Transfer Pricing in the European Union Context

Laurențiu-Mihai Tănase
Irene-Ioana Drăghici
The Bucharest University of Economic Studies, Romania
laurentiu.tanase95@yahoo.com
draghiciirene17@stud.ase.ro
Norina Popovici
"Ovidius" University of Constanta, Faculty of Economic Sciences, Romania
norinapopovici@yahoo.com

Abstract

The practice of transfer pricing for the purpose of fiscal optimization has become the center of attention in recent years due to the negative impact it has on the tax base, the state budget and competition.

In this paper, we analyzed the functioning of transfer prices from two points of view, the value of fiscal optimization and the value of the market.

The purpose was to determine the key indicators that address transfer prices in order to optimize the tax to come up with recommendations that could inhibit this practice.

The results of the paper showed that the indicators are sales revenue, tax level and profit. So, the proposed recommendations considered the three indicators and the main recommendation regarding the profit involves the taxation of profit at the level of the value that would be realized under the conditions of the sale at the market price.

Key words: transfer pricing, multinational companies, profit shifting, European Union
J.E.L. classification: H26, H32, F23

1. Introduction

Transfer pricing is a frequently discussed topic in the field of international trade and even global economics. With the increase in the volume of trade and the growth of economic activities on a global scale, the European Union (EU) has designed a multi-faceted regulatory framework to address the inherent complexities of this field.

Transfer pricing involves the valuation of transactions between related enterprises, which may belong to the same corporate group or be controlled by a common entity. Although these transactions may apparently take place in a competitive and transparent manner on the open market, there are instances where such arrangements are deliberately structured to allocate profits or losses within the corporate group for tax optimization purposes.

Transparency and the reduction of tax evasion are identified, at least in recent years, as essential objectives within the European Union, considering that such practices can directly influence the tax revenues of the member states and can generate unfair competition on the market. As a result, the EU has established a series of specialized directives and regulations aimed at tackling this issue cohesively and uniformly across all member states.

The latest intention to tackle transfer pricing for tax optimization purposes is the new OECD/G20 tax reform plan based on two pillars which seeks to establish a global minimum tax of 15% and reallocate a part of the residual profits of multinational companies to the country where it was made.

Given these intentions regarding the reform of the tax system, in this paper we will examine precisely the concept of transfer pricing in the EU and investigate the reasoning behind the use of these tactics by multinational companies.

This paper is a part of a larger research through which we aimed to determine the impact that the implementation of the new tax reform plan will have on the member states of the European Union.

In this sense, by understanding how the practice of transfer pricing works for the purpose of fiscal optimization, we will be able to monitor whether the implementation of the new reform plan will produce changes in the way that transfer pricing is used.

2. Literature review

Transfer pricing is the price at which goods, services or intellectual property are traded between economically related entities, such as subsidiaries or branches that are part of the same group of companies but operate in separate jurisdictions (Bastin, 2014).

The practice of transfer pricing is closely related to globalization and international trade. The genesis of this practice being found itself when these two variables took off (Hajnikova, 2017).

The correct way to practice transfer pricing is to establish an appropriate valuation of commercial transactions between these related entities, thus ensuring fair conditions similar to those that would have been concluded between independent entities, in a free and competitive market.

Also, correctly applied transfer pricing ensures the proper management of international taxation, having the role of allocating profits in a fair way and in accordance with international tax principles. In this context, transfer pricing regulations aim to prevent the artificial transfer of profits between related entities, so as to ensure adequate taxation of their income and economic activities in the countries in which they operate (Rakovsky, 2018).

In reality, many multinational companies shift their profits to jurisdictions with a preferential tax regime in order to reduce their tax burden in certain states that represent profitable markets for these companies but practice high tax rates (Supukovic, 2021).

Practice of transfer pricing for the purpose of fiscal optimization by multinational companies can have several negative consequences. One of these is related to the decrease in tax revenues of the host country, which could cause tensions between governments and corporations (Solilova et al, 2013).

Improper transfer pricing erodes a country's tax base by understating revenues and overstating costs, leading to an inequitable distribution of the tax burden between companies and citizens, affecting the efficiency of the country's tax system.

Improper transfer pricing practices also affect trade flows and foreign direct investment within a state. Multinational companies that use transfer pricing in this way gain competitive advantages that have a negative impact on other companies, especially local ones.

3. Research methodology

In this paper we propose to examine the way in which transfer pricing is used with the aim of fiscal optimization. So, we propose a descriptive research through which to compile a complete description of the transfer pricing phenomenon.

In this way, we will create a picture of the situation and observe the characteristics that make up the phenomenon of transfer pricing for tax optimization, without determining aspects related to causality.

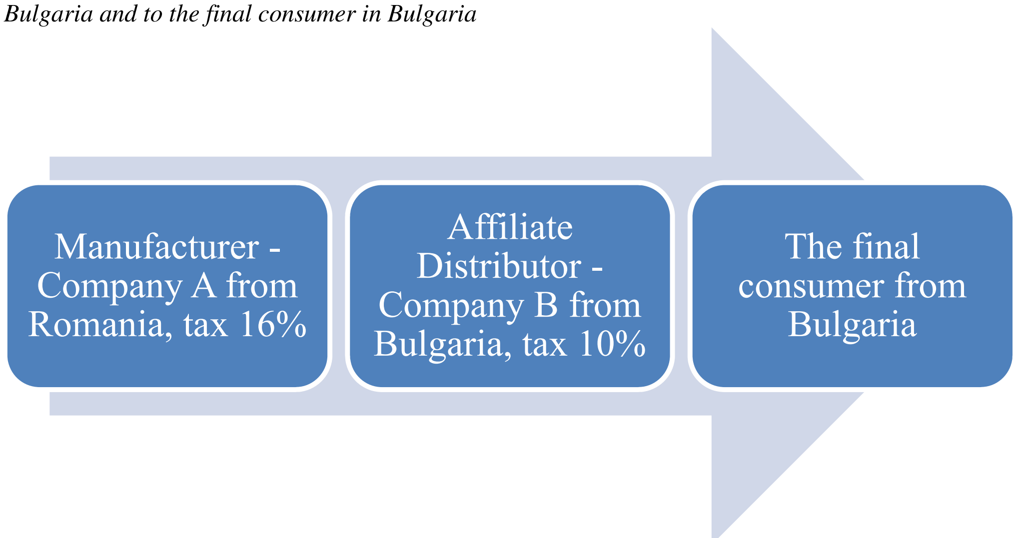
Observing how transfer pricing is used helps determine the stage at which transfer pricing can be used for tax optimization purposes.

4. Findings

In this part we will examine how to use transfer pricing appropriately from the perspective of compliance with the market value principle and inappropriately from the perspective of tax optimization.

Therefore, we will consider company A that manufactures PC systems in Romania, where the tax rate is 16% and sells them to a related company, namely company B in Bulgaria, where the tax rate is 10%. Company B in Bulgaria sells them to the final consumer. The distribution channel is as follows:

Figure no.1. The distribution channel from the manufacturer in Romania, to the affiliated company in Bulgaria and to the final consumer in Bulgaria



Source: own processing

Given the distribution channel in figure 1, there are two possibilities, one of the two involves the practice of transfer prices between the two affiliated companies aimed at fiscal optimization, as follows:

Table no. 1. Transfer pricing practice for fiscal optimization

	Company A **Romania (Euro)**	Company B **Bulgaria (Euro)**	Both **Total (Euro)**
Revenues from the sale of PC systems	800	1000	1800
Production costs	-700	-	-700
Acquisition costs	-	-800	-800
Gross result	100	200	300
Tax	16 (16%)	20 (10%)	36
Net result	84	180	264

Source: own processing

The second possibility is the one in which the practice of transfer prices reflects the market value, as follows:

Table no. 2. Practice of transfer prices at the market value

	Company A **Romania (Euro)**	Company B **Bulgaria (Euro)**	Both **Total (Euro)**
Revenues from the sale of PC systems	900	1000	1900
Production costs	-700	-	-700
Acquisition costs	-	-900	-900
Gross result	200	100	300
Tax	32 (16%)	10 (10%)	42
Net result	168	90	258

Source: own processing

In the framework of the two tables, it can be appreciated that both in the version in which transfer prices are used for tax optimization, and in the one in which the transfer prices reflect the market value, the value of the gross profit remained unchanged.

In the table regarding the practice of transfer prices in order to optimize the tax, the value of the taxes was reduced, increasing the value of the net profit.

5. Conclusions and recommendations

Transfer pricing for tax optimization involves selling a product at a lower price to a related party located in a jurisdiction with low taxes. In this context, the level of gross profit remains the same, but the amount of tax is reduced and the amount of net profit is increased.

Whereas, market value transfer pricing generates the same gross profit, but increases the value of the due taxes indicator and decreases the value of the net profit indicator.

According to the operation of the transfer pricing practice, there could be three directions of regulation that could inhibit the practice. One of them considers the price of products sold to the related party, the second considers the tax and the third considers the profit.

Regulations in the direction of selling prices to related parties could be effective but at the same time could affect the degree of market liberalization. These regulations would require a price range for each product category at which it could be sold to the related party.

In terms of tax, what is being tried now through the new global tax reform plan proposed within the OECD/G20 framework, is definitely the establishment of a global minimum tax. In this way, in any state the company would operate, the budget forecasts can take into account that minimum of 15% and thus the practice of transfer prices for fiscal optimization could not significantly affect the tax base and the state budget.

In the direction of profit, which is also taken into account by the new global taxation reform plan proposed within the OECD/G20 framework, several measures could be taken into account.

In the framework of the reform plan, it was intended to reallocate a part of the residual profit made by the company in the country where it carried out its activity.

Another measure could be taken in the case of multinational corporations that register a significant turnover, namely the taxation applied to the level of profit that could be achieved under the conditions of sale at the level of market prices, be it set at a minimum level. In this way, whether the company uses transfer prices for fiscal optimization or other practices that have in mind the reallocation of profit, their taxation will take into account the minimum profit that would be made following the sale at the correct price, in relation to the market.

6. References

- Bastin, L., 2014. Transfer Pricing and the WTO. *Journal of World Trade*, 48(1), pp. 59-80. https://doi.org/10.54648/trad2014003.
- Hajnikova, T., 2017. Transfer Pricing as a Consequence of Globalisation Processes. *International Scientific Conference for Doctoral Students and Post-Doctoral Scholars (EDAMBA 2017)*, Bratislava, pp. 132-140.
- Rakovsky, P., 2018. Impact of Globalization on the Transfer Pricing After BEPS. *Globalization and Its Socio-Economic Consequences*, Rajecke Teplice, pp. 1787-1793.
- Solilova, V. & Nerudova, D., 2013. Transfer Pricing: General Model for Tax Planning. *Ekonomicky Casopis*, 61(6), pp. 597-617.
- Supukovic, V., 2021. Influence of Transfer Prices on Tax Evasion. *Casopis Za Ekonomiju I Trzisne Komunikacije*, 42(1), pp. 227-239. https://doi.org/10.7251/EMC2101227S.