

PRACTICAL AND THEORETICAL ASPECTS ON TRANSFER PRICING

Assoc. Prof. Radu BUZIERNESCU, PhD
University of Craiova,
Lect. Mihai ANTONESCU, PhD
Spiru Haret University

1. Preliminary considerations

The transfer pricing are the prices at which a company sells tangible or intangible assets or provides services to affiliated companies.

The transfer pricing procedure must comply with the market's value principle (the arm's length principle), this principle representing the standard agreed with the OECD countries to determine the transfer pricing in terms of tax purposes.

The principle of market value is shown in the art. 9, para. 1 of the OECD Model Tax Convention "when two partner companies are, in their commercial or financial relations, bound by the imposed conditions, which differ from those that would be agreed between two independent companies, the profits which under these circumstances would have been made by one of the two companies, but in fact they could not be made because of these conditions, shall be included in the profits of this company and shall be properly taxed".

In summary, according to this principle, the commercial and financial conditions set in the transactions between the two affiliated entities should not differ from the conditions set between two independent entities, in similar transactions, under similar circumstances. If the transfer pricing does not comply with the market's value principle, the tax authorities can make adjustments of companies' profits, to ensure the compliance with this principle.

2. Presentation of the legislative framework in Romania

In Romania, the laws on transfer pricing have been constantly subject to some amendments and additions, in order to improve it.

Article 7, section 26 of the Tax Code includes a definition of the market price, according to which this represents the amount that would be paid by an independent client to an independent provider at the same time and same place, for the same asset or service or for a similar one, in conditions of fair competition. Also, the same article includes the description of the relationships between two persons, which leads to their classification as being affiliated. Thus, a person is affiliated with another person if the relationship between them is defined by at least one of the following cases:

a) a natural person is affiliated with another natural person if they are husband/wife or third-degree relatives, inclusively. Between the affiliated persons, the price at which the tangible or intangible assets are transferred or services are provided represent the transfer price;

b) a natural person is affiliated with a legal person if the natural person holds, directly or indirectly, including the holdings of the affiliated persons, minimum 25% of the value/number of shares or voting rights held by the legal person or if it is actually controlling the legal person;

c) a legal person is affiliated with another legal person if at least:

(i) the first legal person holds, directly or indirectly, including the holdings of the affiliated persons, minimum 25% of the value/number of shares or voting rights of the other legal person or if it is controlling the legal person;

(ii) the second legal person holds, directly or indirectly, including the holdings of the affiliated persons, minimum 25% of the value/number of shares or voting rights of the first legal person;

(iii) the third legal person holds, directly or indirectly, including the holdings of the affiliated persons, minimum 25% of the value/number of shares or voting rights both of the first legal person and the second legal person.

The mandatory character of the affiliated persons to use “the market price” in the transactions between them and the recommendation of acknowledged methods in the guidelines on transfer pricing issued by the OECD as methods that are used to set “the market price” are regulated by the art. 11, para. 2 of the Tax Code.

We emphasize that, by the same article, in order to establish the market price, the principle of using the most appropriate method is set up, considering the following elements: the method which most approaches the circumstances in which the prices subject to free competition on markets commercially comparable are established; the method for which data are available resulting from the actual operation of the affiliated persons involved in transactions subject to free competition; the degree of precision with which adjustments can be made to obtain comparability; the circumstances of the individual case; the activities actually developed by the different affiliated persons; the used method must comply with the given circumstances of the market and the

taxpayer's activity; the documentation that can be made available by the taxpayer.

The methods to establish the transfer pricing are developed in section 22-41 of the GD no 44/2004 on approving the Methodological Norms to apply the Law no. 571/2003 on the Tax Code. The same regulation establishes the rule to perform the reconsideration of records, in order to reflect the market price of assets and services to the other involved affiliated person, too.

By the Order of the President of the National Agency for Tax Administration no. 222/2008, it is approved the content of the file which the taxpayers involved in transactions with affiliated persons are required, upon the request of the competent fiscal body, to elaborate and submit within the terms established by it, in order to establish the transfer pricing.

According to this order, the documentation elaborated by the taxpayer on the transfer pricing provides information structured in two chapters: information about the group and information about the taxpayer. The information about the taxpayer present the transactions with affiliated persons, comparative analysis, affiliated persons and their permanent headquarters involved in these transactions or agreements, arrangements, describing the calculation method of transfer pricing and argumentation of its selection criteria, as well as the description of some conditions considered relevant to the taxpayer. Comparative analysis aims

3. Comparative analysis – main component of the transfer pricing file

The comparative analysis is made to identify some uncontrolled comparable transactions that can be used to establish the comparison interval, thus the determination of transfer pricing in accordance with the market's value principle can not be achieved in lack of a comparative analysis. For a controlled

transaction to comply with the market's value principle, it must be comparable with an uncontrolled transaction. If there are significant differences between the controlled and uncontrolled transactions that would affect the price/profit, exact adjustments must be made in order to ensure their comparability.

To do that, it is necessary to identify and present the following elements which may influence the price or profit of a transaction: characteristics of assets or services; functional analysis of the company (positions, risks, used fixed assets, and so on); contracting terms; economic circumstances; strategies of specific business; information on external or internal comparable transactions.

Characteristics of assets or services. In terms of tangible assets, the physical specifications of assets, the services related to the transaction and the volume of traded assets shall be emphasized, while in terms of intangible assets the duration and protection of intangible assets is important, as well as the expected benefits from their use. In terms of services it is emphasized their type, purpose and quality.

Functional analysis is necessary, because the OECD Guide on transfer pricing for multinational companies and tax administrations mentions that "in the transactions between two independent companies, generally remuneration reflects the functions that each company fulfils (taking into account the used assets and assumed risks)". Mainly, if a campaign fulfils as many features and takes the corresponding risks, its compensation degree increases, too.

The functional analysis includes the description of the functions fulfilled by the company, the held assets and risks to which the company is subject in relation to the activities developed for the benefit of its affiliated persons. Obviously, there is a correlation between the functions fulfilled by each of the affiliated parties, on the one hand and the risks assumed

and used tangible and intangible assets, on the other hand.

In summary, functional analysis is intended to provide information on each entity involved in transaction (functions, risks, assets) in order to identify the uncontrolled comparable transactions.

The functional analysis is made for each type of transaction concluded with each of the affiliated persons, a company being able to fulfil different functions even within the transactions made with the same affiliated person.

A wide range of activities (functions) is identified within a group of companies: research and development; procurement of raw materials, materials and equipment; inventory management; quality control; production; packaging and labelling; sales; advertising and marketing; transport and storage; production planning; technical services; management; administrative positions (general administration, accounting, IT, personnel, financial and legal).

The significant risks that affect the prices in the transactions between the affiliated companies are determined within the functional analysis, such as: the market risk, credit risk, inventory risk, warranty risk and defective products, foreign exchange risk, environmental risk. Assuming by the company of one or more risks determine the remuneration level of that company.

The market risk represents the potential losses incurred by the company due to the unfavorable market conditions. For instance, the branch covers the risk of introducing a new product to the market. But market risks can arise from various reasons: market competition, general economic conditions that may affect the various fields to a different extent, and so on.

The client credit risk is related to the non-payment/delayed payment of the assets supplied by the company.

The inventory risk refers to the losses registered in inventory (loses or inventory depreciation).

The warranty risk and defective products is represented by the costs generated by the replacement of defective products or replacement/remediation of products under warranty.

The foreign exchange risk arises from the fluctuations of the exchange rate of local currency, if the liabilities and debts are paid in other currency other than the local currency.

The environmental risk is generated by the potential costs arising from the compliance with the legal conditions relating to environmental protection.

Making an application of the aforementioned, two types of producers are identified in the production field: contract manufacturers and fully fledges manufacturers.

The contract manufacturers develop the production activities on behalf of the client. Their activity is characterized by the following: their clients are responsible for collecting the orders on products, the clients covering the market risk; they use their own technological knowledge and these are provided to the client; they do not hold intangible assets (trademarks); they only cover the risk related to the production of assets.

A subcategory of contract manufacturers is represented by the toll manufacturers, who provide services on the raw materials supplied by the client, having no right of ownership on the raw materials or obtained products.

The fully fledges manufacturer meets all activity functions and covers all market risks, their transactions being concluded as a result of market demand. Sometimes, they are involved in distribution activities, too.

Regarding the contract manufacturer, because he covers limited risks on business, the remuneration shall

cover the costs and the profit must be constant, but lower than that of the fully fledges manufacturer, that covers all business risks.

To ensure the compatibility of the transactions, the **contracting conditions** should be analyzed, that define how the responsibilities, risks and benefits are divided between the parties in a transaction to the market price.

Economic circumstances. The prices may be different even if it is about the same assets or services in relation to the market place. To ensure the comparability of transactions, there shall be analyzed: location and markets size, the competition with other suppliers/providers, demand; consumer purchasing power; the degree of intervention of authorities in market mechanisms; production costs, and so on.

The implemented **business strategy** also influences the price size and should be analyzed to determine the comparability of the controlled transaction with the uncontrolled transaction. Thus, the promotional trade policies aiming market expansion or penetration of new markets should be considered.

4. Justification of recorded losses

According to section 1.52 of OECD Guide, "the partner companies, so as the independent companies, can undergo real losses, either because of the high start-up costs, the adverse economic conditions, inefficiency, or because of other legitimate economic reasons".

But the existence of losses, as further shown in the document, can only "suggest" the tax administration that it is necessary to check the transfer pricing; the existence of losses does not create an absolute presumption that the prices of the affiliated persons are not market prices.

So, if the company records losses that are not determined by the manipulation of transfer pricing, it is

necessary, in the file on the transfer pricing, to be presented the economic arguments to justify the company's recorded losses.

5. Final considerations

From the above presented it results that the determination of transfer

pricing is not an exact science and the use of transfer pricing to maximize the profits of the groups can generate tax risks. To reduce the tax risks associated with transfer pricing, it is necessary to pay attention to the elaboration of documentation under the applicable laws.

REFERENCES

*****	LAW NO. 571/2003 on the Tax Code, published in the Official Gazette No. 927 dated December 23 rd , 2003, as amended and supplemented;
*****	DECISION OF THE ROMANIAN GOVERNMENT No. 44 dated January 22 nd , 2004 on the Methodological Norms to apply the Law no. 571-2003 on the Tax Code, published in the Official Gazette No. 112 dated February 6 th , 2004, as amended and supplemented;
*****	ORDER OF THE PRESIDENT OF THE NATIONAL AGENCY FOR TAX ADMINISTRATION No. 222 dated February 8 th , 2008 on the content of the transfer pricing file;
*****	Organization for Economic Cooperation and Development (OECD) <i>Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration</i> (The Guide on transfer pricing for multinational companies and tax administrations), 1995;
*****	Pricewaterhouse Coopers, <i>International Transfer Pricing 2011</i> ;