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Transfer Pricing - An Innovative Approach

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Transfer Pricing - An Innovative Approach

Ramona MAXIM[1], Florentina MOISESCU[2]*

Abstract

This paper presents transfer pricing and elements of drafting the transfer pricing file by the big companies. The transfer pricing procedure was founded based upon Order no. 442/2016 and the Fiscal Procedure Code and it represents a method upon which the tax base is transferred from a high tax country to a country with low taxation. This legislation outlines the conditions which companies must observe in order to draft the transfer pricing documentation and the significance thresholds. The purpose to draft a transfer pricing file is to reduce the differences between prices and market value and the actual results of company taxation. Economic double taxation occurs when tax authorities apply price adjustments because the company did not respect the principle of market value. Keeping records of transfer pricing and practicing a price aligned to market requirements contribute to an understanding of business development and the creation of appropriate tax planning. Taking into account all these aspects and the fact that any taxpayer is tempted to pay the lowest possible fees, tax havens become an option. In this context we can speak of a tax haven as a loophole in the use of the market price.

Keywords: *transfer price, double taxation, market value.*

1. Introduction

The debate on the tax competition becomes more and more important as a result of a decrease in the resources generated by taxes and the erosion in the profit tax calculation. Transfer pricing has become an issue for big companies because finding an efficient commercial trading level became problematic. In the case of a competitive market the solution would be the choice of a reference price, but things become different in the context

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of a monopole for the specific good. In general, the economist uses the marginal cost, as a reference point in setting up the transfer price, which depends on the cost of opportunity.

Bengt and Tirole[1] believe that transfer pricing is a means of a company's revenues forecast, revenues which are influenced by tax base and tax amount. Speciality literature has tried to highlight the impact of taxes on the economy but also on the economic agents. Hines[2] believes that taxes charged by the state affect the attraction of foreign investors. The differences of tax values directly influence the profit reported by altering the economic reality of the company. In this context, companies are attracted to countries which practice very low taxes or don't charge any taxes at all. These states, known as "tax havens", in order to seize financial investments, have passed legislation with multiple benefits, including tax exemption or a reduced taxation. A tax haven is defined as "a territory where natural persons or companies feel they pay less taxes than elsewhere"[3].

2. Transfer pricing and the "arm's length" concept

The price of a transaction between related parties outlines the concept of transfer price. Norms underline the operating mode of these transactions. With a view to establishing a fair price, account must be taken of the price of similar transactions carried out in similar economic circumstances. This concept of "transfer" is adopted in order to better trace the results obtained following the transactions between the related parties, as well as correctly register the economic activity. All these measures have been generated due to the fact that the transfer price may result in an increase of the profit obtained by the group within the low taxation states, or reduction of the profit within the high taxation states.

The business environment may be influenced positively, but also negatively, by the use of transfer pricing by the big companies. The benefits of using transfer pricing consist of understanding the operations carried out with affiliated entities, proper allocation of revenue and expenditure and the knowledge of the competitive environment in view of the development of its own economic activities. However, practicing transfer pricing by not taking into account the market conditions can cause a reduction of the taxation base and the double taxation of the obtained results.

The OECD Guidelines stress out that transfer pricing is based upon the "arm's length" concept [4]. OECD considers that when two people meet they shake hands, thus transfer pricing theory requires that their relations should be those of strangers who shake hands when they conclude a transaction, at an arm's length.

To achieve a long-term benefit managers must find the best way of combining the results with the risks involved by obtaining these results. Consequently, a group should consider establishing and understanding transfer pricing policies, drafting the transfer pricing file which must include all documents proving compliance with the market value. Rosenbloom [5] considers that "the problem addressed by the transfer pricing rules is the absence of market friction in transactions between controlled persons and the resulting need to verify prices in such transactions for income tax purposes and, if necessary, to adjust for that absence".

3. Requirements for drafting the transfer pricing file

The transfer pricing file is the document attesting such transactions have been carried out and shall be drafted annually only for certain types of transactions. Fig. 1.1 presents the operations for which such a file must be submitted.

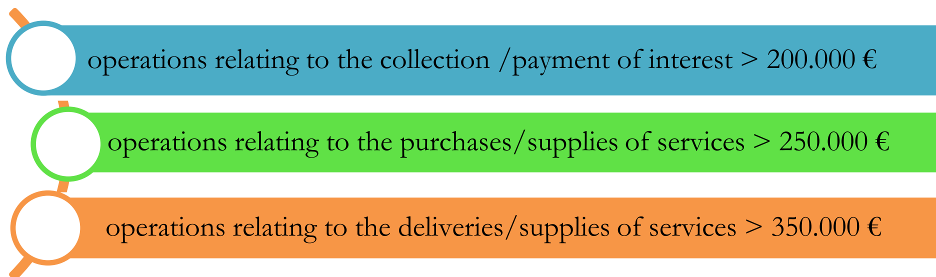

Fig 1.1 Value of the transactions for which the transfer pricing file must be drafted

Moreover, the legislation provides as well the limits of the transactions for which it is not necessary to draft the transfer pricing file. Fig. 1.2 presents these limits and the transactions types.

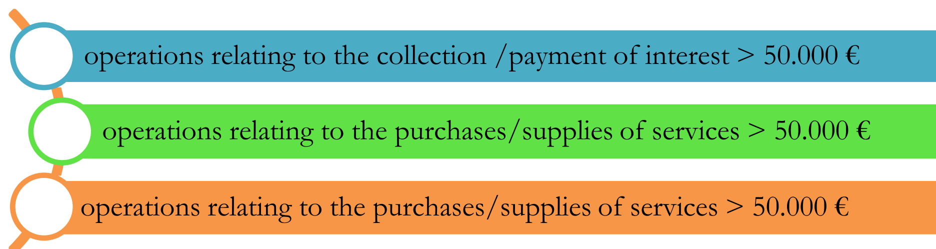

Fig 1.2 Value of the transactions for which the transfer pricing file should not be drafted

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For the purpose of determining the transfer price, companies may use traditional, as well as transactional methods, as specified by Law 571/2003 on the Fiscal Code. Table 1.1 presents the traditional and transactional methods, with a brief description of their characteristics [6].

Table 1.1 Traditional and transactional methods

Traditional methods	Transactional methods
CUP **- similar sales for similar products** **- similar products - no major quality differences**	NNM - considers only profits resulting from a studied transaction - use of financial information
CPM **- circumstances of operations** **- operations with semi-manufacturing products**	PSM - reduced comparability; - difficulty in obtaining data from external sources
RPM **-distribution activity** **-reduced comparability between products**	

The price practiced by a parent company in the transactions with its subsidiaries may be increased or decreased depending on the conventions established between them. The rationale of these price manipulations is explained in fig. 1.3.

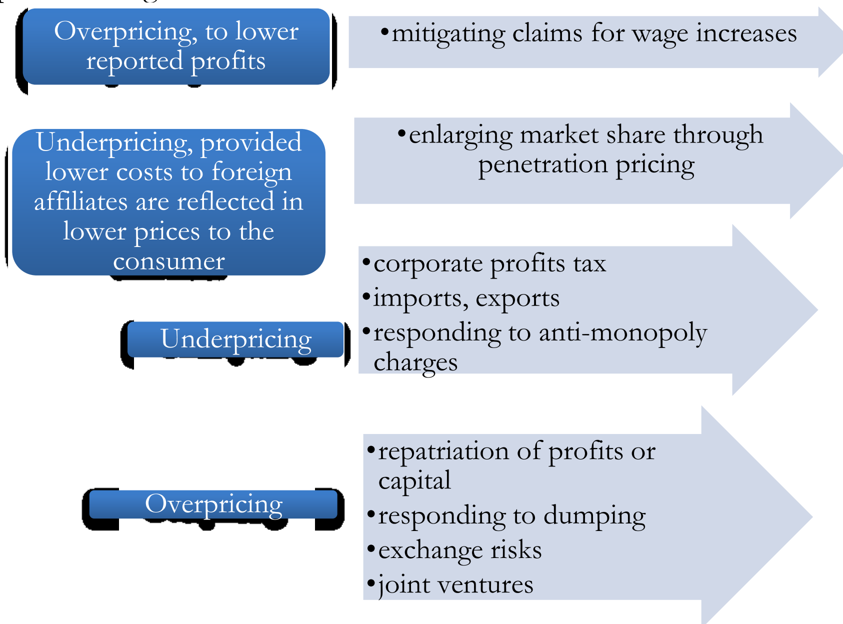

Figure 1.3 Transfer pricing manipulation

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Each company is free to choose the method which fits best its activity, for a faithful representation of the obtained results. The transfer pricing file is the company image, which contributes to the business development.

4. The "tax haven"

Taxpayers's intention to pay the smallest taxes or to be tax exempted is not new. Tax havens were created as a result of the lack of confidence in the local authorities, but also due to the rapid developments of new technologies, making fast financial transfers possible. Chavagneux [7] states that there is a clear definition of tax havens due to the complex activities carried out under them. He believes that the most simple tax havens are those regions that have a range large enough to allow them to promulgate their own fiscal and financial rules. The states considered tax havens have the following specific characteristics:

- reduced fees;
- confidentiality of banking and commercial information;
- growing banking activity;
- encouraging foreign investments.

To bypass the national legislation and to get rid of the documentation necessary for the preparation of the transfer pricing file, companies are choosing tax havens. In this case, companies either benefit of low taxes, or they are tax exempted. There is a list of countries included either in main tax havens, or secondary tax havens. Table 1.2 presents the main tax havens countries category[8]. Secondary tax havens countries are countries with a small territory and a small population. They do not meet all the conditions required to be considered main tax havens.

Table 1.2 Main tax havens

Main tax havens
- "pure heavens" countries: Bahamas, Mauritius, Cayman Islands;
- countries with reduced income tax: Cyprus, Malta, Switzerland, Jersey;
- countries with fixed tax on a territorial basis: Liberia, Malaysia, Great Britain;
- countries where offshore companies and holding companies have special arrangements: Austria, Hungary, Holland, Singapore;
- countries where exporting companies are exempt from duties: Irland, Madeira;
- countries where international business companies have tax advantages: Bermuda, Bahamas, Virgin British Islands;

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- countries where banking companies have tax advantages: Hong Kong, Malaysia, Philippines, Singapore.

The interest of natural persons in using tax havens is to take advantage of state policies, being attracted to countries where taxation is low or is absent. Regarding legal entities, they use the following arguments for tax havens [9]:

- certain tax havens tax the income in the year previous of its realization;
- tax havens concern transactions of patents, trademarks and manufacturing processes;
- a subsidiary in a tax haven can be used by its parent company as a point of purchase for their own goods. These goods are then resold to plants abroad, taking advantage of common remises without losing the benefit of the sale;
- purchase of material goods at the local market price, through a subsidiary located in a tax haven allowing for non-taxable benefits;
- captive insurance companies are used by multinational companies to become their own insurer, due to substantial costs of insurance and insurable due to the activities of some of them. Captive insurance companies can also become a means to finance the investments of the parent company;
- captive banks are created for the needs of a group of individuals. They have the status of non-resident bank and may execute operations of any kind, with the exception of those involving residents of the countries in which they are installed;
- the establishment of a trust is facilitated largely for people originating in a country governed by British Common Law;
- tax havens consist of highly competent lawyers, bankers and accountants.

As mentioned in table 1.2, the list of “pure havens" countries includes also Bahamas, an archipelago which includes companies that are exempted from income tax for a period of approx. 20 years. It is the leading country regarding the quality of provided services and with a high affordability legislation. In the last few years, in response to the monitoring of money laundering and tax havens, Bahamas has reviewed the legislation and has been harmonized at the new requirements, which has made the FATF to pass as a territory that offers safety to investors.

Malta is among the states practicing a low level of the tax on profit, with an overwhelming fiscal system. There are areas where taxes are very low both for natural persons and legal entities. It has the following

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competitive advantages: geographic location, developed infrastructure and a developed business environment.

5. Conclusions

Using the transfer pricing procedure, authorities try to eliminate the relocation process of profit transfer and reduce profits from the tax base. The current legislation specifies which taxpayers are required to draft the transfer pricing file, the file components but also the limits on transactions values. The methods setting up the transfer prices are intended to support the company for a correct fiscal planning.

Also, these methods support the tax authorities in analyzing the results reported by affiliated parties. Transfer pricing documentation should not be seen as a cost, but as a document justifying the choice of end transaction price. In case no transfer pricing documentation is drafted, leading to an incomplete preparation thereof, sanctions are applied, as specified by the law in force, influencing the business by reducing investment values, because resources will be allocated to cover the price adjustments. Countries meeting the characteristics of a tax haven are a "shelter" for companies wishing to reduce or cancel taxation in the country of origin. The next step in the fight against tax havens refers to the culture of secrecy. The absence of opacity in these countries will prevent their use as a means of avoiding the national legislation and transactions between companies, the value of these transactions and all related parties will be easily identified.

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