TRANSFER PRICE-INSTRUMENT OF FISCAL PLANNING

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Abstract: *The issue of transfer pricing is complex for both tax authorities and multinational companies, as the most important tax issue they face today is the most important issue and the way multinationals choose transfer prices in the presence differentiated rates of profit taxation are more or less abusive. Transfer pricing occurs whenever two companies belonging to the same multinational group perform transactions. What is illegal or abusive is the incorrect valuation of the transfer value, also known as handling transfer pricing or abusive transfer prices and using them to achieve tax optimizations.*

Key words*:* transfer pricing; market value principle (arm length); affiliated parties; tax optimization.

JEL Classification Codes: F65, H26, M41.

1. PURPOSE AND MODALITIES OF TRANSFER PRICING, AS REVIEWED BY THE LITERATURE

The transfer price is defined as the price paid in a business transaction for tangible goods, intellectual property, or service provision within affiliated companies (Abdallah, 2004) and can be considered as a significant tool used in performance evaluation within large segmented firms (Langfield-Smith, Smith, 2005). Transfer pricing is a phenomenon studied in developed countries since the second half of the 20th century (in the UK - in 1915 and in the US - in 1917), and in Romania it is an area of relatively recent importance (in 21st century, in 2004). They have existed since antiquity since the emergence of the first multinational groups, starting in the 1600s, by the establishment of the British East Indies Company. The first state to introduce regulations on transfer prices was Norway in 1911, then the Organization for Research and Economic Development issued the first report on transfer prices in 1979. In 1984, the OECD issued a new version of the report , and in 1995 issued the first version of the OECD Transfer Pricing Guide, updated later in 2010. Transfer pricing is one of the most important issues in international and national taxation. In Romania, the concept of transfer price was mentioned for the first time in the 1994 Fiscal Code. However, in 2000 only the legislation required to ensure the application of the market value principle in affiliated transactions (Pricewaterhouse Coopers, 2005) and affiliated parties are defined by Law no. 571/2003, regarding the Tax Code. It should be noted that in the literature, transfer prices are analyzed from different perspectives. The two perspectives deal with different transfer prices:

- economic approach - this perspective involves a technical analysis of prices, differentiating them from the political-economic sector in which they are used. According to this perspective, these transfer prices are used by multinational companies to achieve fixed targets, to assess the individual performance of subsidiaries, but also to allocate resources within the group;

- fiscal approach - the tax perspective wants to create tools that allow transfer pricing not to deviate from market values in order not to inflate competition and the level of taxation in the different jurisdictions where the multinational company operates.

According to the study of the literature, the transfer prices were analyzed through tax accounting studies assessing the stage in which national tax rate differences lead to transfer pricing and income changes (Iacob, 1996; Swenson, 2001; Gupta and Mills, 2002); studies that lead to choosing the optimal method of pricing tax transfer (Swenson, 2001; Van Mens and Porquet, 2001; Douvier, 2005); studies that transfer prices help maximize business value (Michaels, 2005); studies that consider tax rules as one of the environmental factors (Emmanuel and Mehafdi, 1994, Cravens and Shearon, 1996, Cravens, 1997).

The transfer pricing field is a fairly controversial issue, with both supporters and critics, it all depends on their ability to use them in order to reduce the tax burden, thus taking advantage of the opportunities they offer. Conover and Nichols (2000) studied the impact of the enterprise's size on the use of transfer pricing to modify revenue and found that larger enterprises have more chances to change revenue by using transfer pricing. Previous studies have also provided evidence of the types of multinational enterprises that are more prone to manipulate transfer pricing. Jacob (1996) noted that multinationals had the most transfer opportunities and the greatest incentives to change revenue through transfer pricing.

"The OECD Guidelines analyze the assessment methods to see if the commercial and financial relationships of multinational companies respect the principle of full competition and discuss the practical application of these methods" OECD (2009, p.14). In practice, five transfer pricing methods are used, divided into two categories: traditional transactional methods, requiring higher comparability and methods based on transactional profit. Some of these methods are legal and are called creative accounting practices, and manipulation of transfer pricing is considered the practice of observing the actual value of transactions so as to generate the highest profit for the businesses involved. At the same time, a comparative analysis is used, which helps to identify the market interval that actually represents the range of price / profit values for comparable transactions performed by independent companies. In a global economy where multinationals play an essential role, transfer prices are a priority on the agenda of tax administrations and taxpayers alike.

It is necessary for the concluded transactions to observe the market price, but if these transactions are not in the "market interval", the activity is considered to be not transparent because the profits obtained are not correctly reflected. Transfer pricing is an international tax problem and for businesses to operate in optimal conditions, the OECD directives have laid the foundations of the arm's length principle and have enshrined it as the basic principle of transfer pricing theory. The principle of market value or full competition is the international standard of transfer pricing and is used for tax purposes by multinational companies and tax authorities. The reason for adopting this principle is that it ensures a parity of treatment between independent and multinational companies, thus avoiding the creation of tax advantages or disadvantages that could distort the competitive positions of each type of entity. Most countries require multinational companies to demonstrate that their intra-firm transactions respect the market value principle or the "arm length" principle. OECD member countries are encouraged to comply with the OECD Guidelines in their national transfer pricing practices and taxpayers are encouraged to follow it when assessing for fiscal purposes whether pricing is in line with the principle of full competition.

2. TRANSACTIONS BETWEEN AFFLIATED PARTIES AND THE IMPACT OF TRANSFER PRINCING ON THEM THROUGH TAX OPTIMIZATION

Transfer pricing is an important element in the economy of a country, being used by taxpayers and analyzed by tax authorities. In practice, these transfer prices are considered to be tax planning tools as they determine the revenue and costs of a taxpayer, as well as the taxable profits of affiliated companies in different jurisdictions, and thus the corporate tax payable to tax authorities. Transactions between affiliated persons should be conducted in accordance with the market value principle, without the relationship of affiliation between them being influenced. Addressing such pricing can benefit companies through operational advantages such as knowing affiliate transactions and identifying revenue and spending opportunities, profound understanding of the business model, and optimization opportunities that, under other conditions, could be overlooked. However, the use of transfer pricing that does not comply with the market value principle can lead to tax base adjustments and double economic taxation when companies from several countries are involved in transactions. Transfer pricing is an area with great potential for conflict between subsidiaries, and there is often a need for mediation through headquarters.

In practice, there are several definitions of affiliated parties, but each state formulates its own concept of affiliated persons. At international level, the definition of affiliated parties is given by the OECD Guidelines. This definition is taken from the OECD Glossary of Terms and the OECD Model Tax Convention. According to Article 9, sub-paragraph (1a) and (1b) of the OECD Model Tax Convention, two companies are affiliated if one of the companies participates directly or indirectly in the management, control or capital of the other, or if the same persons participate directly or indirectly in the management of both companies. In Romania, starting with 2010, the transactions with related parties between two Romanian legal entities also fall within the scope of the transfer pricing investigations, whereas only previously non-resident related parties transactions have been investigated by to the tax authority. Article 19 of the Romanian Tax Code (Law No 571/2003, as amended) sets out the general rule that transactions between persons or affiliated entities must be valued at the normal market value, that is, the value that would have been agreed by independent parties.

The need to promote greater transparency with regard to the company's activity and to protect the rights of minority shareholders has led to the definition of "related parties" in international standards or IAS (International Accounting Standards) and in particular IAS 24. With IAS 24, a person or an entity is related to the value of the reporting entity (hereafter "the company"), if it has the joint control or control of the company. Similarly, the objective of IAS 24 ensures that an entity's financial statements contain the information necessary to draw attention to the possibility that its financial position and profit or loss have been affected by the existence of related parties and the outstanding transactions and balances of those parties. According to IAS 24.9, "a related party is a person or an entity that is affiliated to the entity that prepares the financial statements." A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

The definition is also related to the person or entity that has a significant influence on the company or the key manager within the company. If one of the above persons has a significant influence on an entity or is a member of the key management, that entity will be considered a related party. The price used by affiliated parties in tangible or intangible assets or in services is the transfer price.

If we refer to the provisions of the OECD Model Tax Convention: "Companies owned / controlled by the same affiliated natural persons are considered affiliated persons and even though there is no clear regulation in the Fiscal Code on the affiliation relationship with regard to the shareholder / the common control held by individuals in the context of transfer pricing takes into account the provisions of the OECD Guidelines, which complement the national legislation" (Patroi et al., 2013). According to the legislation in force, the transactions of affiliated companies must be carried out at market price. Thus, if these transactions do not reflect market value, the tax authorities may adjust the income or costs of the companies concerned in order to identify the market price of the transactions provided for goods and services, and additional obligations may also be assessed on corporation tax, and late payment penalties. In a related party transaction, it is very important to use the functional analysis to determine the role of each participant. Functional analysis involves: identification of functions and processes, intangible assets, resources used, assumed risks, and the characteristics and terms of the transaction. Therefore, identifying a correct functional profile requires transfer pricing to be determined according to the market value principle.

As a result of the increasingly sustainable economic and financial crisis, which is characterized by a reduction in the amounts due to the state budget, the growing interest of more countries in regulating and controlling transfer pricing in order to efficiently manage fiscal and financial risks, these involve them. Lately, there is a growing interest in the transfer pricing phenomenon, both from transnational companies, which seek to optimize tax and obtain optimal circulating capital, as well as from international tax authorities that aim to optimize cash flow. Tax optimization methods used by multinational companies in the countries in which they operate are often at the legal and illegal border as they seek to exploit certain weaknesses in the tax legislative system. With the expansion of economic globalization, there is an increase in inter-state financial flows generated by transfer pricing and, implicitly, the internationalization of economic crime has new valences. Transfer Pricing Strategies are commonly used by multinationals on the global market today. This practice is largely due to the tax and other benefits that can be obtained. As every good is sold / bought at a certain price between a buyer and a seller, it is equally necessary to set a price, even when the two are affiliated. Income tax policies and, of course, regulations of different foreign countries are not the same, and so-called international taxation has a significant effect on multinationals in making their long-term management decisions. Taxation affects the situation in which a multinational enterprise invests, how it sells its products, how to finance and establish the transfer price (Muller et al., 1997) and, of course, fiscal considerations that strongly influence the choice of multinational enterprises (Hines, 1999).

The reasons for using transfer pricing in multinationals can be: obtaining internal and external targets; including evaluating the performance of affiliates and their managers, motivating managers as an internal reason, and reducing taxes. Also, multinationals use transfer pricing to reduce exchange rate risk and position themselves better than competitors to hide fiscal success or maximize profit and minimize tax burden (Dawson, 2000; Mehafdi, 2000).

The following criteria must be met to create an effective international transfer pricing system for foreign operations:

- increase the global profit of the multinational enterprise by minimizing total corporate tax debt, reducing foreign currency losses, minimizing the costs of international transactions, and paying lower tariffs for both imports and exports;
- motivating managers in foreign affiliates to increase efficiency and maximize profits, in line with leadership goals, and at the same time to provide support to foreign affiliates to compete with other firms.

In order to reduce taxes, the use of transfer prices by multinational companies is often abusive, according to Baker's statistics (2005) and the study by Dawson (2000), Hansen (1992), Mehafdi (2000). According to a study recently conducted by Ernst and Young (2008) in our country, companies use transfer pricing as tax optimization, and tax considerations strongly influence the choices that companies make. Lately, multinationals have been associated with handling transfer pricing due to their dominant position on the market for certain goods and services, but also because they have more opportunities through their global network of affiliated companies to trade on prices different from those applied by independent enterprises. Transfer pricing is the trade-in prices between companies belonging to the same group and is frequently used by large companies for fiscal "optimization", favoring certain subsidiaries, in particular those in countries with a lower tariff regime.

Starting from these details and wishing to highlight the link between transfer prices and tax optimizations, I believe that these transfer prices are actually used as a "screen", which helps avoid tax evasion in developed countries. According to the above, there is a question: how can the tax reduction be achieved by using transfer pricing? ... The answer is the following: by transferring goods to countries with reduced income tax rates at the lowest possible transfer price and the transfer of goods from these countries to the highest possible transfer price.

Thus, a common feature of transfer pricing cases relates to the difference between the tax rate of the profit obtained in the parent company's country of residence and the levels of taxation existing in the countries where the other member firms of the group are registered, to countries where they are the least taxed. Since transfer prices and tax optimizations are combined, the benefits thus obtained are impressive. Transfer pricing is important for both taxpayers and tax administrations, as it helps determine revenue and expense and, implicitly, determine the taxable profits of associated companies. In order to achieve a fair balance between the interests of taxpayers and tax authorities, it is necessary to analyze all aspects of the system that are important in a transfer pricing case.

4. CONCLUSIONS

Multinational companies can use their own transfer pricing strategies to benefit from differences in tax rates across countries in order to reduce their tax burden and achieve their corporate goals. These transfer prices should be carefully monitored because their trading is an important part of the tax / corporate tax base. Transfer pricing is seen as an abbreviation for multinational corporations that store profits in tax havens in order to avoid tax evasion in developed countries. Fiscal inspectors should therefore be aware of the existence of these price manipulation strategies, which are considered to be powerful weapons, in relation to international tax issues of transfer pricing. The reduction of taxes through the use of transfer prices is and will continue to be a common and widespread practice among multinational companies. Although the OECD has some regulations to make the practices we refer to more uniformly, they can be circumvented and can sometimes be used to avoid taxing.

As a synthesis, we can say that “transfer prices are the -terminal point- of ingenuity in the exploitation of tax legislation” and multinational companies must pay close attention to the length of the arm, the transactions with their affiliated parties, but also on their documentation, so that they can be prepared for any disputes about transfer pricing with tax authorities.

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