Specific Elements of Transfer Pricing Analysis

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Abstract

At the present time, taxation mechanisms are becoming more complex. On the one hand, the fiscal authorities are preoccupied with selecting the taxation methods that respect the basic principles and, on the other hand, the companies are interested in finding legal ways to maximize their profits also by optimizing the taxation.

In this context, our paper deals with the issue of transfer pricing by highlighting the specific methods of setting it, in general and, the Price Comparison Method, in particular.

Key words: transfer pricing, price comparison method, OECD, cash-pooling
J.E.L. classification: H25; H30; K34

1. Introduction

Transfer pricing is a current issue. It signifies the prices at which transactions are carried out between companies that are part of the same group (also called affiliated parties). According to the law, the transaction between the affiliated parties must be concluded at market price, in other words, at the price at which a similar transaction between independent parties would have been concluded, in comparable economic conditions. If the price of the transaction between the affiliated parties is not within the "*market range*", it is considered that the profits obtained by the parties following the transaction are not correctly reflected, thus affecting the taxes and fees paid.

The "*transfer pricing*" concept refers to a complex system of laws and practices used by states to ensure that the profit obtained from the intra-group transfer of goods / services / intellectual property rights is recorded and charged in the places where it is obtained. This is a very important aspect, since transfer pricing can increase the profit paid by the group in low tax jurisdictions or, on the contrary, they can decrease the profit, in high tax jurisdictions - the so-called "*tax base erosion and profit shifting*" process (BEPS).

2. Theoretical background

The issue of transfer pricing is based on the market price principle or *arm's length principle* and has been developing since the 1960s in the USA, with the active implementation of new regulations in the fiscal code - Internal Revenue Code.

Based on these, states have claimed the right to challenge transfer pricing and adjust revenues and deductions to prevent tax avoidance or to clearly reflect the income of any economic entity or activity (Malherbe, 2017, p. 126).

Transfer pricing aims to determine the level at which independent / non-affiliated parties would trade goods, services or various financing, compared with the specific conditions and synergies used by multinational companies (Ion, 2019, p. 24).

The increasing extent of fraudulent practices related to value-added tax has compelled the European Union to find solutions for fighting against these using analysis tools of intra-EU trade networks (Dobrescu, 2019).

The interest in the economic value of transfers has highlighted the link between transfer pricing and customs value, as well as the impact of transfer pricing adjustments on customs value (Nag, 2019).

Moreover, from the perspective of transfer pricing, new debates and analyses have emerged regarding the stages and methodology on assigning the profits to a permanent office situated in other tax jurisdictions (Săulescu, 2018).

The networks of subsidiaries with different tax jurisdictions inevitably generate risks related to transfer pricing. National studies have revealed the main risk areas that are frequently encountered by tax authorities (Nag, 2018, p. 20). The risk areas are related to certain financial accounting practices that can be deemed inadequate and risky from a fiscal point of view, namely:

(i) royalties and fees for services provided between affiliated companies; (ii) the inconsistency of the accounting models of results; the substantial variation in the profit margin; (iii) practicing different prices for similar transactions; (iv) practicing high-value transactions with affiliated parties that are tax residents in countries with low tax rates.

These practices create fiscal structures in jurisdictions such as "tax havens", which erode the tax base and shifts profits. This highlighted the need to tackle legal tax evasion through the OECD project to fight the tax base erosion and profit shifting (Base Erosion Profit Shifting-BEPS).

The BEPS project recently launched by the OECD and G20 as an inclusion framework for all tax jurisdictions (OECD / G20 Inclusive Framework on BEPS, 2019) has brought up for discussion benchmarks regarding transfer pricing.

These include the methodologies for setting transfer pricing and the specific elements of financial transactions compared with economic transactions. The project provides indications on how to analyze and document the financial transactions concluded with the affiliated entities, but also on how to accurately delineate the financial transactions, such as treasury activities, loans, cash-pooling arrangements, currency hedging, material guarantees, or captive insurance (Alecu et. al., 2019, p. 12).

Given the specificity of financial transactions, the same authors (Alecu et. al., 2019, p. 15) indicate the usable methods by which it can be proved that transfer pricing is at market price level, namely:

- ✓ The price comparison method - greater attention should be paid to comparability criteria;
- ✓ The expected benefits method - the interest saved by the beneficiary is analyzed as a result of the granted guarantees;
- ✓ The cost-based method - depending on the costs incurred by the company issuing certain guarantees;
- ✓ The expected loss assessment method - depending on the probability that the guarantee will be executed;
- ✓ The capitalization method - depending on the profitability of the additional capital that the given guarantee generates.

In our study on transfer pricing, the Price comparison method will be detailed, which can easily be applied in the case of economic transactions of real flow type versus money flow, i.e., deliveries of goods, works, services on a consolidated market. In contrast, financial transactions are rather intangible, i.e. the type of securities that assign value against the money flow.

3. Research methodology

In the current internationalization of business and globalization context, in which more than 60% of the world trade in goods and services is carried out between companies of the same group, transfer pricing has become the number 1 priority on the fiscal agenda of the financial managers of multinational companies and the main area investigated by the authorities during fiscal controls. All the transactions between affiliated persons, whether of goods or intellectual property rights, provision of services or other types of transactions, fall under the provisions of transfer pricing rules.

In accordance with these rules, transactions between affiliated persons must be carried out in compliance with the market value principle (the so-called "*arm's length principle*"), a principle underlying the entire transfer pricing analysis. The justification of the market value of transfer pricing used in intra-group transactions is done by preparing a specific documentation. The market value principle implies that the prices used in transactions between affiliated persons should be equal to those practiced between independent persons, under similar economic circumstances. Frequently, the prices charged between affiliated persons can deviate from the market value principle. The use of intra-group preferential prices offers to the group the opportunity to redistribute its profits or losses in different jurisdictions according to the objectives pursued at the central level. This phenomenon has a direct impact on the fiscal position in each country in which the group operates through its subsidiaries.

Each tax authority is interested in taxing the real profits obtained by the local subsidiaries from the transactions with the affiliated persons, the authorities having the right to make adjustments when the prices charged in these intra-group transactions do not reflect the market value principle. Such adjustments result in the immediate taxation on the same profit of both companies located in different tax jurisdictions. In the specialized language, this type of taxation is called economic double taxation and is characteristic of disputes regarding transfer pricing.

Transfer pricing can influence not only the profitability of the affiliated persons in terms of the method used for allocating the profits and the tax due respectively, but also the money flow, the investment decisions of the group, the performance indicators of the respective company.

Transfer pricing represents an opportunity, but also a threat, its impact on the business of the affiliated persons being significant. The approach of such a large area can benefit the companies in terms of operational advantages, such as knowing the transactions with affiliated persons and identifying the opportunities for the allocation of revenues and expenses, a deep understanding of the business model and the optimization possibilities, which, under other conditions, could be overlooked.

The financial managers, who will succeed in combining the potential benefits with the management of fiscal risks through this new available instrument - transfer pricing documentation file, will provide the company with a long-term competitive advantage. Therefore, it is necessary not only to review and substantiate the transfer pricing policies at group's level, but also to prepare specific and complete documentation, which can demonstrate the market value of the prices practiced in intra-group transactions.

In order to prepare the transfer pricing documentation file, the following steps must be taken:

- Listing the financial years that can be a subject of fiscal inspection;
- For each year the intra-group transactions and their value must be identified;
- Identification of transactions that need to be documented
  - Conducting the "threshold of ownership" test for each affiliate;
  - Carrying out the cost / benefit analysis, defining the materiality
- Checking the availability, at group level, of the policy and documentation of transfer pricing;
  - If available: Do I obey the national law? Does it cover those transactions? Is it updated?
  - If it is not available, start making the transfer pricing documentation file
- Monitoring the application of the established transfer pricing. Building a transfer pricing policy for future transactions.

The price comparison method consists in comparing the set prices for the transfer of goods or services. Thus, the price related to a transaction between affiliated persons ("controlled transactions" carried out at "controlled prices") is compared with the price related to a transaction between third parties ("uncontrolled transactions" carried out at "uncontrolled prices"). This method can be used especially in cases in which the goods or services that are the object of transactions within a multinational group are also the object of transactions between independent persons.

In practice, uncontrolled prices can be identified in the following two situations, presented below.

- when one of the affiliated parties in the transaction concludes similar transactions with an independent entity, under comparable conditions from a commercial point of view (respectively, in comparable quantities, at the same point in the production and distribution chain and under comparable conditions of delivery and payment) - "internal comparables" (table 1)

Table no. 1 The price comparison method – internal comparable

Seller (affiliated party)	Controlled price	Buyer (affiliated party)
	Uncontrolled price	Buyer (third party)

Source: Own design

- ➢ when third persons trade identical or similar goods or services under comparable conditions with the transactions between affiliated persons - "*external comparables*"

Table no. 2 The price comparison method – external comparable

Seller (affiliated party)	Controlled price	Buyer (affiliated party)
Seller (third party)	Uncontrolled price	Buyer (third party)

Source: Own design

In order to apply the price comparison method, it is necessary for one of the following two conditions to be met: (i) none of the differences (if any) between the compared transactions or between the companies participating in these transactions could have a material effect on the price of the transaction on an open market; or (ii) adjustments can be made with a high degree of accuracy to eliminate the effects of such differences.

4. Case study: drawing up the Transfer pricing documentation file within SENNA SRL company using the *Price comparison method*

The transfer pricing documentation file is the document by means of which each company that carries out transactions with affiliated persons must justify the value of the prices of the respective transactions and demonstrate the compliance with the market price.

The fiscal inspector decides to accept or adjust the transfer pricing practiced by the company based on the information presented in the transfer pricing documentation file.

The structure of a transfer pricing documentation file:

A. Group information:

1. the organizational structure of the group, legal and operational, including the participations, history and financial data related to it;
2. a general description of the group's activity, the business strategy, including the changes in the business strategy compared with the previous fiscal year;
3. a description and implementation of the transfer pricing methodology within the group, if applicable;
4. a general presentation of the transactions between affiliated persons, in the European Union:
    a. the trading mode;
    b. the billing mode;
    c. the transactions' equivalent value;
5. a general description of the functions and risks assumed by the affiliated persons, including the changes made in this respect compared with the previous year;
6. a presentation of the holders of intangible assets, within the group (patent, name, know-how, etc.) and royalties paid or received;
7. a presentation of the price agreements in advance concluded by the taxpayer or by other companies within the group, in relation to it, aside from those issued by the National Agency for Fiscal Administration.

B. Taxpayer information:

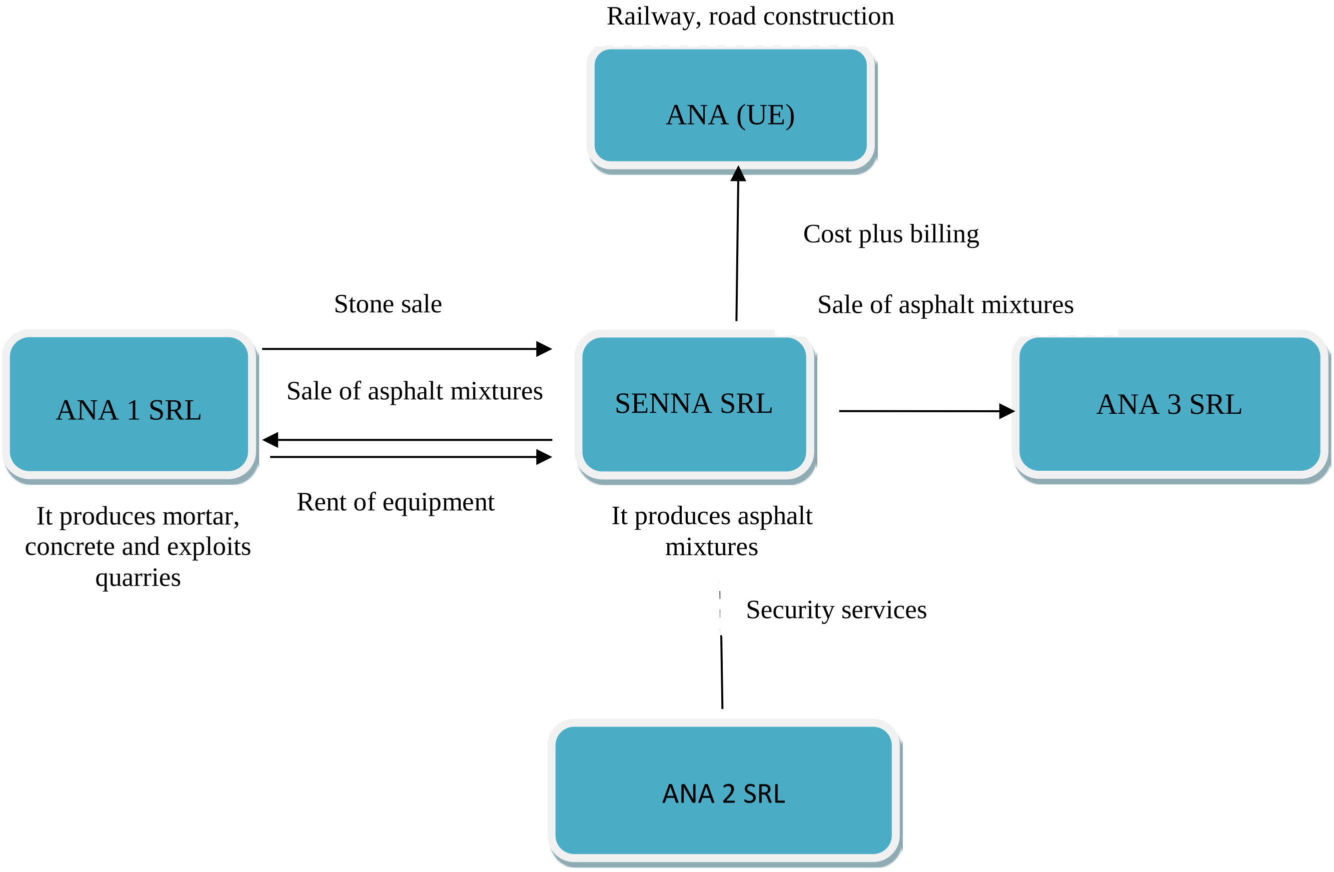
1. a detailed presentation of the transactions with affiliated persons:
    a. the transaction mode;
    b. the billing mode;
    c. the transactions' equivalent value;

2. a presentation of the comparative analysis:
    a. the characteristics of the goods or services;
    b. the functional analysis (functions, risks, used fixed assets, etc.);
    c. the contractual terms;
    d. the economic circumstances;
    e. the specific business strategies;
    f. information regarding comparable external or internal transactions;
3. a presentation of the affiliated persons and their permanent offices involved in these transactions or agreements;
4. a description of the transfer pricing calculation method and an argumentation of its selection criteria:
    a. if traditional methods of determining transfer pricing are not used, this option will be explained;
    b. in all cases where the price comparison method is not applied, this option will be justified;
5. a description of other conditions considered relevant to the taxpayer.

The parties involved

The occasions and circumstances in which the necessity of drawing up the transfer documentation file arose are: the appeal filed by SC SENNA SRL, against the Regional Directorate of Public Finance - the appeal resolution service and A.N.A.F./National Agency for Fiscal Administration – the inspection activity. In order to solve the issues notified by the company it was considered necessary to ask for a conclusion from a legal accounting expert.

Figure no. 1. The transactions between the affiliated companies within ANA ROM group



Source: Own design

In September 2012, an independent auditor prepared a report on the transfer pricing documentation file practiced by SENNA SRL, which shows that in Romania between 2008-2011 the group to which the company SENNA SRL belongs also includes the companies ANA 1 SRL, ANA 2 SRL, ANA 3 SRL, ANA SA (a company in the EU, outside the Romanian borders, specialized in construction). SENNA SRL was established by subscribing and paid-in share capital - 50% ANA 1 SRL and 50% ANA SA. ANA group is also present in Romania through ANA ROM, which in 2008 had a turnover of 113 million lei and 193 employees. Through the capital brought by the two companies in the group, SENNA SRL made investments of 6,826,000 lei.

SENNA SRL is a Romanian company operating in the field of asphalt mix production. When analyzing and documenting the transfer pricing used by a company in transactions with affiliated persons, it is important to consider the information that highlights the particularities of the market in which it operates.

As a rule, the group to which SENNA SRL company belongs aims to observe the principles of transfer pricing. Moreover, within intra-group transactions the aim is to respect the arm's length principle.

According to the OECD's guidelines, transactions comply with the arm's length principle when the conditions imposed and the prices paid in the transactions with affiliated persons are comparable to those imposed and paid by independent companies in comparable situations.

Table 3 presents a brief summary of the operating results obtained by SENNA SRL company in the period 2008 - 2011.

Table no. 3. The operating results of SENNA SRL

Indicator / Period	Year 2008 (RON)	Year 2009 (RON)	Year 2010 (RON)	Year 2011 (RON)
Total operating income	2.460.653	3.229.638	822.211	6.818.177
Total operating expenses	3.052.924	4.357.869	2.961.096	6.908.661
Operating loss	592.271	1.128.231	2.138.885	90.484

Source: Data processing based on financial statements www.mfinante.ro

Prices establishment methodology

The price of the sold materials, namely bitumen and quarry stone, is set by the ANA 1 affiliated company, as seller, based on an offer of goods and prices made available by it.

The set prices are presented in the form of a price list, being annexed to the contract. The signing of the price list by SENNA SRL company represents its acceptance regarding the set prices, as well as the payment conditions.

Table no. 4. Prices stipulated in the contract concluded by SC SENNA SRL with the affiliated company ANA 1 SRL

Product type	Quantity (ton)	Average price aggregates (without VAT)	Quantity (ton)	Average price aggregates (without VAT)
		Quarry 1	Quarry 2	
Crushed sand 0/4	3.000	32 RON	3.000	33 RON
Double crushed stone 4/8	2.300	32 RON	2.200	33 RON
Double crushed stone 8/19	2.300	32 RON	2.200	33 RON
Double crushed stone 16/25	2.400	32 RON	1.800	33 RON

Source: Transfer pricing document file of SENNA SRL

The sale price of the finished product, more precisely the asphalt, is established by SENNA SRL company, as seller, for each manufactured ton. The sale price is also set taking into account the delivery "Ex Works" condition (it is the most convenient delivery condition for the seller who has to make the packaged goods available to the buyer, who is obliged to load it at his own expense and risk).

Table no. 5 Prices stipulated in the contract concluded by SC SENNA SRL with affiliated company ANA 3 SRL

Mix asphalt type	Unit	Price in RON (without VAT)
Asphalt mixtures AB 2	Ton	216
Asphalt mixtures BA 16	Ton	230

Source: Own data processing from SENNA SRL transfer pricing documentation file

The prices set for each product category manufactured by SENNA SRL company, as seller, are presented in the form of a price list, being annexed to the contract. The signing of the price list by the affiliated companies, as well as signing of the transfer documents of the ownership of the products, represents the acceptance by the buyer regarding the payment conditions.

5. Conclusions

Wishing to benefit from the synergistic advantages of the affiliated parties from other jurisdictions, the multinationals reach a situation of distortion of the taxable bases, which requires the adjustment of transfer pricing.

The adjusted transfer pricing involves the appropriate correlative adjustment of tax bases in different jurisdictions, so as to avoid economic double taxation (Malherbe, 2017, p. 149).

The market price principle refers to the economic market conditions that should be the same both for group affiliated companies, and for non-affiliated (independent) companies.

The theory and practice of transfer pricing based on this principle also captures other facets of intra-group and extra-group cross-border transactions at multinational companies' level, such as transaction networks, customs value or permanent office.

The research carried out and the case study presented revealed the fact that the main problem when evaluating transfer pricing is the reference database. One can notice that in the Romanian practice there is not enough experience in finding and accessing support databases for determining transfer pricing, although the method application does not cause problems. Regarding the situation of the big audit and financial consulting companies, they have access to international databases so they can set the needed transfer pricing much easier. However, it should be mentioned that, in our opinion, reference pricing may come from companies with a higher degree of development than the country concerned (Romania, in our case) from a technological, operational, administrative point of view. As a result, we wonder about the extent to which these prices are relevant or what limits they have, as a basis of comparison. This is still an open issue and we intend to address these issues in the future.

Another direction of future research may be the structure of the costs which influence differently the final price of the same goods, in different economies.

Therefore, we think it is important for the people involved in this field (including accounting experts) to concern themselves with accessing databases that correspond as much as possible to the economic context in which the company operates and try to appropriately correlate the reference prices with the technology used, the cost structure, and also with other factors that may influence the value of the related adjustments.

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