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Transfer Prices Report. Case Study in Romania

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Abstract

The current paperwork comprises information about transfer pricing practices in Romania and documentation of the transfer pricing report. It consists of a step by step functional and economic analysis of a transaction carried out between two affiliated parties that activate within building materials sector. To conduct such analysis, commercial databases were used which offered information on comparable transactions.

Key words: transfer pricing, functions, risks, operating profit margin
J.E.L. classification: H25

1. Introduction

According to the law, the transfer pricing report is the necessary document for documenting compliance with the market value principle of transfer prices charged in transactions with related persons. (Order no.442/2016, 2016, p.1)

It was introduced in the tax legislation in 2008, and since 2016, depending on certain thresholds, large taxpayers are required to prepare an annual transfer pricing report, while SME taxpayers prepare such reports only by request of tax inspectors.

The importance of the transfer pricing report has increased as the super-transparency directives came into force in 2018, country-by-country reporting "CbC" (EU Directive 2016/881, 2016, p.3), and starting with 2020, reporting of reportable cross-border arrangements – DAC6 (European Parliament, 2018, Article 3(b) 18). Basically, the tax administration has now direct access to a detailed package of information that allows to query the taxpayer on intra-group/inter-affiliate transactions in a targeted manner. And the relevant taxpayer (European Parliament, 2018, Article 3(b) 22) will have to respond with even more substantiated, documented explanations. This response refers to transfer pricing report.

Since 2021, direct tax inspections not only verify the correct allocation of profit through transfer pricing, but also the correct reporting of tax transactions/arrangements leading to this allocation. Where the relevant taxpayer/intermediary believes that reporting would not be required, the national authorities will want to satisfy themselves that reporting was not indeed required. This is not necessarily worse news for taxpayers who already knew that their transactions with affiliates were and inevitably will be taken very seriously.

In short, an incomplete or not thoroughly substantiated transfer pricing file will be an invitation for the tax inspector not only to adjust transfer prices, not only to penalize non-reporting, but even to question the entire business model of the company/group.

2. Theoretical background

Transfer prices are considered regulated prices: related parties can only enter a transaction (no matter the type - transfer of goods, services, intellectual property rights, etc.) if the "arm's length principle" is respected (OECD, 2018, p.29). Hence, sales or purchases of goods or services between subunits of a company can be measured by using their transfer price as an instrument (Cools, 2014, p.14). This means that prices agreed between affiliates must be like prices at which similar transactions are concluded between independent persons. This means comparability (benchmarking), the centre piece of the transfer prices case, as they only apply to controlled transactions (Kramarova, 2021, p.4).

Tax administrations now have specialised (and increasingly informed) transfer pricing "tracking" departments, which are guided by a simple principle: when a company has not provided conclusive evidence that the price of a transaction with a related party is market-based, the tax inspector has reservations that company's financial result (profit/loss) is the "real" one. In this case, price adjustments will be made, which will lead to a change in the financial result and thus a change in the company's tax position. Hence, companies in such cases use tax avoidance practices, which are considered to be higher in cases where related party transactions are numerous (Park, 2018, p.2; Hieranti et al., 2019, p.373).

This can lead undesirable situations where trading groups have the same taxed profit in two different jurisdictions where the group operates. This is known as double taxation and is the classic subject of transfer pricing disputes.

But transfer pricing affects not only profitability and therefore the tax due, but also the cash flow, the group’s investment decisions, the business model, the performance indicators of the company concerned. Division managers of multinational companies can guide their decisions to maximise profits by using models which can offer information about the optimal transfer prices (Gao et al., 2015, p.349). That is why the necessity to reevaluate and redesign group’s transfer prices policies arises, as they can better reflect intra-group transactions (Munteanu et al., 2019, p.4).

Moreover, transfer pricing can also have a significant impact on the customs value of goods. When transfer prices have been determined by applying a method not accepted by the customs authorities, a new customs value is calculated and the importer must pay additional customs duties, together with interest and penalties.

In Romania, first law regulating transfer prices was adopted in 2002 (Ignat I, 2029, p.756). Large taxpayers are required to prepare an annual transfer pricing file if they carry out annual transactions with all related persons in an amount greater than or equal to any of the following materiality thresholds, excluding VAT (Order no.442/2016, 2016, p.1):

- ✓ EUR 200,000 in the case of interest received/paid for financial services;
- ✓ EUR 250,000 in the case of services received/provided;
- ✓ EUR 350,000 excluding VAT in the case of transactions relating to purchases/sales of tangible or intangible goods.

The report must be prepared only at the request of the tax authorities, by large taxpayers who do not fall into the above category and small and medium-sized taxpayers who carry out transactions with related persons annually in an amount greater than or equal to any of the following thresholds, excluding VAT (Order no.442/2016, 2016, p.2):

- ✓ EUR 50,000 in the case of interest received/paid for financial services;
- ✓ EUR 50,000 in the case of services received/provided;
- ✓ EUR 100,000 in the case of transactions relating to purchases/sales of tangible or intangible goods.

Taxpayers who do not fall into any of the above categories are not required to prepare a transfer pricing report - they document compliance with the market value principle during a tax inspection, in accordance with the general rules laid down by the financial accounting and tax regulations in force.

The transfer pricing report is not requested to taxpayer/payer beneficiary of an advance pricing agreement, for transactions and periods covered by the advance pricing agreement issued by the Romanian National Tax Administration Agency or for transactions for which a decision on adjustment/estimate of income or expenditure of one of the related persons has been issued.

There are four main steps to complete a report:

1. drawing up the descriptive sections - general information about the group and the local company (financial information, main customers and competitors, business strategy, legal structure, etc.);

2. preparation of the functional analysis - identification of the functions the company performs, the risks it takes and the assets it uses as part of its operational activity;
3. description of all types of transactions between the company and related persons - value, contractual terms, economic context, etc.
4. economic analysis - the specific part of a transfer pricing report, involving the selection of the most appropriate pricing method according to the specifics of each transaction and the application of this method to test compliance with the market value principle. This stage also involves, with few exceptions, the preparation of comparability/benchmarking studies using specialised databases (Amadeus, TP Catalyst, Orbis, RoyaltyStat, etc.).

3. Research methodology

Assume that company XYZ and company ABC are affiliated companies and during 2019-2021 the company XYZ sold deliverables to the company XYZ. This transaction being one between affiliated companies should be included in the transfer pricing report.

During 2019-2021 ABC sold deliverables (resulting from the production process) to the affiliated company XYZ.

ABC sold to affiliated companies various deliverables such as wire, welded mesh, and metal pipes. Total sales of deliverables are shown in Table no.1.

Table no. 1 Transaction value of sales of deliverables between 2019-2021

Company name	**Transaction value**		
	2021	**2020**	**2019**
XYZ	109.700.000	77.000.000	70.460.000

Source: Own design based on calculations.

The pricing methodology, the functions performed, the risks assumed, and the assets used in this transaction are presented in section 4.

The intra-group transaction under analysis generally concerns the sale of deliverables, obtained by ABC from its production activity to XYZ, which resells the purchased products to independent customers.

As mentioned above, functional analysis is generally defined as a process of identifying the components of a transaction that contribute to revenue.

In the case of agreements between two independent companies, remuneration is paid for the functions performed, the assets used, and the risks assumed by each company. Therefore, to determine whether transactions between two related companies are comparable to transactions between two independent trading companies, or whether related companies or independent trading companies are comparable, a comparison of the functions performed, risks assumed, and assets used by each participating company in intra-group transactions is required.

In the following, the functions performed are presented, the risks assumed as well as the assets used by ABC in its relationship with the affiliated company in the process of selling goods.

To identify these functions and risks, we looked at the entire trade flow, starting from the purchase of raw materials, their use in the production process alongside other raw materials, and then the sale of deliverables to affiliated companies.

Consequently, we conducted an initial search for all companies with specific CAEN codes, as table no.2 shows. Hence, we first filtered our search. This filter is essential for the relevance of our study and to identify companies as close as possible to the functional profile of ABC. We used TP Catalyst and Amadeus commercial databases.

Table no. 000000000000000002 Accepted NACE codes

NACE Rev. 2 code	**Description NACE Rev. 2 code**
2433	Production of cold-formed profiles
2593	Manufacture of articles of metal wire; manufacture of chains and springs

Source: Own design

Following the application of various selection criteria, we obtained a set of six generally comparable independent companies. Table no.3 below provides information on the companies accepted for analysis. Selection criteria refers to:

- ✓ only active companies;
- ✓ only companies located in Romania;
- ✓ only companies that do not prepare consolidated financial statements;
- ✓ only independent companies (using Bvd independence indicator provided by Amadeus);
- ✓ only companies that own less than 25% of share capital in subsidies;
- ✓ only companies that registered profit in the observed period.
- ✓

Table no. 3 Description of the activity of accepted companies.

Company name	NACE Code	Location	Activity description
Comp_1	2433	BRAȘOV	The company manufactures various products such as roofing sheets, rainwater systems, etc.
Comp_2	2593	BECLEAN	The company manufactures galvanized edged fence panels, galvanized wire mesh, galvanized welded mesh, hexagonal mesh wire mesh, etc.
Comp_3	2593	GALATI	The company produces wire mesh.
Comp_4	2433	BUFTEA	The company produces various metal sheets and profiles.
Comp_5	2593	SANMARG HITA	The company produces braided netting, welded galvanized wire mesh, edged fence panels, barbed wire, fence posts and other wire products.
Comp_6	2593	VALEA ADANCA	The company processes wire and various ferrous materials

Source: Own design

4. Findings

4.1. Functions performed and risks assumed

The functions performed by ABC and XYZ, to which ferrous materials were sold, include:

- Negotiation function;
- Production function
- Storage function;
- Selling function;
- Transport function;

We detail below the functions performed by ABC in transactions with affiliated companies.

- ➢ *Negotiation function*

The negotiation function is part of the whole production process, involving the responsibility of the procurement officer to negotiate payment terms and contract conditions.

Thus, this function consists of direct contact with suppliers of materials and goods as well as with the company's customers and potential customers, and the continuous maintenance of a good commercial relationship with them. ABC is responsible for negotiating contractual conditions and concluding contracts for the purchase of various products and raw materials/sales of deliverables.

Therefore, the negotiating function carried out by ABC plays a very important role, since the policy followed by the company is aimed at finding the best price, under the most favourable conditions, which will allow the company to achieve its proposed sales objectives. As such, it can be interpreted that this function is performed to a large extent by ABC and to a lesser extent by XYZ (which in turn applies the same negotiation policy - best price on the market).

- ➢ *Production function*

The production function is the link between the combination of resources used and the level of output that can be achieved using a particular type of technological process. In the case of ABC company, production is carried out with the help of specialised machinery and human resources responsible for performing specific tasks. Thus, ABC is responsible for this function.

- *Storage function*

ABC orders the quantity of raw material according to its production estimates, orders, and the evolution of certain consumption indices on the Romanian market.

Production and storage are carried out in several specially designed and equipped warehouses. The goods, once prepared for delivery/dispatch, are stored in specially equipped storage areas or in the company's inner yard. Both the warehouses and the rest of the company's property are supervised by security guards employed by ABC and by the surveillance cameras provided. As such, it can be interpreted that this function is performed to a significant extent by ABC.

- *Sales function*

ABC oversees finding customers and managing its sales (its orders to the group are thus influenced by the existing economic situation and market demand). This function is carried out in the sales department by two sales agents, who are responsible for searching the market for customers and maintaining a commercial relationship with them.

- *Transport function*

The transport of the goods to the buyer is carried out either by third parties or with the help of six trucks owned by ABC. Regardless of who performs the shipment, the delivery condition is generally ExWorks. Thus, the cost of transport is borne equally by the buying and selling company. At the same time, the costs associated with insurance are borne by the carrier.

The risks assumed by ABC in transactions with affiliated companies are described below.

Given that ABC is directly and indirectly in charge of finding customers and managing sales, it can be interpreted that, for the sale of deliverables, the *market risk* is borne to a significant extent by ABC and to a limited extent by XYZ.

For manufactured goods, ABC is responsible for stock management, handling, and storage. As such, it can be interpreted that it also bears the *inventory risk*.

ABC, as a production facility, assumes all risks related to the full utilisation of its production capacities. So, it bears the *capacity risk*.

Transport risk is the risk that the goods transported will be damaged or stolen during transport. This risk is borne equally by both the company buying the goods and the company selling them.

Dependence on external suppliers and/or subcontractors is another risk that ABC faces. This risk involves the fact that ABC may be adversely affected because of the inability of affiliated companies to deliver the ordered goods in accordance with the buyer's expectations or requirements (on time, in the required quantity, etc.).

As ABC is constantly in contact with several alternative/secondary suppliers, we could consider this risk to be limited. However, it is fully assumed by ABC, as it is dependent on its suppliers to be able to further distribute goods on the Romanian market. As mentioned above, during the period under review, ABC sold products obtained from its production activity to affiliated companies of the XYZ group.

In the following, we analyse the reasonableness of the prices charged by ABC in relation to producing and selling deliverables to its affiliated companies during the period analysed by applying the net margin method - cost plus method applied to operating costs (TNMM).

4.2. Results of applying the net margin/cost-plus method to the cost/operating margin level

To verify compliance with the market value principle regarding production and sale of deliverables by ABC to XYZ, we searched the Romanian market for generally comparable independent companies with a similar functional profile to that of ABC in its role as a producer of various ferrous materials, sheet metal, wire, metal fittings, etc.

Thus, we used the cost-plus method applied to the level of operational costs, the result being comparable with that obtained by applying the TNMM method on operating profit margin (called NCP) and we proceeded to compare:

- the operating profit margin obtained by ABC from manufacturing and selling deliverables to affiliated companies, with

- the operating profit margin indicator obtained from generally comparable independent companies in Romania with similar activities and similar functional profile to ABC.

The profit margin obtained by ABC from selling deliverables to affiliated companies during the period under review is shown in the table below - Table no.4.

Table no. 4. Profit margins achieved.

Transaction type	NCP (%)		
	2021	2020	2019
Sale of deliverables to affiliated companies	9.00%	5.50%	7.15%

Source: Own design based on calculations

As previously mentioned, after applying various selection criteria, we obtained a set of six generally comparable independent companies whose profitability indicators are presented in the table below - Table no.5.

Table no. 5 NCP resulted from sales of deliverables from the production process.

Company name	2021	2020	2019
Comp_1	31.19%	16.89%	12.97%
Comp_2	8.20%	12.11%	8.41%
Comp_3	7.37%	8.62%	-1.02%
Comp_4	9.70%	10.39%	3.32%
Comp_5	2.26%	7.25%	3.98%
Comp_6	4.39%	3.46%	0.79%

Source: Own processing

Consequently, we designed the interquartile range calculated for these six comparable independent companies. These results made comparisons possible. The minimum, median and maximum values of NCP are presented in Table no.6.

Table no. 6 Interquartile range for sales of deliverables

Description	2021	2020	2019
Minimum	2,26%	3,46%	-1,02%
Quartile 1	5,13%	2,00%	1,42%
Median	**7,79%**	**9,51%**	**3,65%**
Quartile 3	9,33%	11,68%	7,31%
Maximum	31,19%	16,89%	12,97%

Source: Own design based on calculations

The profit margin obtained by ABC from selling deliverables to affiliated companies during the period under review (2019 – 2021) is shown in the table below – Table no.7. As observed, highest NCP was registered in 2021, whilst lowest NCP was registered in 2020. Based on these calculations, we conclude that prices charged by ABC in relation with XYZ are generally in line with the transfer pricing principles applicable in Romania.

Table no. 7 Profit margins obtained by ABC

Transaction type	2021	2020	2019
Sales of deliverables to affiliated companies	9,00%	5,50%	7,15%

Source: Own design based on calculations

Our findings are based on the following results:

- For 2021, the interquartile range varies between 5.13% (quartile 1) and 9.33% (quartile 3), with a median of 7.79%. The operating profit margin (NCP) obtained in 2021 by ABC from selling deliverables to affiliated companies is 9.00%, which falls within the above-mentioned range.
- For 2020, the interquartile range varies between 2.00% (quartile 1) and 11.68% (quartile 3), with a median of 9.51%. The operating profit margin (NCP) obtained in 2020 by ABC from selling deliverables to affiliated companies is 5.50%, which falls within the above-mentioned range.
- For 2019, the interquartile range varies between 1.42% (quartile 1) and 7.31% (quartile 3), with a median of 3.65%. The operating profit margin (NCP) obtained in 2019 by ABC from selling deliverables to affiliated companies is 7.15%, which falls within the above-mentioned range.

5. Conclusions

To carry out an effective economic analysis, all risks, functions, and assets used in a transaction must be carefully analysed to properly categorise the companies involved into functional categories and to find the most relevant comparable. There have been cases in practice where tax authorities have re-focused companies functionally and rejected the comparable presented in the economic analysis.

A full transfer pricing report should be prepared annually by large taxpayers and particular attention should be paid to "artificial" services (e.g., management services) as these are usually challenged for deductibility by the tax authorities.

In view of the above, present paper offers a step by step functional and economic analysis of a transaction carried out between two affiliated parties that activate within building materials sector. Given our findings, the prices practiced by the analysed company in relation to sales of deliverables to its affiliated party are generally in line with the transfer pricing principles applicable in Romania.

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