolidated value of transactions for which the issuance is requested exceeds the equivalent of 4 million Euros, respectively a tax equivalent in RON of 10.000 EUR by other taxpayers.

Changing advance pricing agreement at the request of the taxpayer is also subject to payment of a fee equivalent in RON of 15.000 EUR for large taxpayers and other taxpayers if consolidated value of transactions subject to the agreement exceeds 4 million EUR, respectively a tax equivalent in RON of 6.000 EUR for other taxpayers.

The taxpayer holding an advance price agreement is required to submit, within the time line for submission of annual financial statements, to the tax authority that issued the agreement, an annual report on how to the terms and conditions of the agreement were met. Failure to do so will lead to the annulment of the advance price agreement obtained.

Taxpayers who have obtained an advance price agreement issued by the competent tax authorities of Romania are no longer required to prepare a transfer prices file.

Code of conduct

The provisions of the Code of Conduct of the European Union (OECD) in terms of transfer prices are in a constant development and therefore are often the center of attention in specialist publications. Instead, provisions (OECD) are not as well known - which does not mean that they are not as important. Therefore, we further propose a review of these provisions and their impact on the Member States of the European Union.

What is the Code of Conduct?

Drawn up as a result of the efforts of the European Union Joint Forum on Transfer Prices and adopted by the European Union in June 2006, the Code of Conduct aims to standardize the documentation that multinationals need to provide to the tax authorities to justify the price of cross-border transactions made within the group.

By the Code of Conduct was intended to significantly reduce administrative problems of the companies performing intra-group transactions in the European Union.

Transfer prices file

Regulations concerning the specific content of the transfer prices file to be prepared by the taxpayer, as required by the Fiscal Procedure Code, are represented by Order no. 222/2008 of the President of NAFA and published in Official Gazette no. 129 of 19 February 2008.

It is worth noting that the requirements of national legislation on the transfer prices file contents comply with the Code of Conduct on transfer prices documentation for associated enterprises in the European Union (published in the Official Journal of the European Union no. C176/1 from 28 July 2006) which also complements the provisions of the Order no. 222/2008. Also the Order no. 222/2008 is completed by the transfer prices Guidelines issued by the Organization for Economic Cooperation and Development.

The deadline for the submission of the transfer prices file to the tax authority is determined by it and cannot exceed 3 months. The taxpayer may request a one-time extension of the deadline for submission of the file, for a period not exceeding initial deadline set by the tax. The fiscal body may decide to suspend the tax audit up to the presentation of the transfer prices file.

Refusal to submit transfer prices file by the taxpayer and incomplete disclosure results in the tax authorities estimating the level of the transfer prices and therefore the payment by the taxpayer of the fine imposed for failure to submit the file - only if the taxpayer refuses to submit the file, and also with higher income tax debts with interests for being late - if the forecast made by the tax results in additional income tax liability to the one declared and paid by the taxpayer. Estimation of transfer prices by the tax authorities will be made by identifying three comparable transactions and estimate transfer prices as value of the arithmetic mean of similar price identified by tax authorities. Regarding comparative analysis in selecting comparable transactions, the taxpayers will have to take into account the territorial criteria in the order in which they are prescribed by regulations, namely: national, EU and international. All information submitted in the transfer prices file should be available in Romanian. If there are documents available in another language, they will be accompanied by certified translation into Romanian.

Information available electronically will be presented in an accessible format agreed with the competent tax authority.

Transfer prices file must be drawn up by taxpayers engaged in transactions with related companies and presented to the tax authorities at their request, which will be submitted in writing during the general or partial tax audit.

Methods for determining transfer prices

The following methods are recognized by the transfer prices Guidelines issued by the OECD:

- price comparison method;
- cost-plus method;
- resale price method;
- profit sharing method;
- net margin method.

Content of the transfer prices file

Information about the group

- Organizational structure of the group, legal and operational;
- General description of the group activity, business strategy, including changes in business strategy from the previous fiscal year;
- Description and implementing transfer prices methodology application within the group if any;
- General description of the transactions between affiliated persons resident in the EU: how the trading is done, billing, value of transactions;
- General description of the functions and risks assumed by affiliates, including changes in this respect over the previous year;
- Presentation of the holders of intangible assets from the group (patents, trademarks, know-how etc.) and royalties paid or received;
- Presentation of advance price agreements signed by the taxpayer or by another company in the group, in connection with it, except those issued by NAFA.

Taxpayer information

- Detailed presentation of transactions with related parties:
 - how the trading is done;
 - billing;
 - value transactions.
- Presentation of comparative analysis;
 - characteristics of goods or services;
 - functional analysis (functions, risks and assets used);

- contract terms;
- economic circumstances;
- specific business strategies;
- information on external or internal comparable transactions;
- Presentation of affiliated persons and their permanent establishments involved in these transactions or arrangements;
 - Description of the method of calculation of transfer prices and the argumentation of the selection criteria for it;
 - Description of other conditions considered relevant for the taxpayer.

Conclusion

Dramatic increase in global trade and cross-border direct investment has made the transfer price now to strive in becoming an important determinant of taxation of the members of multinational companies group. It is known that determining the stated price principle before starting negotiations is often difficult for both multinationals and relevant administrations. Starting from the premise that legislative measures are the central pillar in the fight against cross-border tax evasion in the area of transfer prices, it is understood by itself that it is necessary to eliminate redundancies existing in the legal framework, both nationally and internationally, and, from the desire of an uniform treatment of the matter, it is necessary the legislative “matching” of the referential domestic tax laws of the Member with the regulations contained in the OECD transfer prices Guidelines and also with the principles structured in the Code of Conduct of transfer prices.

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