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TRANSFER PRICING – A PRESENT-DAY ISSUE

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Abstract

Within the fiscal inspection procedures and financial control undertaken by the Romanian fiscal authorities, a special place and an everyday more increasing share is occupied by the transactions between Romanian companies with affiliated entities. The principle that should stay at the foundation of these transactions is that every agreement of purchase or sale between affiliates should be made at the market price. This paper aims to present methodological aspects regarding transfer pricing and to underline the evolution and the expectations related to this subject in Romania.

Introduction

The activity report for the National Agency for Fiscal Administration (ANAF) shows that additional payments established, related to the transfer pricing, have increased with 482% in 2011 compared to 2010, 66.6 mil Ron versus 13.8 mil Ron [2]. This outlines a clear indicator of why the transfer pricing is a matter related to the present-day economic activities. For years 2013 – 2016 ANAF [2] has as target the enhancement of the financial controls that involve analyzing the transfer pricing documentation, so that each fiscal inspection to include this area – section specially introduced in the report for fiscal inspection. The Romanian authorities have not hidden the fact that they wish to increase the amounts collected to the state budget, and they even considered it as a priority, so it is expected that the adjustments made following the analysis of the transfer pricing documentation to bring substantial income.

1. THE STATUS OF GROUP COMPANIES IN ROMANIA

In the economic cycle of different countries it can be observed both economic agents that operate as independent legal entities as well as group companies tied together from an economical and

financial point of view, under the control or under the influence of one of these enterprises. Group companies represent a significant reality of the contemporary world.

The National Institute of Statistics (INS) is presenting the status of group companies for 2011 in Romania in the press release no. 98 from 30th of April 2013 [4]. Definitions given by INS for a better understanding of the data shown are: „group” - a number of companies tied together at a head of the group by a nonzero real control share; „head of the group” – a company that is not directly or indirectly controlled by another company and which controls at least one subsidiary; „subgroup of companies” – the units (firms) of a multinational group of companies resident in the same country.

The values presented by INS show that for 2011 Romania had 21.277 groups of companies, out of which 5.555 resident groups and 15.722 multinational company groups (101 of them were controlled from inside the country and 15.621 were controlled from abroad).

The majority of company groups in Romania has activities in commerce, manufacturing or constructions. Depending on the percentage of employees, the majority of the groups of enterprises in Romania is controlled from Germany, France or Holland.

2. LEGISLATION REGARDING TRANSFER PRICING

When we are referring to the transfer pricing we understand the value paid by a company for merchandises, services or loans obtained from a company from the same group. The most important condition in these transactions is that the transfer pricing has to be established taking in consideration the market value of the product,

more specifically if the product is purchased from a company that is not affiliated to the group, the same price has to be paid as the one obtained from the group.

For a better understanding of the concept of “affiliated party”, below you can find the definition of this, from the perspective of the 7th Directive, transposed by the Order of Public Finances Ministry (OMFP) no. 3005/2009. Therefore, we take into account the entities between which there is one of the following relationships [5]:

- ✓ holds the majority of voting rights of the shareholders or associates in another entity, named herein “branch”;

- ✓ shareholder or associate of an entity and the majority of the members of the administration, management and supervision bodies of the concerned entity (branch) that held these functions during the previous financial year, and until the consolidated annual financial situations were issued, they were appointed only as a result of exercising their right to vote;

- ✓ shareholder or associate of a branch, solely holding the control over the majority of the voting rights of the shareholders or the associates of that branch, following an agreement concluded with other shareholders or associates;

- ✓ shareholder or associate of a branch, having the right to exercise a governing influence over that branch, based on a contract concluded with the concerned entity or on a provision included in the articles of association or in the charter, if the regulations applicable to the branch allow this type of contracts or stipulations;

- ✓ mother-company holds the power to exercise or effectively exercises a dominant influence or control over a branch;

- ✓ shareholder or associate of a branch, having the right to appoint or to revoke the majority of the members of the administration, management and supervision bodies of that branch;

- ✓ mother-company and branch are managed on a joint basis by the mother-company.

The way to approach those issues from a fiscal perspective is presented in the Fiscal Code,

article 7, point 21. In case of legal entities, there is affiliation with a person in the following instances:

🚩 When a person is involved:

✓ the person is affiliated with a legal entity if that individual holds, directly or indirectly, including the share of the affiliated persons, a minimum quota of 25% of the value / number of the equity participation to the legal entity or if the person controls effectively the legal entity.

🚩 When a legal entity is involved:

✓ The legal entity is affiliated with another legal entity if at least:

- the first legal entity holds, directly or indirectly, including the share of the affiliated persons, a minimum quota of 25% of the value / number of the equity participation or the voting rights to the other legal entity or if it controls the legal entity;

- the second legal entity holds, directly or indirectly, including the share of the affiliated persons, a minimum quota of 25% of the value / number of the equity participation or the voting rights to the first legal entity.

Romanian legislation includes the following: Law 571/2003 – Fiscal Code, Government Decision no. 44/2004 – Methodological Norms for the Fiscal Code, Government Decree no. 92/2003 – Fiscal Procedure Code, Government Decision no. 529/2007, and Order ANAF no. 222/2008.

International legislation refers to: Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guideline for multinational companies and fiscal administrations and the Code of Conduct of the European Union regarding transfer pricing [3].

3. FORECAST OF THE MARKET PRICE

The importance of the correlation of transfer pricing with the market price and the verification of actual compliance with this rule, is determined by the fact that transfer pricing can influence the cash flow of the affiliated company as well as its profitability. Significant changes could be incurred in performance indicators, as well as in the strategy for future developments and investments on medium and long term. The

relocation of profits through transfer pricing has direct impact on the fiscal position in each country where the group is having activities through its affiliates. Different situations were noticed where the prices moved away from the market price principle, as prices used at group level represent the way to relocate income or losses, as per the central politics [6].

3.1 Methods used to assess market price

In order to find the most adequate method for the price estimation, the following elements have to be considered:

✓ on a base of free competition the method which is closest to the circumstances where prices are established, on comparable markets from a commercial point of view, will be chosen;

✓ starting from the hypothesis of a free competition market, the method for which most data is available from the activity of the related parties will be considered;

✓ the degree of accuracy for adjustments in order to obtain comparability;

✓ activities actually carried by different affiliated parties;

✓ the method used has to answer to the given circumstances of the market and to the activity undertaken by the taxpayer;

✓ the documentation that can be provided by the taxpayer;

✓ the characteristics of the individual case.

The method of comparing uncontrolled prices (CUP)

The calculation of the market price starts with comparing the price of the transaction with prices taken from independent entities when similar products or services are sold.

For the transfer of merchandise or services between affiliated parties, the market price is the price that independent parties would have agreed on, in the existing market conditions, commercially comparable, for identical or similar goods, in comparable quantities, in the same point of the production and distribution chains, and in similar conditions of delivery and payment.

Two transactions have to be comparable from the point of view of:

- ✓ products and services characteristics (physical features, mark types, etc.);
- ✓ the type of activities performed;
- ✓ contractual terms;
- ✓ economic conditions;
- ✓ participation in risk;
- ✓ business strategies.

Method cost – plus (C+)

The cost plus method is based on increasing main costs with a profit margin characteristic to the domain of activity in question.

These costs are established using the same calculation method that the entity that makes the transfer uses in the politics of price calculation referring to affiliated entities. In the situation that the products are transferred through a number of affiliated companies, the method has to be applied separately for each stage, taking in consideration the role and specific activities of each affiliated party.

Price in controlled transaction = Production costs X (1 + Profit gross margin)

Production costs = direct and indirect costs related to the sold production and performed services

Method resale price minus (R-)

The market price is determined based on the resale price of products and services towards independent entities, decreased with sale expenses, other expenses related to the sale of the taxpayer (loading – unloading, manipulation) and a profit margin. Usually, the resale price minus method is used, when the entity that resale's the products doesn't increase substantially the value of the products. The method can be used also when, before resale, the products are suffering an additional processing, so in these circumstances it can be established the adequate margin.

Trading net margin method (TNMM)

The method implies the comparison of the net profit margin obtained by an affiliated entity following a controlled transaction with the net profit margin obtained during uncontrolled transactions.

Profit split margin method

When comparable transactions can't be identified the profit split margin method is used, which implies in the first phase estimating the profit obtained by affiliated entities following one or more controlled transactions, and dividing

the profits between affiliated parties, proportionally with the profit that would have been obtained by independent persons.

4. THE CONTENT OF THE TRANSFER FILE DOCUMENTATION

The companies that are part of the same group and engage transactions with other firms, members of the group, are required to prepare the transfer pricing file. The file must be prepared in maximum three months period and it has to include the following information:

1. Information about the group:

- ✓ organizational structure of the group (legal and operational), including the shares, historic and financial data of the group;

- ✓ overview of the Group, business strategy, including changes in business strategy from the previous fiscal year;

- ✓ the description and implementation of applying the transfer pricing methodology in the group, if the case;

- ✓ the overview of transactions between related parties, from European Union;

- way of trading;

- way of invoicing;

- the value of transactions;

- ✓ the overview of functions and risks undertaken by related parties, including the changes occurred in previous year;

- ✓ the presentation of holders of intangible assets from the group (license, name, know-how) and royalties paid or received;

- ✓ presentation of advance pricing agreements signed by the taxpayer or by other companies from the group, excepting the ones issued by the National Agency for Fiscal Administration.

2. Information about the taxpayer:

- ✓ detailed presentation of transactions with related parties, including the way of transaction, way of invoicing, the value of transactions;

- ✓ presentation of comparative analysis: characteristics of goods or services, functional analysis (functions, risks, fixed assets utilised), contractual arrangements, economical environment, business strategies, comparable

information about external or internal transactions.

✓ presentation of related parties and of their headquarters involved in these transactions or agreements;

✓ the method of calculating the transfer price and argumentation of the selection criteria:
- in case they don't use traditional methods of determination of transfer prices, they will justify this option;

- in all cases in which it doesn't apply the method for comparison of prices, companies will justify this option;

✓ the description of other terms considered to be important for the taxpayer.

5. PENALTIES APPLIED

Failure to submit strong and valid arguments for the prices used in transactions between affiliated parties could lead to significant adjustments on the company, and hence, adjustment on the income tax of 16%.

Penalties for late payment are also included; starting with 01.10.2010 a late penalty interest applies of 0,04% for each day of delay, as well late penalties as follows:

- 0% if payment is made in 30 days from due date;
- 5% if payment is made in the next 60 days after due date;
- 15% after 90 days from due date.

Failure to present a transfer pricing documentation or having an incomplete file will be penalized by applying a fine between 12.000 and 14.000 Ron.

As more companies expand their economic activity, fiscal authorities grow more demanding regarding transfer pricing. But the issue of transfer pricing and methods involved are not an exact science. That is why the calculation of the market price of goods or services, by different methods, will always be a matter of dispute between companies and fiscal authorities.

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