

Transfer Pricing – An Analysis from the Romania`s Perspective

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Abstract

Given the fact that through transfer pricing companies could move profits from high tax jurisdictions to low ones, world countries have begun to pay particular attention to transfer pricing subject, adopting specific legislation in this respect. The first transfer pricing concepts have been introduced into the Romanian tax legislation more than 25 years ago. This paper presents an evolution of the Romanian transfer pricing legislation, illustrating the main legislative acts in this domain. In addition, the paper presents the key concepts specific to the transfer pricing legislation, exemplifying them through case studies.

Key words: transfer pricing, arm`s length principle, related parties, transfer pricing methods, Romania

J.E.L. classification: M40

1. Introduction

Soon after the Second World War, developed countries began to make massive investments in the reconstruction of their own economies. Subsequently, more and more companies began to carry out their activity across several countries. Moreover, since then, the number of these companies has been steadily rising, leading to a significant increase in the number of transactions performed between multinationals. Therefore, in this context, more and more groups of companies are set up, and the fact that these groups set up subsidiaries in different countries has led to issues related to the group results taxation and respectively to the transfer pricing concept.

According to researchers (Mehafdi, 2000; Satapathy, 2001; Smith & Eden, 2001; Matei & Pirvu, 2011; Gao & Zhao, 2015; Liu et al., 2015), transfer prices are those prices invoiced by the parent entity to its affiliates or invoiced by the affiliates to the parent company, as well as the prices invoiced between affiliates or between divisions of the same group of entities for the transfer of goods or the provision of services.

Going forward, given that the number of companies operating on a multi-country basis is steadily rising, this leading to a significant increase in the number of transactions between multinationals, world countries have begun to pay particular attention to prices at which these transactions are performed and to be aware that through the transfer prices there could be performed a profit moving from high tax jurisdictions to low ones. In this context, there were adopted transfer pricing regulations.

Lohse et al. (2012) conducted a study to capture the international evolution of the times when countries have adopted transfer pricing regulations in their domestic legislation. The study was conducted until 2009, the results showing that most countries have adopted transfer pricing regulations after 1990, more precisely between 1990 and 2000. Romania has adopted a detailed transfer pricing legislation since 2008 (i.e. once with the adoption of Order 222/2008 regarding the content of the transfer pricing file). Consequently, the transfer pricing concept represents relatively a new concept for both Romanian specialists and Romanian tax authorities, this being the motivation for the research carried out and the preparation of the present paper.

Given all the above, the paper presents an overview of the evolution regarding the Romanian transfer pricing framework, providing practical examples for a good understanding of the basic aspects from this area. From this point of view, the work could be useful both for transfer pricing practitioners and for those who want to start in this field, as it offers the opportunity to familiarize and understand the way in which the main concepts related to the transfer pricing are working.

2. Research methodology

Regarding the objectives of this paper, they were as follows:

- identifying the main legislative acts in the transfer pricing's field in order to capture an evolution of the Romanian transfer pricing legislation;
- identifying the key concepts specific to the transfer pricing legislation and exemplifying them through case studies.

Regarding the research methodology applied for achieving the two objectives, this was a qualitative one, based on both a theoretical and a practical perspective. The qualitative research based on a theoretical perspective was applied in relation to the evolution of the Romanian legislative acts applicable in the field of transfer prices and the one based on a practical perspective when exemplifying the main concepts in the field of transfer prices.

Moreover, the qualitative research was based on a deductive approach that started from definitions and notions specific to the field of transfer pricing and turned to illustrating them in practical examples. Research methods used include document analysis (i.e. the legislative acts) and case study.

3. Evolution of the Romanian transfer pricing legislation

The Romanian transfer pricing legal framework has a history of about 25 years. The below table summarizes a chronological presentation of the main Romanian legislative acts applicable in the transfer pricing field.

Table no. 1: Evolution of the Romanian transfer pricing regulations

Period	Details regarding the Romanian transfer pricing regulations
1994	Adoption for the first time in the Romanian tax legislation of the arm's length principle concept . However, for the effective application of this concept, there did not exist a legislative framework.
2002	The first legislative provisions on transfer prices were adopted through the <i>Law 414/2002 on corporate income tax</i> .
2003	The year 2003 was marked by the publication of <i>Law 571/2003 regarding the Tax Code</i> and of the related Methodological Norms, applicable from 1 January 2004. The Tax Code included definitions for the following concepts from the transfer pricing field: related parties and the arm's length principle (referred to as the free market price principle). The Law 571/2003 also included a description of the transfer pricing methods . In this context, it is important to mention that the Methodological Norms for the application of Law 571/2003 stipulated that when applying the transfer pricing legislation, Romania follows the provisions of the OECD Guidelines, although Romania is not an OECD member state .
2005	<i>Government Ordinance no. 92/2003 regarding the Tax Procedure Code</i> has been changed in order to introduce the concept of advance pricing agreement (i.e. an agreement concluded between the tax authorities and taxpayer in order to establish the transfer pricing methodology and the conditions under which a related party transaction will be performed).
2006	<i>Government Ordinance no. 92/2003 regarding the Tax Procedure Code</i> has been amended for the purpose of introducing requirements for the provision of supporting documents for transfer prices.
2007	Through the <i>Government Decision no. 529/2007</i> the necessary legislation for the issuance of an advance pricing agreement and the preparation of the related documentation was adopted at the level of Romania.

Period	Details regarding the Romanian transfer pricing regulations
2008	By <i>Order 222/2008 regarding the content of the transfer price file</i> , regulations were introduced in Romania in relation to the preparation of the transfer pricing file.
2010	By <i>Law 76/2010 regarding the approval of the Government Emergency Ordinance (GEO) no. 109/2009 on the amendment and completion of the Law no. 571/2003 regarding the Tax Code</i> was introduced at the level of Romania the obligation to document the transfer prices also for the transactions carried out between Romanian affiliated persons, not only for transactions between non-resident affiliated persons.
2015	By <i>Law no. 227/2015 regarding the Tax Code</i> , applicable from 1 January 2016, significant changes were made in the field of transfer pricing, as follows: <ul style="list-style-type: none"> • the definition of affiliated persons has been changed; • the concepts of transfer pricing estimation and the central trend of the market were introduced. <i>Law no. 207/2015 regarding the Tax Procedure Code</i> introduced the obligation to prepare the transfer pricing documentation, even if it is not requested by the tax authorities (as previously provided in <i>Order 222/2008</i>). Also, in 2015 the <i>Decision 529/2007 for the approval of the procedure for issuing the anticipated individual tax solution and the advance pricing agreement</i> was abrogated. There was issued a new legislative act in relation to the issuance of the advance pricing agreement, namely <i>Order no. 3735/2015 on the approval of the procedure of issuing and modifying the advance pricing agreement, as well as the content of the application for issuing and modifying an advance pricing agreement</i> .
2016	The year 2016 was marked by the publication of <i>Order no. 442/2016 regarding the values of the transactions, the deadline for the preparation, the content and conditions for the request of the transfer pricing file and the procedure of the adjustment / estimation of the transfer prices</i> . This order replaced <i>Order 222/2008</i> and brought important changes related to the content of the transfer pricing file, the obligation to document the transfer pricing and the procedure for adjusting / estimating transfer pricing.
2017	<i>Emergency Ordinance no. 42/2017</i> transposed into the Romanian legislation the EU Directive 2016/881 in relation to the country by country reporting (i.e. a report from the transfer pricing area that should be prepared by a group of companies if certain conditions are met).

Source: own processing

4. Theoretical background and practical aspects regarding the transfer pricing` key concepts

In the following it will be presented the key concepts used in the field of transfer prices, namely: arm`s length principle, related parties and transfer pricing methods. There was chosen the presentation of these three concepts as they are considered the most important in terms of understanding the mechanism of transfer pricing.

As presented in the previous section, Romania applies the provisions of the OECD Guidelines on Transfer Pricing (in practice, the provisions of these Guidelines are complementary to the local provisions). Therefore, the relevant provisions of the OECD Guidelines have been detailed in the presentation of these key concepts.

A. Arm`s length principle

The arm`s length principle is defined under article 7, paragraph 33 of the Tax Code. Practically, based on the arm`s length principle, transactions between affiliated parties must be carried out under conditions/ circumstances that must not be different from commercial or financial relationships established between independent entities. The arm`s length principle is defined as the generally used tax method for attributing the profits recorded by affiliated entities (Hamaekers, 2001).

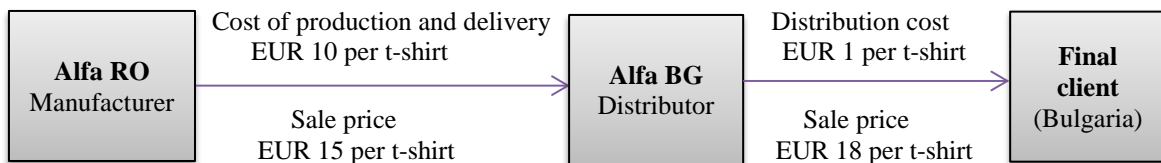
Moreover, Keuschnigg & Devereux (2013) considered that the arm's length principle was adopted by the states of the world to protect the tax base recorded by the multinational entities, and Oguttu (2006) stated that the arm's length principle is used internationally as a means of combating tax evasion.

A practical approach of the arm's length principle is presented the following example.

Case study – arm's length principle

Alfa RO manufactures t-shirts Y model in Romania and sells them to its affiliated entity Alfa BG, a Bulgarian company. Alfa RO has a cost of EUR 10 for the production and delivery of a t-shirt. Furthermore, the sale price of a t-shirt from Alfa RO to Alfa BG is of EUR 15. Alfa BG sells t-shirts on the Bulgarian market at a price of EUR 18 per t-shirt, incurring a distribution cost of EUR 1 per t-shirt. The flow of transactions could be represented as shown in Figure 1 below:

Figure no. 1: Transactions flow



Source: own processing

If independent entities which perform the manufacture of t-shirts Y model sell such a t-shirt at a price between EUR 14 and EUR 17, then the price invoiced by Alfa RO to Alfa BG (i.e. EUR 15) complies with the arm's length principle. The range of prices applied by independent entities is determined based on comparability analyses.

As a result of the above transactions, the Group of which Alfa RO and Alfa BG entities are part of has recorded a profit of EUR 7 (i.e. the profit recorded by Alfa RO (EUR 15 – EUR 10) + the profit recorded by Alfa BG (EUR 18 – EUR 15 – EUR 1)), of which EUR 5 has been taxed in Romania and EUR 2 in Bulgaria. Considering that the corporate income tax from Bulgaria is lower compared to that from Romania (i.e. 10% vs. 16%) the two entities could try to move profits from Romania to Bulgaria. In order to do this Alfa RO could invoice to Alfa BG a lower price than the level of prices applied on the market (i.e. lower than EUR 14), this meaning that transaction is not performed in compliance with the arm's length principle.

B. Related parties

Under article 7 (26) of the Tax Code, two entities are considered affiliated (i.e. related parties) if:

- one of the entities directly or indirectly owns at least 25% of the participation titles or voting rights of the other entity or effectively controls the other entity;
- a third person (an individual or a legal person) directly or indirectly owns at least 25% of the participation titles or voting rights of both entities or that person effectively controls both companies. The Law 571/2003 on the Tax Code did not contain provisions regarding the situation in which two entities are affiliated because they are owned at a minimum of 25% or are controlled by an individual, in practice being various uncertainties if this situation generates an affiliation relationship between two entities. As a result, Law 207/2015 on the Tax Code (i.e. the new Tax Code) clarified this situation.

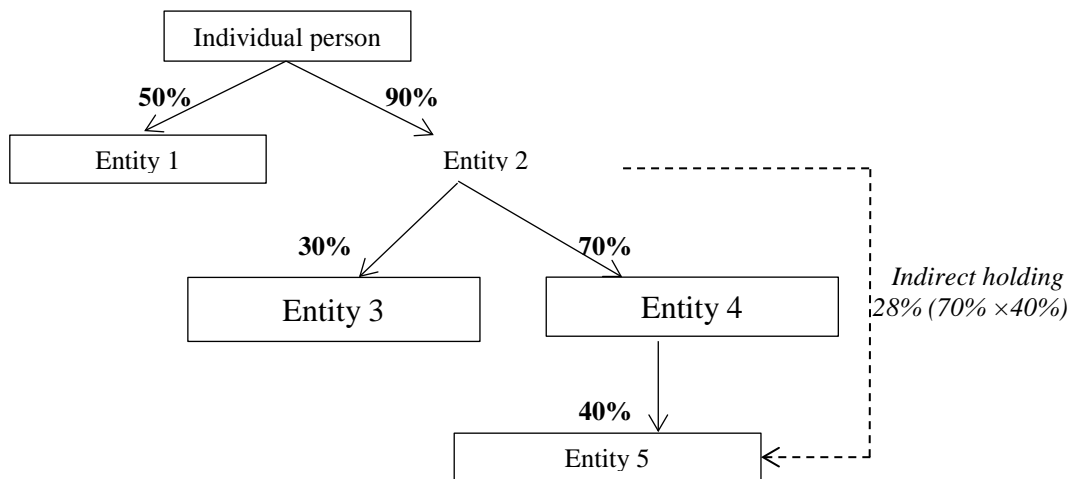
In the Methodological Norms for the application of the Tax Code, it is mentioned that a person can actually control an entity if that person is the manager / administrator of the entity, having the capacity to make decisions on the entity's activity by entering into transactions with another entity under its control (i.e. the same person is the manager / administrator of the two entities). It is also considered that effective control is exercised at the level of two entities if the management of one

of the two legal persons is a shareholder or an administrator of the other legal person. Thus, two entities may be affiliated under effective control even if the holding percentage is less than 25%. Starting from the definition of the related parties presented above, the following case study presents a practical application regarding the affiliation relationship between two entities.

Case study – related persons

Figure 2 below illustrates the percentages of ownership at the level of 5 legal persons (i.e. 5 entities).

Figure no. 2: Case study – related persons



Source: own processing

Based on the above figure, the following affiliation relationships can be determined:

- Entity 2 owns Entity 3 and Entity 4 directly, in a proportion greater than 25%, which means that Entity 2 is affiliated with Entity 3 and Entity 4. The same reasoning applies also for the determination of the affiliation relationship between Entity 4 and Entity 5;
- Entity 2 owns Entity 5 indirectly, in a proportion of minimum 25%, which means that the Entity 2 is affiliated with Entity 5;
- Entity 2 owns both Entity 3 and Entity 4 directly, in a proportion grater than 25%, which means that Entity 3 and Entity 4 are affiliated entities;
- Entity 2 owns Entity 3 directly and Entity 5 indirectly, in a proportion of minimum 25%, which means that Entity 3 and Entity 5 are affiliated entities;
- The individual owns Entity 1 and Entity 2 directly, in a proportion grater than 25%, which means that Entity 1 and Entity 2 are affiliated entities;
- The individual owns Entity 1 directly and Entity 3 indirectly, in a proportion of minimum 25%, which means that Entity 1 and Entity 3 are affiliated entities. The same reasoning applies also for the determination of the affiliation relationship between Entity 1 and Entity 4, respectively Entity 1 and Entity 5.

C. Transfer pricing methods

The Tax Code (in article 11, paragraph 4) presents five methods for determining transfer pricing as shown below. These methods apply, depending on the specific conditions of each, to determine whether the transfer prices have been established in accordance with the arm`s length principle:

- comparable uncontrolled price method;
- cost plus method;
- resale price method;

- transactional net margin method;
- profit split method.

Comparable uncontrolled price method

The comparable uncontrolled price method compares the price practiced between affiliates for the transfer of goods or the provision of services with the price invoiced between independent persons performing comparable transactions, in circumstances comparable to those from the transaction between affiliates. This method cannot be applied if there are material differences between the two transactions that are being compared (i.e. the transaction between affiliates and the one carried out between independent persons) - for example, the type of traded goods is not the same, the quantities marketed are not comparable, outlets are not similar etc. (Ondrušová, 2016).

However, according to the OECD Guidelines, in practice it is difficult to identify perfectly comparable transactions and that, in such situations, certain adjustments can be made to eliminate the impact of price differences (OECD Price Transfer Guide July 2017, paragraph 2.16: 101-102). This approach is also presented in the Methodological Norms for the application of the Tax Code. According to the Methodological Norms for the application of the Tax Code and the OECD Guidelines, the comparison of prices provided by the comparable uncontrolled price method can be done as follows:

- internal price comparison - this situation is applicable when one of the affiliated entities participating in the analysed transaction carries out similar transactions under comparable conditions with independent entities;
- external price comparison - applies when there can be determined publicly available market prices for similar transactions between independent entities, performed on a comparable basis to the analysed transaction.

The below case study illustrates how to apply the comparable uncontrolled price method.

Case study – comparable uncontrolled price method

Chocolate Production and Chocolate Distribution are two entities from the Chocolate group. Chocolate Production performs the production of chocolate candies and Chocolate Distribution carries out the distribution of candies purchased from the affiliated entity Chocolate Production. Chocolate Production sells 100 candy boxes with vanilla flavour to Chocolate Distribution at a price of EUR 10 per box. At the same time, Chocolate Production sells the same candies, in comparable circumstances, to an independent customer, but for a quantity of 50 boxes and at a price of EUR 11 per box. Given all these, there is a difference in the number of boxes sold by Chocolate Production to the two entities. According to the commercial policy, Chocolate Production grants a 10% discount for sales of more than 70 boxes.

In this case study, the sale performed by Chocolate Production to Chocolate Distribution is a deal between affiliates, and the sale performed by Chocolate Production to the independent customer is a transaction between independents. Thus, in order to apply the comparable uncontrolled price method, an internal comparison can be made between the price paid by Chocolate Distribution and the price paid by the independent customer. Since, as mentioned earlier between the two transactions under consideration, there is a difference in quantity, it is necessary to make an adjustment before the actual comparison is made to eliminate the impact of this difference on the price.

The adjustment is to apply the 10% discount (offered by Chocolate Production to sales greater than 70 boxes of candies) to the price charged by Chocolate Production to the independent customer (EUR 11 per box), obtaining a price of EUR 10 per box. As could be observed, after performing the discount adjustment, the price charged by Chocolate Production to its affiliated entity is the same with the price charged by Chocolate Production to the independent customer. Therefore, the price charged by Chocolate Production to Chocolate Distribution respects the arm's length principle.

Cost plus method

Generally, the cost plus method is used when the analysed transaction is represented by the production of goods or the provision of services. According to this method, the comparison is made at the level of the gross mark-up added by the supplier to the costs incurred for the production of goods/ provision of services (Matei & Pîrvu, 2011).

Similar to the comparable uncontrolled price method, the gross mark-up comparison can be made either on the basis of internal comparisons or on the basis of an external one. Internal comparison applies when similar products/ services are sold/ rendered to both a related party and an independent entity, in this situation being compared the gross mark-up obtained in relation to the affiliated entity with the gross mark-up obtained in relation with the independent entity. External comparison involves conducting a benchmark study to determine a range of gross mark-up applied by independent entities performing the same functions and assuming the same risks as the tested entity. If the gross mark-up applied in the transaction between independent entities falls within this range, then it can be concluded that the arm's length principle is respected.

Compared to the comparable uncontrolled price method, the cost plus method puts more emphasis on the circumstances in which a transaction takes place, without requiring the products/ services compared to be identical. However, it is recommended that the products/ services to be compared to have the same functions, being classified in the same category.

The OECD Guidelines recommend that profitability indicators (e.g. gross mark-up) to be determined as a ratio between the operating profit from the transaction under consideration and a denominator not affected by related party transactions (OECD Transfer Pricing Guidelines, July 2017, paragraph 2.94: 126). When analysing the example of a manufacturer which records revenue from sales transactions in relation to affiliates, and costs associated with production are recorded by the manufacturer as a result of transactions with independent entities, the denominator should be the amount of the cost recorded in this respect.

Furthermore, the OECD Guidelines mention that the difference between a gross and net profitability indicator is represented by the cost structure. Thus, a gross profitability indicator is based only on direct and indirect production costs, while a net profitability indicator also includes operational expenditure - for example, general administration expenses (OECD Transfer Pricing Guidelines, July 2017, paragraph 2.54: 114).

Considering the above, in general, the gross mark-up for applying the cost plus method is determined according to the formula below:

$$\text{Gross mark - up} = \frac{\text{Operating revenues} - \text{Cost of goods sold or services provided}}{\text{Cost of goods sold or services provided}} * 100$$

In addition, the application of the cost plus method requires a comparability at the level of the cost base at which is applied the gross mark-up. Therefore, if there are differences in the cost base of the transaction being analysed and conducted between affiliates and the cost base of the comparable transactions, the cost plus method cannot be applied. For example, financial statements prepared according to the Romanian accounting regulations do not allow for a separation between the cost of the goods sold / services provided and the other operational expenses, since the profit and loss account presents expenses by nature rather than by destination. In this situation, in the absence of internal comparisons, the cost plus method may be difficult to apply (Luca, 2009).

The below case study illustrates how to apply the cost plus method.

Case study – cost plus method

Chocolate Production produces two types of chocolate candies: vanilla flavoured candy and strawberry flavoured candy. The cost of production (which includes only direct and indirect costs, without the allocation of the general administrative expenses) of a vanilla-flavoured candies box is of EUR 8 and the production cost of a strawberry candies box is of EUR 3.2. Vanilla flavoured candies boxes are sold to the affiliated entity Chocolate Distribution at a price of EUR 10 per box, and the strawberry flavoured candies are sold to an independent customer at a price of EUR 4 per

box. The conditions under which the two transactions are performed are similar.

Considering that the compared products are not identical, the comparable uncontrolled price method would not be indicated to apply in this situation. However, considering that the products can be classified in the same category, the cost plus method could be applied. Therefore, in order to test the compliance with the arm's length principle by applying the cost plus method, the gross mark-up obtained by Chocolate Production from the sale to Chocolate Distribution will be compared with the gross mark-up obtained by Chocolate Production from the sale to the independent customer.

Therefore, the gross mark-up obtained by Chocolate Production from the sale of vanilla flavoured candies to Chocolate Distribution is 25% (i.e. $(10-8) / 8 * 100$) and the gross mark-up obtained by Chocolate Production from the sale of strawberry flavoured candies to the independent customer is also 25% (i.e. $((4-3,2) / 3,2) * 100$).

In view of the above, it can be concluded that the price of EUR 10 per box paid by Chocolate Distribution to the affiliated entity Chocolate Production respects the arm's length principle.

Resale price method

In general, the resale price method is used when the analysed transaction consists in the distribution to independent entities of the goods acquired from affiliated entities. According to the OECD Guidelines and the Methodological Norms for the application of the Tax Code, the analysis made to determine whether the transfer pricing complies with the arm's length principle starts from the price at which a product purchased from the affiliated entity is resold to the independent entity. Subsequently, this price is reduced with the gross margin obtained by the distributor from the resale of the products, obtaining in this way the transfer price at which the products were traded between the affiliated entities. Further, the gross margin obtained by the distributor is compared with the gross margin for similar transactions between independent persons. If this gross margin is at market level, then the price at which the goods were transferred between affiliated entities respects the arm's length principle (Hughes & Nicholls, 2010; Jain, 2015).

Similar to the cost plus method, the resale price method can be applied both by using internal or external comparables.

Starting from the provisions of the OECD Guidelines mentioned above in the cost-plus method presentation, in general, the gross margin for the application of the resale price method is determined according to the below formula:

$$\text{Gross margin} = \frac{\text{Operational revenues} - \text{Cost of goods sold}}{\text{Operational revenues}} * 100$$

Similar to the cost plus method, in case of the resale price method the comparability of the products is not an essential condition (i.e. the products should not be identical, but should have similar functions so that they can be classified in the same category of goods) but there is required a high degree of comparability for the functions performed, the risks assumed and the assets used by the entities participating in the transactions.

At the same time, taking into account the factors that may lead to differences in accounting treatment with regards to cost classification (as detailed in the presentation of the cost plus method), the resale price method may be difficult to apply in the absence of internal comparables.

The below case study illustrates how to apply the resale price method.

Case study – the resale price method

Chocolate Distribution purchases chocolate candies from the affiliated entity Chocolate Production in order to resell them to independent customers. Chocolate Distribution purchases a candy box from Chocolate Production at a price of EUR 10 and resells it to independent customers at a price of EUR 12.

Neither Chocolate Distribution purchases candies chocolate from other independent entities nor Chocolate Production sells candies to other independent entities. Therefore, the resale price method based on internal comparison cannot be applied.

After performing a benchmark study it was determined that independent distributors with a functional profile similar to that of Chocolate Distribution and which distribute similar products obtain a gross margin of 10%.

In order to test whether the transfer price of EUR 10 charged by Chocolate Production to Chocolate Distribution respects the arm's length principle there will be reduced the resale price of EUR 12 with the gross margin obtained on the market by the independent distributors (i.e. EUR 12 - 10% = EUR 10.8). Based on this results, it can be concluded that the transfer price of EUR 10 does not respect the arm's length principle.

Transactional net margin method

The transactional net margin method is similar to the cost plus method and the resale price method, the only difference being that the two methods operate with gross profitability indicators while the transactional net margin method operates with net ones (OECD Guidelines on Transfer Pricing, July 2017, paragraph 2.64: 117).

The transactional net margin method is the most often used in practice as companies often face a lack of information on the classification of expenditures needed to determine gross margins/mark-ups for independent comparable companies. Therefore, when applying the transactional net margin method other operational expenditures (such as general administration costs) is also considered in addition to, for example, the cost of goods sold.

Based on a functional analysis (i.e. the identification of the functions performed, the risks assumed and the assets used by each affiliated entity involved in the transaction under review), it is determined whether the transactional net margin method should be applied similar to the cost plus method or similar to the resale price method, and what profitability indicator should be computed. According to Luca (2009), the profitability indicators used in this respect can be the operational margin (used in the case of distributors, when the transactional net margin method applies similarly to the resale price method), return on assets and the net cost plus (used in case of manufactures or service providers, when the transactional net margin method is applied similarly to the cost plus method). These profitability indicators are determined according to the below formulas:

$$\text{Operational margin (OM)} = \frac{\text{Operational result}}{\text{Operational turnover}} * 100$$

$$\text{Return on assets (ROA)} = \frac{\text{Operational result}}{\text{Operational assets}} * 100$$

$$\text{Net cost plus (NCP)} = \frac{\text{Operational result}}{\text{Operational costs}} * 100$$

Where,

Operational results represents the result obtained by the distributor/ manufacturer/ service provider strictly from the transaction analysed and carried out with the affiliated entity, being determined as a difference between the operational revenues obtained from the transaction, the cost of the goods sold/ services rendered and other operational expenses.

The below case study illustrates how to apply the transactional net margin method.

Case study – the transactional net margin method

Chocolate Production manufactures and sells chocolate candies to the affiliated distributor Chocolate Distribution. The net mark-up (i.e. the net cost plus indicator) obtained by Chocolate Production from sales to Chocolate Distribution is of 8%. According to a benchmark study conducted on a sample of independent entities with a functional profile similar to that of Chocolate Production, the average net mark-up on the market is between 5% and 10%.

Therefore, it can be concluded that the transaction between Chocolate Production and Chocolate Distribution respects the arm's length principle (since the net mark-up obtained by Chocolate Production is within the comparability range).

Profit split method

The profit split method is typically used when in a transaction the activities performed by entities are interdependent so that a separate analysis of each activity cannot be performed or when affiliated entities make unique contributions to the transaction (for example, unique intangible assets are used). In this situation, it is recommended to apply the profit split method as independent companies would opt for dividing the profits generated by the transaction according to their contribution within that transaction (Chand & Wagh, 2014).

According to the OECD Guidelines, profit split can be achieved in two ways: contribution analysis and residual analysis (OECD Transfer Pricing Guidelines, July 2017, paragraph 2.124: 136). Based on the analysis of the contributions, the cumulative profit generated by the transaction and allocated to each company should reflect the functions performed, the risks assumed and the assets used by each entity. This profit is determined by reference to the conditions prevailing on the market, namely how third companies would share the profit under similar conditions. The residual analysis divides the cumulative profit into two steps. First, a profit is allocated to each entity to provide a "normal" profit margin for the analysed transaction (i.e. a profit margin that independent entities would have obtained if there were not, for example, valuable invaluable assets). Subsequently, what remains after the division according to the first step is the residual profit that is allocated according to the contribution of each entity to the transaction and in line with market conditions. For example, if one entity owns a unique intangible asset that contributes significantly to generating profit, then that entity is entitled to receive a significant proportion of the residual profit.

The below case study illustrates how to apply the profit split method.

Case study – the profit split method

Chocolate Production has a unique manufacturing recipe for chocolate candies, these candies being the most appreciated by the public. Thanks to this recipe, the chocolate candies produced by Chocolates Production are unique, superior to those made by competitors. Candies are sold exclusively to the affiliated entity Chocolate Distribution. Chocolate Distribution also owns the "Bonbon" brand under which candies are marketed, a recognized brand on the market as a leader. In addition, Chocolate Distribution owns a list of customers to whom most of the candies purchased from Chocolate Production are sold.

The cost of producing a box of candy is of EUR 10 and the resale price is of EUR 15. The marketing costs recorded by Chocolate Distribution for the promotion of candies are EUR 1 per box. The cumulative profit for the sale of a candies box is of EUR 4 (EUR 15 – EUR 10 – EUR 1). According to a benchmark study, it was concluded that cumulative profit should be allocated 60% to Chocolate Production and 40% to Chocolate Distribution. Thus, following the application of the profit split method, the transfer price for the sale of candies by Chocolate Production to Chocolate Distribution should be EUR 12.4 (EUR 10 + 60% * EUR 4).

5. Conclusions

Transfer pricing legislation in Romania has a history of more than 25 years, being gradually developed either by changes to existing regulations or by the adoption of new regulations. Although not an OECD member, from the point of view of transfer pricing legislation, Romania follows the provisions of the OECD Guidelines. The main legislative acts existing at the level of Romania governing the transfer pricing are: Tax Code, Tax Procedure Code, Order 442/2016, Order 3735/2015 and Emergency Ordinance no. 42/2017.

One of the most important moments in the history of the transfer prices in Romania was the adoption in 2008 of the Order 222/2008 regulating the issues related to the documentation of the transfer prices. Subsequently, the moments in the history of transfer prices that had the greatest impact on the business environment took place in 2016 when Order 442/2016 was adopted (which replaced Order 222/2008) and in 2017 when was adopted the Emergency Ordinance no. 42/2017. By Order 442/2016 at Romania level the obligation of annual preparation by certain categories of taxpayers of a transfer pricing file has been introduced, value thresholds have been established in order to determine which entity has the obligation to document the transfer prices, has been modified the deadline for submitting the transfer pricing file at the request of the tax authorities, was amended the procedure for estimating and adjusting transfer pricing and was supplemented the structure of the transfer pricing file. By Emergency Ordinance no. 42/2017 Romania has adopted the necessary legislation to implement at national level a CbC documentation in accordance with the Action 13 "Transfer pricing documentation and country-by-country reporting" of the BEPS Action Plan.

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