Short Reflections about the Transfer Pricing File

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Substantive development of the international trade over the past 20 years, reflecting to some extent the degree of integration of national economies and technological progress, presents tax issues of increased complexity in the determination of income and expenses of a company or of a permanent establishment which is part of a multinational group and which must be approached within a jurisdiction. In principle, the specific the right of taxation of each state depends mostly on the tax system used by it: if it is a tax system based on tax residence, source of income, or both. In applying those principles in taxation of multinational companies, one of the most difficult problems encountered consists in establishing, for tax purposes, the appropriate transfer pricing.

Taking into account the phenomenon of internationalization of the economic crimes, this paper aims treat uniform the subject in question, but with references to certain mandatory provisions contained in the OECD Guidelines regarding of the transfer pricing.

Keywords: multinational companies, tax jurisdiction, market price, comparative methods

Jel Classification: H21; K34; M16

1. Introduction

According to the Fiscal Code of Romania, in case of transactions between related parties, the tax authorities may adjust the income or expenses of any person to reflect the market value of the goods or services covered by the transaction. However, this reconsideration does not affect the financial statements of Roman society, only the fiscal position.

For setting the market pricing of transactions between related parties may be use the most appropriate of the following methods:

- method of comparing price (MCP), through which the market price is determined based on the price of other entities that sell products or services comparable to independent entities;
- cost-plus method (CP-M), through which the market price is determined based on the good or service costs plus a appropriate profit margin;
- resale price method (RPM), by which the market price is estimated based on the resale price of products and services to independent entities, less the expenses of sale and other expenses of the taxpayer and a profit margin; and
- any other method recognized in the OECD Guidelines on transfer pricing, such as the method of division profit (MDP) or the method of net margin (MNM).

In the purpose of calculating the tax obligations of related parties, the tax authorities in Romania may reconsider the records of related part from Romania, for tax purposes, if as a result of a special relationship between the related parties, these records do not reflect the actual profits taxable in Romania. The records of the related parties are also reconsidered when the transactions between parties take place in the open market commercial terms, respectively as transactions between independent parties. Through the amendment from May 2010 of the Fiscal Code, the provisions on transfer pricing applies not only to trade relations between Romanian and foreign affiliates but also to trade relations between the Romanian affiliates. The Romanian Fiscal Code and the Implementing Rules stipulates that Romanian tax authorities must rely also on transfer pricing guidelines established by the OECD to analyse the level of prices charged between related parties. In addition, the Romanian law regarding the documentation requirements on transfer pricing also refer to the European Code of Conduct on transfer pricing documentation. In accordance with the requirements concerning the transfer pricing documentation from Romania approved by the Order of NATA (Order 222/2008 regarding the content of the transfer pricing file), the local entities conducting transactions with related parties must make available to the tax authorities at their request also within the period specified, the transfer pricing documentation file for these transactions. Taxpayers who do not have are signed a in advance pricing agreement (PAA) for transaction with related parties do not have are have the obligation to prepare and

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2 For details see, C176 / 1 of 28 July 2006.
3 National Agency for Tax Administration.
Article 9 of the OECD Model Tax Convention, which stipulates the following:

"The market price principle" is an international standard applied for determining the transfer pricing for tax purposes.

When independent companies carry out transactions, the commercial and financial conditions of these relationships are established, usually depending on market forces. When associated companies carry out transactions, it is possible that external market forces to not affect in the same manner the commercial and financial conditions and relations between them. In the establishment of the transfer market prices is respected the principle of the market price applicable to the transaction, because, thus, are eliminated the tax distortions caused by the transactions between associated enterprises. "The market price principle" is an international standard applied for determining the transfer pricing for tax purposes.

The principle of market price determined in accordance with OECD guidelines is provided in Article 9 of the OECD Model Tax Convention, which stipulates the following:

"... If, between the two companies in their commercial or financial relations are agreed or imposed conditions which differ from those which would be between independent enterprises, in this case, any profits which, in the absence of these conditions would have been made by one of the company, but were not made because of these conditions can be included in the profits of that enterprise and taxed accordingly." 

Based on the different policies and principles in different transfer pricing regimes under which multinational enterprises operate, certain principles were drafted by the OECD to ensure uniformity in interpretation of various transfer pricing principles. OECD member states have agreed that, for tax purposes, profits of associated enterprises can be adjusted as needed to correct these distortions and thus to ensure that the market price is respected. Given the above, an economic analysis is usually undertaken to determine the market price namely the price at which independent enterprises would have made similar transactions to those carried out by associated enterprises.

Romania introduced transfer pricing rules establishing certain methods that will be implemented to estimate the market value of transactions between related parties. Local legislation includes provisions on transfer pricing guidelines like OECD and can be used for local transfer market pricing.

In the selection of the most suitable method, OECD Guidelines presents some possible methods to assess whether international transactions are conducted at market prices. In assessing the factors for determining the comparability between the controlled and uncontrolled transactions, the OECD Guidelines states as relevant factors the character of the goods transferred or the service provided, functional analysis, contractual terms, economic circumstances and business strategies. However, the OECD Guidelines recognize the fact that it is possible that data on comparability factors mentioned above may not always be available. In general, these methods take into account the prices or profits for similar transactions with unrelated parties as a reference for the market price principle. The analysis performed to determine the market price identifies comparable elements obtained from the search of transactions and / or comparable companies and establishes the market price character for international transactions.

2. Achieving the economic analysis

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The analysis performed to determine the market price identifies comparable elements obtained from the search of transactions and / or comparable companies and establishes the market price character for international transactions. According to paragraph 1.33 from OECD Guidelines: "Implementing the market price principle is generally based on a comparison of the conditions within the controlled transaction and conditions of the transactions between independent enterprises. In order that such a comparison to be useful, relevant characteristics of the situations economically under comparison must be sufficiently comparable [...] " Consequently, the search strategy applied to identify the transactions / comparable companies must be developed in order to justify these relevant features from the economic point of view.

3. Selecting and prioritizing the most appropriate method to determine the market price

In the OECD Guidelines\(^5\) are set a number of methods to demonstrate the compliance with the rule on the market price principle, which are classified into two main groups\(^6\):

- Traditional transaction methods: Method CP, RPM, and CP-M.
- Methods based on trading profit: MDP and MNM.

In accordance with OECD guidelines, the choice of transfer pricing method always involves identifying the most suitable method for each specific case separately. For this purpose, the selection process must take into account both the strengths and weaknesses of the OECD recognized methods.

The traditional transaction methods are regarded as the most direct means for determining whether, in the commercial and financial relations between associated enterprises established are set according to market conditions. OECD Guidelines stipulates that, if a traditional transactional method and a transactional profit method can be applied to the same extent, is preferred the traditional transactional method in expense of the transactional tax method. There are situations where the transactional profit methods are considered more appropriate than traditional transaction methods. For example, if there are no or the public information are limited reliable regarding the gross income margin of third parties, the traditional transaction methods may be difficult to be applied in other cases than those in which there are internal comparable, and a transactional profit method may be the most appropriate one considering the availability of information.

**MCP method**

MCP method evaluates the amount billed or paid for goods / services in a controlled transaction by reference to the amount charged in a comparable uncontrolled transaction. So exactly the exact comparability of the products or services will generally be the most important factor in this method. Thus, MCP is the most direct and reliable method for applying the the market price principle. Thus, in case information are available, MCP method is preferable to the detriment of all other methods.

**RPM method**

MPR method applies to the transactions involving the purchase and resale of the same goods or services. This method takes the price at which a product / service is resold to an independent third party.

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\(^4\) A similar approach will be found in Article B 4, Annex 1, Order No. 222/2008.


and reduce the price of resale with the corresponding gross margin representing the amount in which the reseller would seek to cover operating expenses and selling and given its features and risks, obtain an adequate return. The comparability of the RPM method assumes that there are no differences to significantly affect the resale price margin market or that reasonably accurate adjustments can be made to justify these differences. The level or reliability of these adjustments will affect the relative strength analysis through the RPM method. Are required fewer adjustments to justify the differences of product than in the case of MCP method, but other attributes of comparability and functions, generally have greater importance.

\textit{CP-M}\textbf{ }

CP-M method involves the calculation of direct and indirect costs production incurred by the enterprise regarding the goods transferred or services provided to an associated enterprise. A normal gross profit margin is added to the cost which is adjusted for and of other nature functional differences, if there are between the controlled and uncontrolled transactions. The amount obtained by adding normal gross profit margin can be considered the market price of the original controlled transaction.

\textit{MDP}\textbf{ }

MDP can be applied generally in an international transaction involving transfer of unique intangibles or in multiple international transactions which are so closely interrelated that can not be evaluated separately to determine the market price for a single transaction. MDP is therefore suitable for integrated transactions between associated enterprises. MDP calculates profit (either total or residual) obtained from the controlled transaction and shares the profit depending on the contribution of each entity and, therefore, is consistent with what would have happened under the market price principle. The contribution of each entity is determined by conducting a functional analysis and evaluated, if possible, by reference to reliable data regarding the foreign market.

\textit{MNM method}\textbf{ }

The MNM method examines the net margin profits made by an entity in a transaction or transactions with related parties and compares it with the margin set by the same entity in transactions with independent entities or to that of the margin of independent entities in comparable transactions. Since The MNM method examines the net margin of profit in correlation with the corresponding (ie cost, sales), this works in a way similar to CP-M. Thus, The MNM should take into account only the profits of the controlled company that are attributable to the transactions covered by this study. Application of the MNM method at company level is not appropriate if the company is involved in a wide range of different controlled transactions that can not be fully comparable with those of a company comparable uncontrolled.

4. Conclusions

It is assumed that all conclusions drawn from the comparative study are tenable. Even in these circumstances, there was no guarantee that the tax authorities will agree with the analysis. Since tax law is constantly changing\textsuperscript{7} but also the inconsistent practice in interpreting laws\textsuperscript{8} and choosing the most suitable method could have a significant impact on fiscal consequences. More so, the tax authorities will have doubts if, for example, the operation would take place at a modest price in a free zone or an offshore company\textsuperscript{9} and subsequently through re-export, increasing significantly the price to the true destination. Therefore, the study itself is a guarantee that the Romanian authorities or any other authorities will not try to adjust the transfer market prices for the period under review or will not be calculated penalties. Therefore it is recommended that the study should include information obtained from independent third parties such as: databases used by institutions recognized, tax annual financial statements submitted and prestigious publications in the field.

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\textsuperscript{8} See Bernard Castagnede, Precis de fiscalite internationale, PUF, Paris, 2010, p.105

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