Transfer Pricing Documentation – A Current Issue

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Rather quick development of the business environment has led to the implementation of legislative measures to meet the requirements and amendments thereto. With the adoption of the Fiscal Procedure Code and Order no. 442/2016 were founded transfer pricing procedures, denoting a means of making taxable transfer of a high tax country to a low tax country. These laws have laid down conditions that must be met and materiality thresholds that must take into account the taxpayer to draft transfer pricing documentation file. The aim of these measures is to reduce the differences between the prices charged by the related parts and the market value and also to actual results of company taxation. The tax authorities are entitled to apply price adjustments when it is not the principle of market value, which entail economic double taxation. Application and dossier preparation of transfer pricing contribute to a collective vision on the market in which the company operates, understanding how business development and, not least, the creation of an appropriate fiscal planning.

Keywords: transfer price, intra-group transaction, related parts

Introduction

The rapid expansion of intra-group transactions generated increased attention from the authorities regarding the method of taxation of such transactions.

What is intragroup transaction?

All agreements made by an entity that is part of a financial conglomerate with another entity of the same group or by a natural or legal person who has relationships with member entities of the group. When we talk about financial conglomerate?

An entity's relationship with a related part may have influenced both positive and adverse outcome and its financial position in light of the aim pursued in carrying out such transactions. Transfer price represents an important issue, particularly for multinational firms, having followers but also criticism, depending on their ability to get a benefit from its use.
Transfer prices-definition and concept

Transfer pricing is the price of the transaction carried out between related parts. The legislation requires that such transactions be carried out at market price, in other words the price at which a transaction was conducted the same transactions between independent entities, in similar economic conditions. The term "transfer price" includes all the laws by which the states want results related party transactions to be accounted for at the time and place of occurrence. So desired as transfer pricing can generate an increase in profit achieved by the group in countries with low tax or, why not, may reduce profits where taxation is high. In other words, we speak of the erosion of the tax base and a transfer of the profits made.

The use of transfer pricing can be both an opportunity and a threat, having significant influence on the business environment. Addressing a vast field can benefit companies in terms of operational advantages, such as knowledge of related party transactions and identifying opportunities for allocation of revenues and expenditures, deep understanding of the business model and optimization possibilities, which in other conditions could be overlooked. However, the use of transfer pricing does not respect the market value may result in adjustments to the tax base and economic double taxation when transactions involving companies in several countries.

Managers who will be able to combine the benefits of taking advantage of the potential fiscal risk management through the transfer prices, the company will ensure a long-term competitive advantage. Therefore necessary to re-examine and substantiation of price transfer policies at group level and the preparation of a specific and complete documentation through which you can demonstrate the value of market prices in the context of intra-group transactions.

The concept of "arm's length"

Directives Organization of Economic Cooperation and Development (OECD) believes that the cornerstone of transfer pricing is the "arm's length". OECD believes that when two people meet are tempted to embrace and price theory of transfer requires that they be relations between strangers who shake hands when they conclude a transaction, finding himself in an arm away.

Methods of transfer pricing

Methods of determining the transfer prices are analytical tools for the determination or evaluation of market value of transactions between affiliated persons. Multinational companies are using these methods of tax planning and/or documentation of transfer prices charged. Tax authorities use these methods to test the market value of transactions between affiliated persons in order to determine the "actual profits", that is, profits that would have been obtained in the absence of the affiliate relationship between the two parties.

Further will be pricing methods of transfer provided for by legislation, namely law No. 571/2003. Similar guidelines for transfer prices issued by the Organization for Economic Cooperation and Development, the national legislation makes reference to the 5 methods of transfer pricing. This includes both traditional methods and transactional methods.

Traditional methods:                Transactional methods:  
- price comparison method                            - net margin method  
- cost plus method               - profit sharing method  
- resale price method

In addition to the five methods above, OECD Guide permit application/use and other methods, provided that such transfer prices comply with the established principle of market value, and to justify the taxpayer through a need for documentation of such election methods.

Method CUP (Comparable Uncontrolled Price) compares the price charged for property or services, in a controlled transaction to the price charged property or services in an uncontrolled transaction in similar circumstances.

Example
It is considered 2 companies:
• company A-manufacturer of bicycles based in Romania, and
• company B-importing company based in Belgium.

The transaction is based on controlled transfer between bicycle company A and company B who purchase and resell bikes for independent dealers in Belgium. Thus the company is a parent company for company B.
To determine if the price charged for the bikes this transaction is controlled at arm's length, taking into account the following information:

- the price charged for bikes transferred to a comparable uncontrolled transaction between the company A and the Dealer 3;
- the price charged for bikes transferred to a comparable uncontrolled transaction between the company B and the Dealer 1;
- the price charged for bikes transferred to a comparable uncontrolled transaction between Dealer 1 and Dealer 2.

Comparable uncontrolled transaction, such as the transaction 1 and 2 are referred to as comparable internal transactions and transaction is a transaction 3 comparable external (neither of the two sides is not an associate). In the CUP method, a comparable uncontrolled transaction with a transaction is considered to be controlled if:

- there are no differences between comparable transactions that would affect the price;
- it is possible to make adjustments as accurate to determine the significant differences between the two types of transactions.

Cases when using the CUP method:

- comparable sales for the same product;
- the effect of geographical differences;
- minor differences between products.

Method CPM (Cost Plus Method) used to determine the market price, the cost of which is recorded by the producer of goods or of services in a transaction controlled, cost is appropriate profit margin increased by scope. If the profit margin is low when the market price and the transfer price will be at the same level. As with the CUP method, CPM method can be applied when a producer sells finished products to both affiliates and third parties or when the finished goods are sold between related third parties.

The market value of controlled transactions will be determined based on the margin of comparable uncontrolled transactions, while in external comparable transactions this will be determined based on a comparative analysis on a sample of independent company tested similar. The applicability of this method is comparable transactions so that no differences to produce a material effect on the profit margin or, if that appears to can make adjustments to eliminate these differences.
Example

Color company SRL produces 2 types of pencils: pencils HB type and type F. The production cost of HB type pencils is 1 ron and for pencils type F the cost is 0.8 ron. Type HB pencils are sold by the Color Distribution SRL of 1.2 ron, while the other pencils are sold by a company independent of 0.96 ron. It is considered that the other conditions of the transaction are similar.

Transaction by Color Distribution
Margin = (pv-cp)/cp * 100 = (1,2-1)/1 * 100 = 20

Transaction by a company independent
Margin = (pv-cp) * 100 = cp (0,96-0,8)/0,8 * 100 = 20

It can be inferred from the analysis that the price-making type HB is set at market value.

To remember

- CPM method is used when talking about selling some semi-finished products between affiliated parties, provision of services (research and development) or sales/purchase contracts concluded long-term;
- considering the circumstances in which the transaction takes place and does not require that the goods that are the subject of an uncontrolled transaction should be identical to those in a controlled transaction;
- a classification of expenses which will be covered in the cost. In the event that a controlled transaction costs differs from that of an uncontrolled transaction and cannot make adjustments in order to eliminate these differences, then the method cannot be applied;
- in the context of financial statements prepared in accordance with accounting regulations are described after the Romanian costs of their nature and not according to their destination, which makes it possible to distinguish between the cost of goods sold or services rendered and other operational expenses of comparable companies.

RPM method (Resale Price Method) consists in transfer pricing starting from the purchase price of a product, from an affiliated entity/person and resold to third parties. Resale price thus established is the reduced gross margin enabling the entity to obtain a profit what highlights the functions fulfilled by this, risks and also market conditions. The result constitutes the market price of the transfer of goods between the affiliated parties.

Example

The company Alpha acquires for resale sports equipment from the Beta at price of 100 $. They will be resold to third parties at price of 110 $/piece. Functional analysis has led to the conclusion that Alpha company acts as distributor with functions and risks limited. On the basis of a comparability study performed on the market for sports equipment retailers resulted in a gross margin of 20% sales. The market value of the transfer price will be reduced by the gross margin, which leads to the conclusion that between the two companies is not respected the principle of market value.

Figure 5 Method RPM

Given price = 110 lei;
Resale price margin (20%) = 20 lei
Arm’s length price = 90 lei

Transfer price = Reseller price * (1- Margin Profit)

To remember

- RPM method is one of the most effective methods for analyzing the activities of distribution system operators;
- is used when an entity has not added substantial value to the product before reselling it (trade mark);
• unlike the CUP method, in which the comparability of products is an essential condition, for
the application of the method RPM comparing the appearance products has a lower
importance.

**Method NMM** (Net Margin Method) is based on economic theory that considers the net profit
margin obtained by a company who are engaged in similar activities, on the same market and in the
same industry tends to equilibrate after a certain period of time. This method is similar to the CPM and
RPM, with the difference that using NMM it analyzes the net margin of profit and not the gross margin.
Net profit margin is calculated as the ratio between profit from operating activity resulting from a
controlled transaction and a base (assets, cost, sales). The market value of the controlled transaction is
determined by comparing the net margin from this transaction with that obtained by a company
affiliated in transaction with independent persons.

**To remember**

- The method is based on economic theory that considers the net profit margin obtained by a
  company what is the method most commonly used in practice due to the financial information
  that are necessary for the purpose of calculating financial indicators to determine the
  profitability of affiliated entities;
- is used with the aim of drawing documentation of transfer pricing prices;
- the advantage of this method is that transactional differences with direct impact on the price
  of the transaction have a insignificant influence on the net margin. It is more tolerant to
certain differences between the controlled and uncontrolled transactions than the gross
margin;
- in the context of this method shall take into account only the profits resulting from a
  transaction reporting.

**Method PSM** (Profit Split Method) is used when the affiliated persons hold the intangible assets
that have a high value or where transactions between the parties are so complex that they cannot be
separated into independent transactions. At the same time, this method is also used when entities
decide to conclude a partnership to share the profits. The strength of this method in the fact that it is
not based on, directly, transaction with a high degree of comparability, can be used in cases where it
cannot be established with these transactions between independent entities. As disadvantage may
highlight the fact that independent entities do not use the SLP method because it is difficult to identify
specific external data. If the external data are more vague with both the Division of profit is more
subjective.

**Transfer prices dossier**

Transfer prices dossier will be compiled only when talking of transactions between affiliated
persons and represents the document justifying those transactions. Will be drawn up annually by the
great contributors to the transactions of a total value exceeding:

- 200,000 € (the equivalent in ron at the rate of NBR\(^{139}\) being determined on the last day of a
  fiscal year) for collection or payment of interest;
- 250,000 € (the equivalent in ron at the rate of NBR being determined on the last day of a fiscal
  year) for purchases or services;
- 350,000 € (the equivalent in ron at the rate of NBR being determined on the last day of a fiscal
  year) for purchases or deliveries of goods.

The deadline for the presentation of great contributors is 10 calendar days from the date of the request
by the tax body. Transactions that do not result in keeping records must comply with the following
limits:

- 50,000 € (the equivalent in ron at the rate of NBR being determined on the last day of a fiscal
  year) for collection or payment of interest;
- 50,000 € (the equivalent in ron at the rate of NBR being determined on the last day of a fiscal
  year) for purchases or services;
- 100,000 € (the equivalent in ron at the rate of NBR being determined on the last day of a fiscal
  year) for purchases or deliveries of goods.

In this situation the transfer prices dossier shall be made only at the request of the tax body, when we
speak of a tax inspection being presented within a period of between 30 to 60 calendar days from the
date of application. The term might be one change by no more than 30 calendar days thereafter, at the

\(^{139}\) NBR- National Bank of Romania
request of the taxpayer. It should include both, information about the group as well as information on the taxpayer.\(^\text{140}\).

Table 1 Contents of the dossier transfer prices

<table>
<thead>
<tr>
<th>Information about the group</th>
<th>Information about the taxpayer</th>
</tr>
</thead>
<tbody>
<tr>
<td>➢ the organisational structure of the group, legal and operational, including equity interest, history and financial data relating to it;</td>
<td>➢ presentation of transactions with affiliated persons: how billing and trading counter value transactions;</td>
</tr>
<tr>
<td>➢ general description of the work of the group, business strategy, including changes in business strategy compared to the previous fiscal year;</td>
<td>➢ the comparative analysis:</td>
</tr>
<tr>
<td>➢ presentation of transactions with affiliated persons: how billing and trading counter value transactions;</td>
<td>a) the characteristics of the supplies/services;</td>
</tr>
<tr>
<td>➢ general description of the functions and risks of affiliated persons, including changes in this respect compared to previous year;</td>
<td>b) functional analysis (functions, risks, assets used, etc.);</td>
</tr>
<tr>
<td>➢ overview transactions between affiliated persons in the European Union: the way of trading, transaction and billing counter value of all transactions;</td>
<td>c) terms of the contract;</td>
</tr>
<tr>
<td>➢ overview transactions between affiliated persons in the European Union: the way of trading, transaction and billing counter value of all transactions;</td>
<td>d) economic circumstances;</td>
</tr>
<tr>
<td>➢ presentation of affiliate persons and their permanent premises involved in such transactions or arrangements;</td>
<td>e) specific business strategies;</td>
</tr>
<tr>
<td>➢ presentation of affiliate persons and their permanent premises involved in such transactions or arrangements;</td>
<td>i) information on comparable transactions in external or internal;</td>
</tr>
<tr>
<td>➢ general description of the work of the group, business strategy, including changes in business strategy compared to the previous fiscal year;</td>
<td>➢ presentation of affiliate persons and their permanent premises involved in such transactions or arrangements;</td>
</tr>
<tr>
<td>➢ general description of the work of the group, business strategy, including changes in business strategy compared to the previous fiscal year;</td>
<td>➢ description of the method of determining the transfer prices and the rationale for its selection criteria.</td>
</tr>
<tr>
<td>➢ general description of the work of the group, business strategy, including changes in business strategy compared to the previous fiscal year;</td>
<td>➢ description of other circumstances considered relevant to the taxpayer.</td>
</tr>
</tbody>
</table>

The need for transfer prices dossier result from the fact that:

a) is prescribed by the legislation Romanian, penalizing failure or incomplete presentation of it with a fine between 12000 and 28000 ron;

b) commissioners shall receive information that are used in a much more adequate control of the risks of transfer prices, and the taxpayers are required to pay all necessary attention to the establishment of their.

c) an actualization of its price adjustments which protects against transfer.

It is considered two companies SC X SRL and SC Y SRL forming part of the multinational group XY. Company X is a resident company in Romania which has as main activity the production of auto parts. Company Y is a resident company in Poland dealing with distribution of auto spare parts. The financial statements of the company are as follows:

Tabel 2 Financial statements

<table>
<thead>
<tr>
<th></th>
<th>Company X</th>
<th>Company Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income of sales</td>
<td>85</td>
<td>105</td>
</tr>
<tr>
<td>Cost of production</td>
<td>60</td>
<td>85</td>
</tr>
<tr>
<td>Gross margin</td>
<td>25</td>
<td>20</td>
</tr>
<tr>
<td>Operating costs</td>
<td>15</td>
<td>16</td>
</tr>
<tr>
<td>Operating result</td>
<td>10</td>
<td>14</td>
</tr>
</tbody>
</table>

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\(^{140}\) Order 442/2016 concerning time limits for the amount of the transaction, preparing the contents and conditions of the transfer prices dossier and procedure for adjustment of prices/estimation, Art. 2.
From financial statements that company X has obtained an operating result of 10 million € taxable under the laws of Romania, and Company Y a result of 14 million € taxed under the laws of Poland. The amount of the profit of the group is 24 million €. Group Y is subjected to a check carried out by the empowered tax authorities from Poland because they believe that the price at which the spare parts are purchased by the company X does not faithfully reflects the market value thereof. As a result of the investigation it is decided a purchase price adjustment with 3 million €.

<table>
<thead>
<tr>
<th>Company</th>
<th>Company Y (without adjustment)</th>
<th>Company Y (adjusting)</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>85</td>
<td>105</td>
</tr>
<tr>
<td>Y</td>
<td>60</td>
<td>85</td>
</tr>
<tr>
<td></td>
<td>25</td>
<td>20</td>
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<td>16</td>
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<td></td>
<td>10</td>
<td>14</td>
</tr>
</tbody>
</table>

Adjusting the purchase price had increased as a result of the impact of the operating result of society Y from 14 million € to 17 million €, led finally, to the amendment of tax payment by the company in Poland. Profit at the level of the Group recorded an increase of 15 million € (10+14) € to 27 million (17-10), which leads to a tax and amount of 3 million € twice: in Romania and in Poland. In order to avoid double taxation, authorities from Romania had to adjust the earnings of X with the same value.

**Conclusions**

Transfer prices they had a major impact for the majority of the tax authorities, the endeavouring to eliminate the process of moving the results and eroding the taxable base. Current legislation provides information about categories of taxpayers who are required to prepare transfer prices dossier about the components of a file and not the least significance thresholds that must be taken into account. Regards methods for determining transfer prices may conclude that their role is to assist the company in fiscal planning process and in obtaining information regarding the transfer prices used. These methods for tax authorities offer the opportunity of checking the correctness of individual profits affiliate parties.

Transfer prices dossier is not unnecessarily cost the company but is choosing a document justifying the price for completion of a transaction. In the context of past transactions are analysed, which had an impact on the company’s results, being necessary a permanent update of it especially when we are talking about significant events for the company, for example, major restructuring changes market operates and mergers etc.

Impact of neîntocmirii a file transfer prices and make inappropriate of it, not only does it attract the penalties provided for by law, but also affects the group’s business by blocking the investments as available resources will be transferred to cover the price adjustments. Are more highlights and a situation in which an entity may be subject to tax in two states (legal double taxation). An example is when a non-resident entity is taxed both in the state in which he resides as well as in the state where a permanent establishment for the proceeds of the permanent establishment.

A file transfer prices must be like a jigsaw puzzle whose pieces joined together, justified and compelling financial business success determined.

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