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General Considerations on the Impact of Transfer Pricing Performed by Multinational Companies on a National Economy

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Abstract

The presence of an increasing number of multinational companies leads to an increase in the number of international transactions due to trade between entities belonging to these companies, but also due to exchanges with other international companies. Transactions made by the entities belonging to the same multinational company are influenced by the laws in force which apply to a national economy and which regulates international money flows; such laws have different provisions from one country to another, and thus generating income losses for these companies. At the same time, revenue transfers made by multinational companies can cause revenue losses to the budgets of those host states where these revenues are generated, governments being very concerned about transfer pricing. Thus, it is worth noticing the main methods used by multinationals in terms of transfer pricing policy, what is the impact of these transfers on a national economy, especially on Romania's economy, and what measures governments take to counteract the loss of budget revenues due to transfer pricing.

Keywords: multinational companies, rules, transfer pricing, profit

1. Introduction

An extremely important factor that has led to an increased globalization of international markets and transactions is the revolution in information and communications technology (ICT) and the development of an efficient communication system. Thus, multinational companies have come to represent a large share in many of the national economies, characterized by a high integration process between the component entities, generating large sums resulting from the financial transactions concluded between the branches of a multinational company. These transactions occur between entities subject to different tax regimes belonging to different national economies. Thus, multinational companies will seek to use their most favorable tax regimes to maximize revenue and, implicitly, the profit earned by the parent company to the detriment of the national economy where those revenues were made.

Many countries have put forward a series of rules to force companies to use transfers in order to get higher profits in other areas with more favorable tax arrangements. These rules are mainly based on the arm's length principle, which means that the transactions between the parties involved must be economically comparable with similar transactions made by independent parties. The Organization for Economic Co-operation and Development (OECD) has made many efforts to establish the arm's length principle as the basic principle in the case of transfer pricing theory, by issuing a series of guidelines and guides in the matter thereof. However, there are still many differences in the way this principle applies both between OECD countries and non-member countries. Last but not least, since rules and regulations in this area are changing very often, it is very difficult to collect reliable and up-to-date information.

2. The concept of transfer pricing

Multinational companies comprise multiple sectors of activity, being involved in the manufacturing/rendering and sale of many products and services. The management of such companies can not control all the financial flows of each parent company's entity. For this reason, these companies are usually structured on the divisions (also known as related parties), each division being an autonomous entity. The parent company's management has the role of coordinating the activity of subordinated divisions, in order to maximize the overall profit of the organization. These organizations include financial flow tracking mechanisms for each product/ service as well as for each subordinated entity, being organized on cost centers. Each division needs to be evaluated, which is why it is necessary to have clear monitoring methods of measuring the performances of such entities. This can be done by setting prices for transferable goods from one division to another, also known as transfer prices.

The transfer pricing is defined in accordance with Article 7, Paragraph 26, letter d) of the Law no. 227/2015 on Fiscal Code, as "the price at which the tangible or intangible assets are transferred or the services are rendered" between related parties.

Although such related parties may be doing business within the same country, the tax authorities are more concerned with those entities of companies that are located in different countries. If there were no legislation regulating transfer pricing, it would be extremely easy for a multinational company to transfer profits made within a territory of a country to any other country. The main reason for which profits are transferred from one country to another is the difference a company may obtain from different corporate tax rates between the countries. The difference between the tax rates applied by tax authorities in different countries is not the only reason for transfers made by companies. The latter wish to have lower transfer pricing, to make ensure, for instance, that their subsidiaries have competitive pricing on their local markets (Schlegelmilch, B, 2016).

Another important reason is the presence of foreign currency exchange controls. Transfer pricing not only applies to property, but also to services, intangible assets, administration fees, and financing. Funding in multi-affiliated companies is a matter of interest to the tax authorities of a country where the amount thereof is very high and transfer pricing may be very subjective.

In addition to the implications of charging multinational companies, the planning of the transfer pricing may also influence the allocated resources, the way of supplying the component entities or the managers' benefits package.

The transfer pricing techniques and methods consist mainly in the incorrect invoicing of commercial transactions (Palan et al, 2010), this being done through the following methods:

- Invoicing less the exports to a tax haven where the amounts will be expatriated. The goods are sold at the real value, the resulting difference being the value of the transfer capital;
- Invoicing to a higher value of the imports to a country where the amounts will be expatriated. The resulting difference, i.e. the transfer capital, is often deposited in the bank accounts of the importer in the tax heaven;
- Incorrect reporting of the quality or type of imported products to support the over or underestimation of the declared value for the reasons outlined above;
- Setting-up fictitious transactions for which payments are made. A widely used tactic is to pay for goods or services that will never actually exist.

A distinction must be made, on the one hand, between tax planning, which is a legitimate and accepted way by tax authorities to minimize taxes and tax evasion, on the other, which is illegal. Tax cuts are achieved by producing temporary or permanent tax savings. The temporary tax savings a company can make is only postponing the payment of taxes up to a certain point in time. Permanent savings are made irreversible, using for example fiscal losses or by transferring taxable income to tax heavens. (Lohse et al, 2012).

Multinational companies, in their quest to achieve continued profitability growth, are continually seeking to identify ways of transferring profits to countries with favorable tax arrangements. There are two ways to achieve this: one way is to transfer people, goods or services to a low-tax country, as has been done in the past by moving production capacities to China or Romania. Another way is to transfer revenue to a country with a favorable tax regime, such as Cyprus. This revenue can be moved in several ways, such as adjusting prices for trade transactions between parent companies' subsidiaries, through internal financing between subsidiaries or centralizing the company's functions. These ways of action can be followed because the entities subordinated to a parent company are treated as independent companies by the tax authorities. These companies encourage the development of bilateral agreements between different countries, aiming exclusively at obtaining benefits from the transfer of income to the country with a more favorable tax regime. Governments have become aware of this in time, and besides issuing transfer pricing rules have sought to introduce measures to prevent the transfer of profits from the country where they are made. In the OECD, some guiding principles were developed for the first time in 1995; these principles provide guidance on arm's length principle, pricing methods and transaction comparability, as well as recommendations (OECD, 2017).

2.1. Transfer pricing rules

The OECD member countries' fiscal codes contain measures regulating inter-company transactions based on the arm's length principle used as the standard for transfer pricing. Although Romania is not an OECD member, the arm's length principle, has been taken over into domestic legislation as a market value since 1994 and was applicable to transactions concluded between related parties, including those between a foreign legal entity and its permanent establishment in Romania. Thus, only transactions between Romanian entities with non-resident related parties could be verified by the tax authority. Since 2010, transactions between related parties representing Romanian legal entities fall within the scope of the transfer pricing rules.

In addition to the general framework adopted by the OECD, many countries have also adopted specific transfer pricing rules over the past two decades. This was due to the globalization and increasing sensitivity of the taxpayers of the countries adopting these rules, in order to protect taxable income. Most countries applying these rules are states that have adopted a high tax regime, such as Germany, the USA or Japan. Other countries, such as Ireland, Switzerland or Austria which have not adopted such specific transfer pricing rules are countries that attract many international investments due to their generous tax regime. All these specific rules are applied to transfer pricing between related parties. Two entities are considered related parties if they have at least one percentage point (1%) of participation in the share capital of the other. In the case of Romania, this percentage is at least 25% of the value/ number of participation titles (shares) or voting rights in the other legal entity (Law 227/2015 on the Fiscal Code). For other countries, this percentage differs from 5%, for example in Poland, to 25% in the case of China, which is actually the most used percentage, to 50% in the case of Argentina or Japan. There are also cases of countries such as Brazil, Chile, Venezuela, which apply transfer pricing rules to unrelated parties.

3. The main methods used for transfer pricing

By making use of the arm's length principle, several methods have been established to determine the correct transfer price for certain transactions. According to the OECD, the first methods put forward and which are considered traditional methods are the cost plus pricing method, which compares the gross profit margins achieved over cost; the resale price method, which compares gross sales margins; the price comparison method, which is the most used

and which compares prices in similar transactions. In the 1995 OECD Guidelines, besides traditional methods, there are two other transactional methods, namely: the transactional net margin method, which compares net profit margins obtained by a company with net margins obtained by independent companies carrying out similar activities; as well as the profit sharing allocation method, which starts from the profit obtained from transactions carried out by the related parties and which is shared among the participants according to the contribution thereof.

3.1. Price comparison method

Under this method the price of a transaction in which no related parties are involved is compared with the price of transaction of a related party. The main prerequisite is the comparability of the transaction. Thus, there must be several common features such as product type, availability, quality, contractual terms, economic circumstances, etc. However, there are also cases where this method can not be applied despite the above prerequisites, such as in a non-competitive market or in the case of products with rare or unique characteristics that can not be compared to others or in the case of intangible assets whose trading is based on the negotiating power of the parties.

The price comparison method directly compares the price of a related party transaction with the price of an uncontrolled transaction, being the most direct method for calculating the price the arm length principle. (NTA Japan, 2017)

This method is used mainly in setting the transfer pricing of fees, commissions, royalties and the level of interest rates applicable between related parties.

3.2. Resale price method

By this method, a price is sought for a product that has been purchased from a related party and resold to a third. This resale price is reduced by an appropriate gross margin. Gross margin is calculated as follows: $\text{Gross margin} = (\text{Sales} - \text{Cost of goods}) / \text{Sales} \times 100$. Gross margin can be compared to margins obtained from transactions of unrelated persons. What results from the downward margin operation can be considered as a market price for the transfer of goods between related parties. The main condition for applying this method is that gross margins are comparable for all products, meaning that the transaction takes place under similar conditions. The OECD Guideline suggests the need for some adjustments in the application of this method due to the fact that gross margins are not generally equal for different companies.

The resale price method may be applied subject to the similarity of the functions performed by the company, the risks assumed, and the contractual terms used. There are important shortcomings in using the sale price method when there are differences between the accounting standards used by companies to calculate and report gross margins on sales. In the case of Romania, in the financial statements the expenses are presented according to the nature/type thereof and not in relation to their destination/purpose, which makes it difficult to distinguish between the cost of goods sold and the operational expenses of comparable goods. The resale price method is used most effectively in running the analysis of distribution activities when the reseller has not made a substantial change to the physical properties of the product or added some marketing attributes such as the trademark before re-selling.

3.3. Cost plus method

This method is similar to the previous method, but refers to the fact that the company sells similar products to both related and unrelated parties. Thus, the profit margin made by the related party from the selling to another related person will be assessed by comparing it with the profit margin obtained from selling to a third entity. At the cost of the supplying company,

a profit margin corresponding to the field of activity shall be added. If the profit margin is at market value, then the transfer pricing is at market value. The profit margin should represent a profit that reflects the functions performed, the market conditions and the risks assumed by the company. The profit margin is calculated as follows: Profit margin = (Sales - Cost of goods) / Cost of goods x 100. There are the same shortcomings in using the cost plus method as in the case of the resale price method.

The cost plus method can be applied subject to the existence of similar transactions so that current differences do not have a significant material effect on the profit margin or adjustments can be made to eliminate such differences. It is necessary to clearly define the categories of costs that come under the cost base. If the cost structure of transactions between related parties is different from uncontrolled transactions and no adjustments can be made, then the cost plus method can not be used. The cost-plus method tends to use a net profit margin.

The cost plus method is most useful when analyzing the sales of semi-finished products, processing services, RDI services, etc., as well as long-term sales and purchase contracts.

3.4. Net margin method

This method works in the same way as the cost plus method and the resale price method, the main difference consisting in the fact that the net margin method analyzes the net profit margins obtained by companies that have similar activities within the same industry on the same market and which tend to equalize in time.

The Net margin method is based on the calculation of profit margins determined as the report between operating profit derived from a transaction between related parties and a certain base consisting of sales, assets or costs. Market value is determined by comparing the net margin realized in a transaction between related parties and the transaction of the same related parties and an unrelated one or between unrelated, independent parties with a similar functional and risk profile.

The net margin method is used in the documentation of transfer prices that are used during a tax period.

The net margin approach is most effectively used in the case of financial data on the basis of which various financial indicators can be calculated to test the profitability of related persons. The big advantage of the net margin approach is that net margins are subject to lesser influence by transactional differences that have a direct influence on the transaction price. Net margins have a higher tolerability than profit margins to some functional differences between transactions between related parties and uncontrolled transactions. The net margin method should only take into account those profits of the related person that derive exclusively from the transaction under consideration.

The financial indicator used is chosen in relation to the functional and risk profile of a related party. The most used financial indicators to find out the market value of transactions between related parties are as follows: the net margin of sales, which is used in the case of distributors (it is calculated as the report between operating profits and sales); asset rate of return (calculated as the ratio between the operating profit and the assets used, less the financial assets and cash availability), which is used in the case of the manufacturers; the profit margin on costs (calculated as the ratio between operating income and total operational costs), which applies to manufacturers or service providers. The financial indicators used will be calculated for an average period of 3 or 5 years to reduce the influence of external factors such as the shelf life of the product. A statistical benchmarking is used to calculate the market value of the net profit margin. If related parties have a net profit margin falling within the comparison period, it can be said that related parties conduct transactions in line with market value principles.

3.5 Profit sharing allocation method

This method is based on determining the aggregate profit resulting from transactions between related parties. The profit obtained is divided between the related persons in such a way as to simulate how the profit would have been allocated if the transaction had taken place between two unrelated parties on the basis of market value. The allocated profit must respect the functions performed, the assets used, and the risks assumed by each of the parties.

Profit can be allocated into two ways, namely by running an analysis of contributions and a residual analysis, respectively. By analyzing the contributions, the aggregate profits from the transactions concluded between related parties are divided between them according to the value of the functions performed by each party, taking into account external market data showing how the non-affiliated parties would divide the profit resulting from transactions carried out under similar conditions. This profit is, in general, the operational profit.

The residual analysis is a two-steps analysis, namely: in the first part, each related party is allocated a profit to secure a profit margin deemed natural for the type of transaction performed; in the second stage, what remains is to be known as residual profit and is allocated between the related parties involved in the transaction, while analyzing the circumstances in which this profit would be distributed among unrelated persons.

The profit sharing allocation method is used when related parties have intangible assets with a high value or where the transactions between related parties are so complex that they can not be separated into independent, stand-alone transactions. A related party that owns a tangible or intangible single asset is entitled to receive a portion of the residual profits thereof.

The great advantage of this method is that it does not focus on transactions that are highly comparable and can therefore be used in cases where similar transactions between unrelated parties can not be identified.

The disadvantage is that the unrelated parties do not ordinarily use the profit sharing allocation method and it is therefore difficult to identify external data.

4. Penalties, taxing arrangements and litigations

4.1. Penalties in the case of transfer pricing

The penalties to be applied for detecting violations of transfer pricing rules vary according to severity thereof. In most cases, sanctions consist in applying a percentage of the misappropriated sums subject to taxation or the amount of the illegal transfer price. Almost half of the countries use as a penalty less than 100% of the additional tax/duty thus due. Thus, Austria applies a 2% sanction, and at the opposite end there is a sanction of 400% in the case of Argentina.

Another issue is the interest payable for the late payment of taxes and duties on transfer pricing adjustments. While some countries only use a time-to-pay rate, other countries use interest rates that include late payment penalties which may reach 3% per month, as is the case of Vietnam.

Many countries impose penalties for mispredicting documentation and for lack or delay of delivery thereof. These penalties may take the form of a fixed amount, a percentage of the unpaid tax/ duty or may be another specific factor defined by domestic legislation thereof. Countries that impose a fixed fee as a penalty for incomplete or erroneous documentations are Romania or Argentina, while countries such as Belgium or Great Britain only impose a fine if there is no documentation at all. Other countries like Brazil or Colombia imposes sanctions in the form of a percentage of the transaction value for which the information is wrong or missing. In the EU Member States, sanctions may vary between 10-200% of the unpaid tax/ duty or represent 5-30% of the misappropriated amounts subject to taxing (Cooper J et al, 2016).

4.2. Taxing arrangements

For transfer pricing rules, litigation may occur between companies and tax authorities. In the absence of agreements between countries representing trading parties, double taxation of the same transaction is very possible. Double taxation is generally recognized as an obstacle to international trade and investment. Thus, in order to promote trade and investment, countries sought to avoid and eliminate double taxation situations by concluding tax agreements. The number of tax agreements is steadily increasing, with more than 3,000 such agreements now in place worldwide (W.C.O., 2015).

Two approaches to resolving tax disputes have been set up within the OECD, namely the mutual agreement procedure and the corresponding adjustment procedure. In the case of the first approach, it is emphasized that tax authorities have to settle disputes by establishing clear provisions in the agreements to prevent double taxation. In the event of misunderstandings, tax authorities are required to settle disputes within two years, otherwise companies may call for arbitration. The appropriate adjustment procedure refers to the related party's request according to which tax authorities should coordinate the adjustment activity in order to avoid double taxation. At EU level, important steps have been taken to resolve disputes relating to transfer pricing. Thus, there is an arbitration agreement, signed by 27 members of the EU, which applies to transfer pricing that is not deliberately wrongly established and does not involve large sanctions. This Convention also sets out the duration of mutual agreements between two or more EU Member States. By signing in advance pricing agreements, pre-defined features of the transaction between related parties are established for a certain period of time. Some Member States set unilaterally such agreements for the tax authorities and companies within their jurisdiction, but this affects the tax liability of related parties and requires the presence of an agreement procedure between the jurisdictions involved (Convention 90/463/EEC).

Many countries start by making unilateral advance pricing agreements, being easier to manage, and then extending the procedure to bilateral agreements. There are also countries that only offer bilateral agreements before introducing transfer pricing rules, as is the case with Germany. In conclusion, countries tend to offer increasingly pricing agreements in response to the need for multinationals to reduce their transfer pricing related risks.

5. Conclusions

Due to the particular impact of transfers made by companies located in different countries on a country economy, many countries are interested in regulating transfer pricing to ensure consistent tax revenues for their budgets. Transfer pricing rules usually apply only to foreign related parties. With regard to transfer pricing methods, there are few a methods which apply between countries, mainly those presented by the OECD. There are differences only on the priority of using methods, most countries preferring traditional methods. A major goal of many governments is to obtain budget revenue for budget consolidation, so tax authorities are interested in identifying and collecting taxes and duties which apply to corporate income made within the country. Tax control measures that a country's authorities and bodies can take to prevent the transfer of profits from multinational companies will not completely eliminate this phenomenon. A new win-win approach in the relation with foreign investors is needed to prevent major macroeconomic imbalances leading to economic crises at the scale of national economy.

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