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Transfer pricing file- a contextualized Approach. Case Study

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Abstract
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

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 is relatively easy to achieve, for the intangible ones (patents, trademarks, brand etc) quantifying future benefits waived by the affiliated person compared to the situation in which it would be independent, is harder to be established.

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. 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.

This research topic was chosen for the following reasons:

Transfer prices regime is the "end point" of ingenuity on exploitation of tax legislation, as it is the glue that connects existing tax rules in different national markets. Moreover, starting from the assumption that in the cost structure of the products can also be found fiscal influences (sometimes not insignificant), 'host' firms of the transfer mechanism of taxable material achieve, although not exactly in an "orthodox" manner, an "additional income", which can then be used to obtain a "Power" position in a particular market.

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.

The subject of transfer prices has become increasingly discussed over the last two years, and the attention of the tax authorities in this area had a very important role in this respect.

In Romania, justification by taxpayers of the transfer prices is based on the Fiscal Code, on its implementing rules, as well as on the provisions of the OECD Guidelines on Transfer Prices. In short, under these provisions, a taxpayer's transactions with related parties have to be undertaken in market conditions, i.e. respecting business and financial conditions that are to be expected and agreed between independent persons, on the background of comparable circumstances.

Case Study: transfer prices file at SC. Romvag S.A

1. Company Overview

SC. Romvag S.A is a company for the production of freight wagons, of the Railways Industries International Group.

SC. Romvag SA is a joint stock company founded in 1990, headquartered in Bucharest, Calea Vacaresti, no. 88-103, Romania, whose main activity is the production of freight cars.

SC. Romvag SA is certified as a producer of freight wagons by the Romanian Railways and by relevant entities in other European countries such as Germany, Belgium, Switzerland, Austria, France, Great Britain, Slovakia, Italy, Sweden, Hungary, the Netherlands and the Czech Republic.

2. Financial data

Main consolidated financial data of the Group for the period 2006 - 2010 are shown in the table below:

Table no. 1. Financial data of the group for the period (2006-2010)

Financial information	*In 2006*	*In 2007*	*In 2008*	*In 2009*	*In 2010**
Turnover	67,284	110,260	176,146	188,696	67,818
The net result	53,796	-8,922	-5,661	-14,004	-49,422
Total assets	196,523	118,285	171,875	188,541	146,404

Source: own compilation

3. General description of transactions between related parties from the European Union in the IRS group

During the 2006 – 2010 period, within the IRS Group were developed the following main categories of transactions between related parties from the European Union:

- production and sale of freight wagons;
- production and sale of bogies;
- selling axles;

4. Transfer prices and advance price agreement methodology

Transfer prices methodology

The methodology applicable for the setting of transfer prices within the major categories of related party transactions carried out in the IRS Group is, as follows:

- production and sale of wagons by the producing entities from the freight wagons Division to related parties.

Transfer price is set at recorded production costs level plus a profit margin of up to 5%.

- production and sale of bogies by the producing entities from the freight wagons Division to related parties.

Transfer price is set at recorded production costs level plus a profit margin at market value.

- selling raw materials and materials between affiliated entities.

Transfer price is set at recorded production costs level (acquisition cost or standard cost) plus a profit margin at market value.

- selling subassemblies and components between affiliated entities.

Transfer price is set at recorded production costs plus a profit margin at market value.

Transfer price is set at the unamortized book value level plus a profit margin at market value.

- transport services carried out by entities in the transport division to the producing entities from the freight wagons Division.

Prices charged for transportation services are established using a methodology similar to that used in setting tariffs for companies providing these services in relation to independent parties.

5. Advance Price Agreements

During the period covered by this case (i.e., 2006 to 2010), there is no information about requesting or obtaining by any entity in the Group IRS of an advance price agreement.

6. Holders of intangible assets

All intellectual property rights related to the Group's products are owned by other companies in the Group.

SC. Romvag SA does not have significant intangible assets and also pays no royalties to related parties for the use of intangible assets.

7. Description of related party transactions

In the period January 1, 2006- December 31, 2010, SC. Romvag was involved in the following types of transactions with related parties from the IRS group:

- production and sale of freight wagons by SC. Romvag S.A to IRS Industries;
- production and sale of bogies by SC. Romvag S.A to IRS Industries and Meva.

8. Application of transfer prices method

After selecting the transfer price method, the next step is to apply this method to analyze compliance of the tested transaction with the principle of market value.

To test compliance with the principle of the market value of the sale transaction of finished products by manufacturers to their affiliated parties by applying the net margin method must be taken the following steps:

- identifying the party that will be subject to analysis (the tested part);
- developing a comparability study (i.e. identification of comparable companies and choosing an indicator of profitability);
- setting a market range;
- testing compliance with the principle of market value by comparing the profit margin applied by the tested part to the values included in the market range.

8.1. Identifying the party that will be subject of the analysis

In order to analyze the compliance of the tested transaction with the principle of market value, you must first select the affiliated company that shall be subject to review (the tested part). The tested part is that participant in a transaction between related parties whose profits will be analyzed for compliance with the principle of market value.

After the functional analysis performed, we determined that producers are the least complex part of the transaction analysis perspective, being without marketing or sales functions and not taking risks related to market evolution.

8.2. Comparability study

Search Strategy

According to the Romanian legislation, the search was first done at a local level, on companies with headquarters in Romania.

As there weren't identified comparable companies in Romania that can be used as a comparability reference for Producers, in accordance with the provisions of the Order 222/2008 on the content of the transfer prices file, we expanded our geographic search at EU level.

The search process involved examining companies from the Orbis database, eliminating companies that do not meet the selection criteria and identifying those companies that could be used as a comparability reference for the production of wagons or similar products.

A summary of the search strategy is presented below:

- Geographic criteria
- Activity code
- participants in subsidiary
- stock
- turnover
- negative exploitation result

8.3. Selection of the profitability indicator

Profitability indicator used in this comparability study is the profit margin related to operating costs (of exploitation), which express a company's profitability by reference to the total operating costs. This profitability indicator accurately reflects manufacturer's profitability, considering the costs that it registers for adding value to products.

8.4. Setting market range

After identifying a set of companies performing comparable activities to those held by Producers and selecting an indicator of profitability, the next step is to establish the market range. In accordance with local regulations, market range is defined as the interval between the lower quartile and the upper quartile.

Results for companies in the final sample were calculated as a weighted average using financial data for a period of five years (i.e. 2006-2010) and are presented in the table below.

Table no. 2. Profit margin related to operating costs (2006 - 2010)

Profit margin related to operating costs (2006 - 2010)						
	No. companies	***Minimum***	***Lower quartile***	***Median***	***Top quartile***	***Maximum***
Final sampl e	9	1.58%	**3.01%**	**3.72%**	**11.01%**	11.92%

Source: own compilation

The profit margin related to operating costs for the independent companies included in the final sample for the period 2006 - 2010 range between 1.58% and 11.92%, calculated market range is between 3.01% (lower quartile) and 11.01% (top quartile), with the median at 3.72%.

In accordance with the local law, this period (i.e. between 3.01% and 11.92%) is considered to provide a relevant estimate for the market value.

8.5. Analysis of compliance with the principle of market value

■ Results of the tested company

In the period under review, according to the methodology for setting the transfer price, for the sale of finished products to related parties Producers have applied a 5% profit margin.

■ Analysis of the compliance of the tested transaction to the principle of market value

In order to analyze the compliance of the tested transaction with the principle of market value, we compared the results obtained by independent producers with limited functions and risks from the final sample with the profit margin applied by producers. As you can see the 5% profit margin is within the range of comparison (between 3.01% and 11.01%) which shows that the market value of the transfer prices charged was not distorted by the influence of transfer prices.

Conclusion

The objective of this case was to determine whether transfer prices applied to transactions carried out between Astra Wagon and its related parties during 2006 and 2010 are based in accordance with the principle of market value.

Checking the consistency with the principle of market value of intra-group transactions undertaken by Astra Wagon was made for each type of intra-group transaction separately and included:

■ Understanding of the economic context in which the Company operates and has generated the need to conduct transactions;

■ Feasibility analysis of applying each method for setting transfer prices in order to assess the market value of intra-group transactions performed, considering the circumstances and characteristics of each type of intra-group transactions in part;

■ applying the selected transfer price method in order to establish the compliance of each intra-group transaction with the principle of market value.

Following the analysis, we concluded that intra-group transactions carried out between Astra Wagon and its affiliates during 2006 and 2010 were conducted respecting the principle of market value, as it is defined in the OECD Guidelines and national legislation.

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