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# Transfer Pricing Rules: National and International Approach

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**Abstract**

*The need to regulate transfer pricing is a subject of international importance due to the needs developed by international corporations. The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations made a opinion paper on the transfer pricing system used by transnational companies as early as 1979, and in 1995 made a guidelines on transfer pricing for tax administrations and transnational companies. In the European Union, these operations have become widespread and generate significant losses of tax revenue, leading to an acute need for legislation to normalize these practices. In order to help countries where this issue is frequently encountered, the European Union has come up with a real solution, namely to adopt a common consolidated corporate income tax base.*

**Key words: t**ransfer price, tax administration, OCDE, report, income tax
**J.E.L. classification:** M41, M21, F38

## 1. Introduction

An exceptionally convoluted subsystem of the retail economy, cost come up as a style of economic evaluation, in fiscal statement, of the expenses of materials. It is the outcome of the force of a multitude of changing, varied and often antithetical factors: the value of the commodity; the purchasing power of the currency; the demand-supply ratio existing on the market; the economic integrity assisted by the countries of the world (Nitu, 2003).

The concept of *transfer pricing* originates from the United States (19th-20th century) and represents a fair share of tax. This concept developed because of diverse tax, on the same way that states assessed costs set at the territorial level (varying in bulk from state to state) and the federated state demanded from the single tax set. (Ciumag, 2006).

The moving the value is the cost at which a person's relocation of goods - tangible and intangible (e.g. trademarks) - and services to an connected person (Licu, 2008).

Transfer pricing rules apply to all concerns between related persons, whether transfers of goods or intellectual property rights, provision of services or other types of proceedings. Under these rules, affairs betwixt linked society must be carried out in conformity with the arm's length principle, which underlies the whole transfer pricing analysis and is reflected in Article 9 of the Model Double Taxation Convention as well as in national law (Luca, 2019).

## 2. Literature review

Transfer pricing is an increasingly important issue for multinational companies in determining tax planning. Today, around 60% of world trade is between related persons. With so many multinationals operating across borders, tax authorities in each country are becoming increasingly

attentive to the level of taxes that multinationals pay in each jurisdiction, corresponding to the economic activity in each country.

This means that these firms have to charge arm's length amounts in transactions between related persons, respecting the arm's length objectives as defined by the Organisation for Economic Co-operation and Development (OECD, 1995). Otherwise, multinationals could artificially changeover earnings from a high-tax country to a low-tax country by changing the prices of goods and services between related persons.

The International Transfer Pricing Rules, published by the OECD, set out three rules that a deal must meet in order to decrease under transfer pricing values:

- Existence of a cross-border transaction;
- The transaction is between two related entities;
- The transaction must relate to a good, a service or anything of economic value.

The international principle accepted by OECD affiliate states and other countries for determining transfer prices is the "arm's length principle". It is exposed in Article 9(9). (1) of the OECD Model Convention:

Where two undertakings are linked in their economical partnership by agreed terms or conditions or by charges which vary from the above mentioned which would have been agreed among independent undertakings, revenue which, but for those terms or surroundings, would have been built by one of the undertakings, but could not in fact have been made by reason of those terms or conditions, may be comprehended in the assets of that undertaking and charged consequently (OECD, 2008).

The arm's length rule is based on the premise that, in uncontrolled transactions, it is market forces that shape the conditions and terms of the transaction, reflecting the correct price. In controlled transactions, it is the control of ownership that dictates the price. The arm's length principle seeks to eliminate the effect of common ownership on price by requiring the parties to trade as independent parties, who are at arm's length from each other, rather than as closely related parties (Balan, 2004).

Often, however, market conditions cannot be fully captured because transactions of a related person nature may not be concluded if they were independent companies, and this is because of the very subject matter of the transaction.

Transfer pricing can influence the profitability of the affiliated company, its cash flow, the performance indicators of that company and the group's investment decisions or business model.

There are situations where these prices deviate from the market value principle, as intra-group pricing is a way for group companies to reallocate profits or losses according to centrally determined policies. Such profit reallocations have a direct impact on the tax position in each country in which the group in question operates through its subsidiaries (Botezatu, 2019).

In practice, a profit manipulation operation through transfer pricing would have the following structure:

- A taxpayer C in a jurisdiction pays more than necessary on a purchase from parent company M.
- At the same time, taxpayer C receives inadequate compensation for a good supplied to parent company M.

Taxpayer C, however, is located in a jurisdiction with a high tax rate, while the parent company is located in a jurisdiction with a lower tax rate. It is clearly to the benefit of the multinational group as a whole to direct its profits to places where they are taxed less. From the point of view of the host country of taxpayer C, however, this represents a tax loss by taxing less of the profits that were earned in its territory and which, by virtue of tax sovereignty, it was entitled to tax.

Internationally, these repeated practices by multinational companies have led to efforts to define and regulate the phenomenon. The leading international document on this issue is the "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators", issued by the OECD in 1995. It has had three additions since then: in 1996 a chapter on industrial property, in 1997 a chapter on intra-group services, and in 1999 a chapter on cost contribution arrangements (cost contribution arrangements - these are unincorporated forms of collaboration based on a contract, whereby the parties assume risks and obligations of participation in exchange for the right to exploit the outcome of that contract; they are usually used in research and development).

But these OECD Guidelines are not a convention. They are intended as a practical guide rather than a set of strict rules. The very name of the Guidelines underlines the fact that the OECD has left it up to countries to incorporate them into national legislation.

The Directives are largely based on the "OECD Model Double Taxation Convention", a convention adopted by most of the world's countries as a model for their bilateral double taxation treaties.

Transfer pricing is a relatively new phenomenon in Romania. It was first reported by Prime Minister Adrian Năstase in 2002. According to the Prime Minister, steps were needed to ensure that taxes and corporate taxes in Romania are not only levied on SMEs (Balan, 2004).

It should be noted that immediately after these observations, the Corporate Income Tax Law (Law 414/2002) was adopted, which provided, for the first time in national legislation, for the regulation of the market price in transactions between associated enterprises.

## 3. Research methodology

In this article we will analyse national and international information on the transfer pricing dossier. In this respect, in order to achieve the main objective, i.e. the comparative analysis of the legislative provisions on the transfer pricing file, we will use the comparative method of the legislative texts and the information available at international level.

The qualitative method will be the basis for the analysis of the transfer pricing file and after which we will formulate relevant conclusions and come up with recommendations and assessments for the adaptation of the autochthonous legislation in terms of possible improvements in the way the transfer pricing file is analysed. These proposals can be easily implemented thanks to the countless examples found in the literature, both practical and theoretical. This can bring additional clarifications to the legislation already existing in Romania as well as practically, through the methods applied for the analysis of the transfer pricing file abroad.

## 4. Findings

### 4.1. Importance of transfer pricing

In today's background of business internationalisation, where more than 60 percent of global trade in services and raw materials takes place between entities of the identical association, transfer pricing is the last update.

Transfer pricing turn into an progresively important issue for multinationals operating in Romania. Intra-group transaction pricing policy can take essential consequence on tax costs (penalties, double taxation) as well as on the benefits and competing improvement entities of all sizes with international activities.

Transfer prices are these prices debited in intra-group affairs and must normally reproduced the market rate of the raw materials or services being interchanged, i.e. they should be conducted under the similar auspices as affairs between independent people. And up to know, in many cases, prices charged between related persons (Fiscal code) diverge against the market value asumption, adopting alike fees, allowing them to distribute their revenue or losses like to the principles followed centrally, with a explicit impact on the fiscal environment of each country. Furthermore, tax advisor bord have an interest in the taxation of real income earned by local entities from transactions with their related persons, with the legitimacy to make adjustments where payments in intra-group affairs do not follow the market value rule.

In recent years, Romanian transfer pricing legislation has undergone continuous development and is now aligned with the Organisation for Economic Cooperation and Development (OECD) transfer pricing rules and European Union (EU) standards regarding documentation requirements. Recently, the content of the transfer pricing file to be prepared by Romanian residents go through transactions with associated persons has been approved. It is interesting to note that the file must contain, among other things, information on transactions between all related persons within the EU, even if the Romanian taxpayer is not a direct party (Luca, 2008).

Transfer pricing is not an exact science. Therefore, whenever someone tries to regulate the market price of a good or service, using different methods, they will always obtain a spectrum of amount within which the prices charged in intra-group transactions will drop.

In theory, the expenses used in intra-group concerns are a simple and convenient way for companies in a group to reallocate profits or losses according to centrally pursued objectives. If group companies are located in different countries, then group decisions can influence the tax position in each country where the group operates (PriceWaterHuseCoopers).

It is important that each company involved in related party transactions is able to document that the transfer prices charged are at market value.

### 4.2. International transfer pricing rules

Repeated transfer pricing practices by transnational corporations have led to efforts to define and regulate the phenomenon. As early as 1979, the OECD produced a opinion on the transfer pricing instrument used by international companies and in 1995 it thought up advices on transfer pricing for both tax administrations and transnational companies.

It is not only the OECD that is concerned about transfer pricing. The EU Commission has also become active in the area of transfer pricing. As such, the Commission has set up a Joint Transfer Pricing Forum and an Arbitration Convention, just two examples of the Commission's continued and sustained effort in this area. The latest actions are the Code of Conduct (EU Code 2005) on transfer pricing evidence for affiliated persons in the European Union and the Commission's proposal on implementing methods for leading pricing accord. The Code of Conduct is a position paper, which was endorsed in the Council of the European Union in June 2006 and is awaiting ratification by each Member State, proposing a template for standardized documentation for related companies operating in the European area. The stated aim is to minimize companies' efforts in preparing transfer pricing documentation and to simplify the task of tax inspectors who will check intra-group transactions.

The argument of transfer pricing is grow into more and more crucial in the globalised economy, as many firms develop their economic activity apart from their home country borders, trading goods and services between the group. The OECD's recommended transfer pricing rules set out the following requirements that a commercial buying must feet in order to fall under transfer pricing rules:

- the presence of a cross-border transaction;
- the agreement is between two related legal entity;
- the commercial contract concerns a good, service.

As transfer pricing can keep goals other than cost evasion, tax advisory board should not naturally consider that cross-border firms are undertaking to shape the revenue, specially as in some situations it is very challenging to determine the market price precisely. The OECD's Committee on Fiscal Affairs created a determined regulations to decrease the risk of misconception or abuse of the tariff of certain affairs within companies, building the so-called arm's length principle. The OECD Model Tax Convention clarifying the meaning of this principle: where circumstances exist or are prescribed between the commercial and financial relationships between two similar firms which differ from those which would have been made between independent firms, then any earnings which would be made by one of the firms in the hooky of these surroundings may be comprehended in the payable profits of that firm and taxed correspondingly (OCDE, 2010). This attempts to adjust collective revenue by relating intra-group affairs to the rules that would have governed relationships among independent firms in equal transactions. The arm's length principle puts associated and independent firms on an equal foothold in terms of tax, escaping the formation of advantages and disadvantages that could mangle the ambitious position of each category of entity. The application of the principle has demonstrated adequate in positions where correlations can be made with equal transactions betwixt other independent entities. There are many positions where the application of this doctrine is laborious: for example, in the case of worldwide groups active in the manufacture of highly specialised goods.

Paragraph 2.1 of the OECD Guidelines lists traditional methods of transaction analysis and transactional methods as possible methods of calculating transfer prices. According to paragraph 2.2 of the OECD Guidelines, the picking of a transfer pricing approach is constantly aimed at discovering

the most convenient method for a particular cross-border intra-group transaction. The most fitting method is the one that reckon all the strengths and weaknesses of the methods recognised by the OECD (OCDE, 2010).

To determine the most appropriate method, the OECD Guidelines recommend that taxpayers consider;

- Availability of reliable information;
- The scale of analogy between transactions between related parties and transactions between independent parties; and
- The correctness of corelations improvement that may be necessary to eliminate material discrepancy among them.

The methods for pining down transfer prices established on transaction study are: (OCDE, 2010)

The Comparable Uncontrolled Price (CUP) method is gleaned from comparing the payment of the purchase under consideration with the payment charged by other autonomous entities of the transaction when same products or services are sold.

For the transmission of goods, products, commodities or services between related entities, the market rate is that expense which would have been stated by independent entities down circumstances prevailing in commercially proportionate markets for the transmission of identical or similar goods or commodities, in equipollent quantities, at the same point in the manufacturing and sharing chain and under proportionate delivery or payment terms. In this respect, the following may be used to establish market value:

- analogy of payment agreed between connected entities with prices planed between self-reliant entities for same transactions (internal price comparison);
- analogy of payment agreed between connected entities for equal affairs (external price comparison).

The Resale Price (RP) method whereby the market payment is settled as stated by the resale amount of manufactures and services to self-reliant entities less marketing expenses and a profit quota.

This technique is enforced in accordance with the amount at which a produce botched from an affiliated person is resold to an autonomous entity. This amount is then shortened by a corresponding gross margin characterizing the amount from which the last seller in the group will attempt to cover its selling and other operating expenses on a transaction basis and make a corresponding benefit.

Following points should be borne in mind:

- circumstances relating to the time period betwixt original asset and resale, along with those relating to market changes in expenditure, swap rates and inflation;
- circumstances relating the condition and degree of wear and tear of the furnishings which are the subject of the transaction, counting adjustments brought about by mechanical progress in a field;
- the absolute right of the reseller to hawk assured goods or rights which could effect the decision on a amount margin change.

The cost-plus approach (Cost Plus - C+) is based, for the determination of the normal market price, on increasing the main amount by a rate of earnings comparable to the taxpayer's field of movement. The starting point is the costs of the producer or service income producer.

Where goods or services are relocated over a larger number of related entities, this method is to be applied separately for each stage, taking into account the specific role and activities of each related company.

Methods established on profit analysis are (OCDE, 2010).

The Profit Split (PS) method involves adjusting the net earning margin earned by a man on one or more affairs with related entities and estimating that margin established on the matched earned by the similar person on agreements with independent entities or on the limit earned on equal activities by self-reliant entities.

This approach involves comparing certain financial indicators obtained by affiliated organisations with the similar index obtained by autonomous organisations engaged in the same field.

The Transactional Net Margin (TNMM) method is used when affairs between affiliated organisations are so intertwined that it is not desirable to identify proportionate transactions (OCDE, 2010).

This manner involves estimating the profit earned by the connected organisations from one or more transactions and dividing these profits betwixt the affiliated organisations in dimension to the earnings that would have been earned by the autonomous organisations. Profit sharing must be achieved by an convenient estimate of the revenue realised and the amount incurred as a result of one or more sales by each organisation. Profits should be common so as to show the activities accomplished, risks simulated and belongings used by each of the related parties.

Aiming to determine the higher fitting transfer pricing method, the following elements shall in principle be taken into account:

- the method which higher closely approximates the assets in which freely competitive prices are established in commercially comparable markets;
- the method for which information relating to the actual activity carried out by affiliated organisations convoluted in agreements subject to open match is available;
- the degree of rigor with which adjustments can be made to bring about analogy;
- the circumstances of the particular case;
- the actions actually committed by the different affiliated entities;
- the approach used requisite correspond to the given market chances; and
- the taxpayer's business;
- the documentation which can be made available by the resident.

The means of the personal case to hold taken into account in examining the market price are: the category, condition, condition and degree of oddity of the goods, commodities and services transferred; the market surroundings in which the goods, commodities or services are used, involved, treated, handled or sold to separate organisation; the activities carried out and the phases in the production and distribution chain of the entities mulled; the provisions have in the transfer contracts relating to agreements, payment terms, deductions, guarantees granted, assumption of risk; the special circumstances of competition.

Where proportionate undisciplined transactions can be dogged, the price comparison method is the most explicit and continuous way of applying the arm's length principle. Tax governments in most countries also find the cost comparison method to be the most viable way of pricing sales between linked organisations. The use of debatable profit methods must be limited to notable situations where data are not available or insufficient to practice one of the classical transfer pricing methods. Until the US reform, there was international consensus on transfer pricing rules. On the one hand, OECD recommendations are relatively faithfully applied by OECD member countries, with the exception of the US, with indirect regulatory power and contributing to the harmonisation of international practices in this area. On the other hand, the US transfer pricing reform has provoked reactions among OECD member countries, which have had to adapt their regulatory framework to the new data, moving closer (Australia, Canada, New Zealand) or further away from the US model (Japan, France, UK). Under these circumstances, European countries have not reacted in a coordinated manner to the US reform, particularly as regards the APA, so that tax harmonisation in Europe is still a challenge (Nitu, 2003).

"The issue of transfer pricing is a complex one for both tax authorities and multinational companies, as non-compliance with the market value principle can affect the tax burden at group level" (Luciu, 2019). Thus, tax administrations around the world are showing an increasing interest in acting to prevent multinationals from artificially shifting profits from a high-tax country to a low-tax country by changing the prices charged for goods and services transactions between individuals within the same group. In order to solve this problem, the concept that the price of transactions between related persons should be the market price has been introduced at international level, and this concept has also been adopted in Romanian legislation (Condor, 1996).

### 4.3. National transfer pricing rules

In 2002, Romanian regulations containing references to analogous parties and transfer pricing were advertised for the first time, as a first stride towards adjusting Romanian legislation with foreign rules (Law 414, 2002). In 2003-2004, the EBRD assessed the Romanian legislation on corporate governance against the *Principles of Corporate Governance* published by the OECD, the result showing that the Romanian regulations in this area has a small level of consent with the OECD. Among the major problems identified in this assessment were insufficient regulation of related party transactions and the lack of specific approval procedures for larger transactions (Tiron Tudor, 2019).

In Romania, the issue of transfer pricing has been addressed with more interest since 2004 with the introduction of transfer pricing methods in the Tax Code.

The recommended methods to be applied for recalculating the price of transactions taken from the OECD guide are:

- cost comparison;
- the cost-plus;
- the resale cost;
- any other method recognised in the transfer pricing guidelines issued by the Organisation for Economic Co-operation and Development (Tiron Tudor, 2006).

These were followed by the introduction of the obligation to have a file documenting the prices charged, (Fiscal code) and in 2008 the content of the file is determined by order of the National Tax Administration Agency (Law 222/2008).

In 2010, clarifications were introduced regarding the obligation to submit documentation for transactions between Romanian affiliated entities.

Transfer pricing is a relatively new concept in Romanian law. The market value principle was first introduced in 1994. But the real recognition came only ten years later, in 2004, entering into force of the Tax Code (Law 571/2003).

Currently the transfer pricing legislation is provided by the Tax Code - art. 7 and art.11, the Tax Procedure Code - art. 42 and art. 79, Decision no. 529/2007 on Advance Pricing Agreements and Advance Tax Solution, Order 222/2008 - Contents of the transfer pricing file.

At present, the vast majority of Romanian organisations do not have solid, standardised documentation on transfer pricing. Just entities that are part of international associations have some elements of transfer pricing documentation. In the absence of methodological rules, the OECD guidelines should form the basis for the improvement of standard transfer pricing documentation.

The National Tax Administration Agency, concerned with improving tax control activity, has developed a transfer pricing control guide for tax inspectors, on the recommendation of the Directorate-General for Taxation of the European Commission.

In this regard, Dutch experts, beneficiaries of the "AMADEUS" database, which contains standardized information on more than 7 million taxpayers in Europe (including 450,000 in Romania), have provided ANAF with a list of 350 large Romanian taxpayers at high risk of transfer pricing problems. A trial version of this database has also been made available to ANAF to analyse the possibilities for use in risk analysis (Tiron Tudor, 2006).

The O.G. no.35/2006 makes it compulsory for taxpayers who carry out transactions with connected people to draw up a Transfer Pricing File; the file must be submitted at the demand of the adequate tax authority, within the limit set by the latter. The fulfilled of the transfer pricing case will be approved by form of the President of the National Tax Administration Agency.

According to Article 11 of the Tax Code "in a transaction between Romanian persons and related non-resident persons, as well as between related Romanian persons, the tax authorities may adjust the amount of income or expenditure of either person to reflect the market price of the goods or services provided in the transaction". It systematically sets out the explanation of connected people, the market value principle and the approach for define transfer prices.

## 5. Conclusions

Transfer pricing as a whole is not a properly rules like all the other fiscal rules and therefore relies on the professional judgement of company specialists on the flip side, and the professional judgement of tax authorities on the other, to provide full cooperation and understanding of the situation in which a company conducts related party transactions, with the ultimate aim of providing a fair assessment of whether the transfer prices charged in these transactions are in line with the market value principle.

Transfer pricing is both convenience and a threat, and its impact on the business of related parties is compelling. Tackling such a broad area can gain companies through useful asset such as knowledge of related party transactions and identification of opportunities to allocate income and expenses, in-depth understanding of the business model and optimisation possibilities that might otherwise be overlooked.

In my view, the transfer pricing regime is the high point of creativity in tax law, as it is the linking element between tax rules in different national markets. The big problem, however, is not the transfer of capital between jurisdictions, but the particular prices and conditions under which these transactions are carried out. Transfers often do not comply with the free market principle, thus distorting the tax base and consequently the taxes due. Such transactions trigger the intervention of the tax authorities, which may review the transactions in order to determine the fair taxes that should be payable by each State.

In conclusion, it can be said that transfer pricing is not only a complex and sensitive area, but also a dynamic one, which is continually updated by the competent bodies in order to keep pace with the changing realities of the globalised economy and to eliminate the negative effects that its intrinsic characteristics can have on society as a whole.

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