

THE EFFECTS OF FISCAL POLICY IN THE FIELD OF TRANSFER PRICING - EMPIRICAL RESEARCH

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Abstract: In the context of globalization, the phenomenon of expanding business across national borders has grown, so that multinational groups have strengthened their position in the world economy. This has led to the adoption of legislation in the field of transfer pricing, the purpose of which is to regulate the taxation of profits within groups by combating the phenomenon of the erosion of the tax base and the transfer of profits. Through this scientific approach, we analyze in a pragmatic way the significant transactions of a Romanian subsidiary in correlation with the transfer pricing file prepared. The article also aims to summarize the stage of implementation of actions aimed at stopping the phenomenon of erosion of the tax base and global profit transfer (BEPS).

Keywords: transfer pricing, transfer pricing file, OECD; BEPS; affiliate relationships.

JEL Classification: F23, M40.

Introduction

The issue of transfer pricing is still one of the priorities of specialists worldwide, whether we are referring to international regulators, national tax administrations, multinational groups, consulting companies or practitioners in the field.

Transfer prices are the values at which transactions in goods or services are made between related parties. According to the regulations, these prices must comply with the market value principle (i.e. arm's length principle), i.e. be at the level of the market price charged between two independent parties, under comparable economic conditions. If the price charged between the related parties is not within the market range, it is assumed that the profits obtained are not correctly quantified; therefore the declared taxes and duties are not fair either. Such situations lead to adjustments of profits and, implicitly, of taxes on the part of the tax authority (Rus A., 2020).

Through this article we analyse the case of an entity in Romania, part of a multinational group, whose transactions have been subject to control by the tax authorities. The objective of this analysis is to offer an empirical vision on some theoretical aspects drawn by the guidelines issued by the Organization for Economic Cooperation and Development (OECD) and taken over by the Romanian legislation in the field of transfer pricing.

Moreover, through this scientific approach we summarize the stage of implementation of actions aimed at stopping the phenomenon of erosion of the tax base and transfer of profits globally (base erosion and profit shifting - BEPS), started at the initiative of the OECD.

The purpose of this scientific approach is to make a significant and pragmatic contribution to the literature on transfer pricing, especially as the concerns of national and international regulators and harmonization of mechanisms and legislation in this area are obvious.

The article is structured in four parts, as follows: the first part presents the research methodology used, the second part summarizes the state of knowledge in the field by reviewing the regulations in the field of transfer pricing, both nationally and internationally; the third part analyses in a pragmatic way, the effects of the fiscal policy in the field of transfer pricing with direct impact on the activity of an affiliated entity; the last part of the article contains the conclusions as well as possible perspectives for future research.

Research methodology

Our study focuses on the two main objectives of the research. The research methodology supports the achievement of these objectives by approaching the research techniques appropriate to the topic, described below.

The first objective is to present in a pragmatic way the effects of fiscal policy in the field of transfer pricing. In order to achieve this objective, the qualitative research methodology was approached, using as a tool the case study of an entity, part of a multinational group, and involved analysis of significant transactions, analysis of segmentation of revenues and expenditures, analysis of market study on price range for similar products by independent entities.

One aspect that we attach special importance to in research is the confidentiality of the data analyzed. Therefore, all figures presented have been adjusted by a coefficient and are used for illustrative purposes, in order to formulate conclusions and future research directions.

The second objective of the research is to make a synthesis of the degree of implementation of BEPS actions, for which more than 135 countries collaborate so as to discourage tax avoidance strategies by exploiting fiscal gaps between different jurisdictions (OECD, 2021). To achieve this goal, the guidelines and progress reports issued by the OECD and published on the platform www.oecd.org/tax/beps were analyzed.

The state of knowledge in the field

International transfer pricing regulations

The upward trend in cross-border transactions imposed by multinational corporations has led to concerns about defining and regulating the phenomenon. The first step in this direction was to draw up a report on transfer pricing at the initiative of the OECD in 1979, and in 1995 the Guide to Transfer Pricing for Multinational Enterprises and Tax Administrations was prepared, addressed to both multinational corporations and tax administrations (Matei et al., 2011). An updated version of the OECD Guide was developed in 2017 in accordance with the BEPS Action Plan, an initiative to which Romania has joined since the same year (Feleagă et al., 2017).

According to a study conducted by the consulting company Deloitte Romania (Deloitte 2017), the latest recommendations impact companies in terms of increasing the importance of analysing the economic substance of each transaction, as well as increasing transparency due to additional reporting of group activities. Thus, a more detailed risk analysis from a fiscal point of view can be determined, regarding the allocation of revenues, profits and taxes between companies, and the country-by-Country Report. Also, additional terms are introduced for the remuneration of group companies, not only on the basis of capital generated, but also on the basis of the control exercised in the decision-making process.

The aim of the OECD directives is to create a common conceptual and methodological framework for applying the market value principle to transactions between affiliated companies, so as to support tax authorities and multinational groups, in order to reduce possible conflicts that may arise between part.

In order to determine transfer prices in accordance with the market value principle, the OECD Guide describes the pricing methods between affiliated entities and divides them into two categories: traditional transaction methods and profit analysis methods (transactional profit methods). In order to choose the calculation method so that the price provides the best estimate of the market value, a functional analysis of transactions is recommended in terms of advantages and limitations of the methods, relevance of the method to the nature of the controlled transaction, availability and consistency of comparable uncontrolled transactions and the degree of comparability between controlled and uncontrolled transactions (OECD 2017).

Methods of determining transfer pricing

The traditional methods of analysing transactions are: the price comparison method, the resale price method and the cost plus method; the methods based on the profit analysis are: the net margin method and the profit sharing method.

The price comparison method, along with the other two traditional methods based on transaction analysis, are categorized as the most direct means of determining whether financial and trade relations between related parties comply with the market value principle (OECD, 2017). Thus, the Guide recommends that, if the price comparison method can be used in setting prices in the same way as any other method described, the former be chosen. This method involves comparing controlled and uncontrolled prices under market conditions and similar circumstances.

The resale price method involves the existence of three parties between whom the transaction is made. This method applies when an entity purchases a product from an affiliated entity and resells it to a third party. The starting point in applying the method is the resale price to third parties. In the next stage, the purchase price from the affiliate is determined as the difference between the resale price and the added profit margin. The added profit margin in case of resale to third parties is compared to the profit margin practiced in uncontrolled transactions, carried out under market conditions and for similar products. If under these conditions the profit margins are in the same range, then the market value principle is considered to be respected.

The cost-plus method is used in the case of the production of goods or services and involves comparing the profit margin added to the full cost of goods sold or services provided to affiliates with the profit margins incurred in similar uncontrolled transactions. The market value principle is respected if the profit margins are within the market range.

The net margin method, although a method based on profit analysis, is similar to traditional cost plus and resale price methods, the difference being that in this case the market interval is set for the net profit margin and not for the gross margin.

The profit sharing method is recommended when transactions between affiliated entities are interdependent and comparable uncontrolled transactions cannot be identified. Thus, the estimated profit from these transactions is allocated proportionally between affiliates, taking into account the activities carried out, the risks assumed, the resources involved by the parties in creating value.

Harmonization of Romanian legislation with OECD guidelines

Concerns in the field of transfer pricing have existed in our country since 1994, but the first conceptual framework was developed in 2000 (Feleagă et al., 2017). The regulatory law framework regarding the documentation of transfer pricing, as well as the content of the transfer pricing file was introduced by Order 222/2008.

Tax legislation in the field of transfer pricing has undergone significant changes in order to align with the OECD Guidelines. Thus, the President of ANAF (National Anti-Fraud Agency) issued the Order no. 442/2016 regarding the amount of transactions, the deadlines for drawing up, the content and the conditions for requesting the transfer pricing file and the procedure for adjusting / estimating the transfer pricing.

In order to comply with the market value principle through transfer pricing between affiliated entities, the Romanian tax authorities have the right to adjust a taxpayer's income and expenses so that profit margins are within the market, if the tax inspection finds that this principle is violated.

Starting with 2017, Romania became an associate member of the BEPS Implementation Forum. As many officials have mentioned, the BEPS project has the potential to significantly change the fundamental principles of international taxation. Naturally, the change in international regulations in the field of transfer pricing will lead to a subsequent change in relevant European and national regulations.

The implementation stage of the BEPS Action Plan

BEPS refers to the tax planning and optimization strategies used by multinational groups, with the role of exploiting the weaknesses of tax systems to avoid paying due taxes. According to the OECD assessment, the exploitation of these weaknesses in tax law in different jurisdictions causes more than \$ 240 billion in damage annually, the equivalent of about 10% of the value of corporate tax due globally. The BEPS initiative was launched in 2013 and includes a set of 15 actions whose main objectives are to stop the phenomenon of tax avoidance by moving profits to jurisdictions with a lower tax burden, increase the exchange of information between national tax systems and provide a basis common tools for managing the phenomenon, as well as creating a transparent fiscal environment. More than 135 developed and developing countries are making sustained efforts to transpose BEPS actions into national tax laws (OECD, 2021).

The BEPS plan provides support to the legislature in enforcing the rules and provides them with the necessary tools to prevent multinational entities from fictitiously shifting their profits between jurisdictions and to tax revenues where value-added economic activities take place. The action plan is also intended to support taxpayers through the transparency of the international legislative framework and the standardization of reporting.

The 15 actions included in the BEPS action plan cover a wide range of areas that could be avoided by multinational entities. In the following table (table no. 1) we briefly present the content of each action and the implementation stage.

Table no. 1 Summary of the BEPS Action Plan

Action	Action description	Implementation stage
1. Fiscal challenges resulting from the digitization process	fiscal challenges faced by the economy as part of the digitization process; challenges in enforcing international tax rules in a digital economy.	measures from the second half of 2021
2. Neutralize the effects of hybrid arrangements	development of provisions and recommendations of model treaties on the design of internal rules to neutralize the effects of hybrid instruments and entities.	2015 and 2017 OECD report on neutralizing the effects of hybrid arrangements;
3. Controlled foreign entities	rules for foreign controlled entities to prevent the transfer of profits to lower tax jurisdictions.	2015 OECD report on Designing effective rules for foreign controlled companies.

4. Limitation of the right to lower the interest	limiting the right to deduct interest related to intra-group loans in order to prevent the decrease of profits.	2015 OECD report on Limiting base erosion through interest deductions and other financial payments.
5. Abusive tax treatment	transparency and economic substance of transactions to prevent abusive tax practices; elimination of preferential tax regimes.	minimum standard, annual progress report starting with 2016.
6. Prevention of abuse in tax treaties	preventing the abusive application of double taxation treaties.	minimum standard, annual progress report starting with 2018.
7. Permanent headquarters status	prevention of the fictitious creation of the permanent headquarters;	OECD Framework Tax Convention of 2017.
8-10. Align the results obtained by applying the transfer pricing rules with value generation	indications for the application of the market value principle in the field of value creation.	final report on actions 8-10 of 2015; OECD Transfer Pricing Guide - being updated.
11. BEPS data analysis	collecting and analyzing information on the economic and fiscal effects of tax avoidance behaviors and the impact of measures adopted under the BEPS Plan.	measurement and monitoring report of BEPS actions from 2015; report Statistical Database on corporate income tax from 2019;
12. Mandatory disclosure rules	recommendations for the development of rules requiring taxpayers and advisers to disclose aggressive tax planning arrangements.	OECD Report on Mandatory Disclosure Rules for Abusive Tax Planning, Corporate Governance Avoidance Arrangements and 2018 Offshore Non-Transparent Structures.
13. Documentation of transfer pricing and country-by-country (CbC)	the obligation of large multinational entities to document the overall allocation of revenues, expenditures and taxes for each jurisdiction in which they operate; the CbC is made	minimum standard, annual progress report starting with 2017.

reporting	available to the tax authorities in each jurisdiction to increase transparency and facilitate the assessment of transfer pricing risks and BEPS practices.	
14. Mutual agreement procedure	streamlining international dispute settlement and amicable settlement (MAP) mechanisms	minimum standard, progress report in two stages, from 2016 and 2021.
15. Multilateral instrument to avoid double taxation	concrete solutions for governments to close gaps in international tax treaties by transposing the results of the BEPS project into bilateral tax treaties worldwide.	implemented since 2018.

Source: Author processing after the OECD 2021 (www.oecd.org/tax/beps/beps-actions/)

Fiscal effects in the field of transfer pricing - analysis of the profit adjustment decision following the tax inspection

Our research focuses on the case study of an affiliated entity, part of a multinational group, in relation to the methodology for setting transfer prices and the tax effects generated by the profit adjustment decision to be within the market range, in order to comply with the market value principle.

From the analysis of the transfer pricing file for 2017-2019 prepared by the entity, hereinafter referred to as SC ABC SRL, it results that the price comparison method was used to determine the market value of the main transactions consisting in the production and sale of finished products to related parties. The products sold to the affiliated companies were resold by them to third parties. The comparison was made only on the selling price charged between SC ABC SRL and the selling price charged by the related parties in relation to third parties. The quantities traded were not taken into account.

The use of the price comparison method is recommended by the OECD Guide, being a direct method of testing compliance with the market value principle. However, this method can only be used if identical or substantially similar products are sold in identical or similar circumstances, both in controlled and uncontrolled transactions.

Following the functional analysis of the operations, the authorities requested the analysis of the main transactions with related parties from the perspective of using the net margin method, considering the method appropriate in the given circumstances. Given that sales of finished products to companies within the group were 98%, they were analyzed in terms of compliance with the market value principle.

The following table (table no. 2) summarizes the analysis carried out by the tax authorities and its result.

Table no. 2 Situation of the analysis on interquartile range and calculation of transfer pricing adjustments

Transfer pricing verification method	Net Margin Method		
Profitability indicator	Total cost effectiveness rate		
Comparability range	2017	2018	2019
Lower quartile	3.4%	3.4%	2.4%
Median	7.6%	6.7%	7.5%
Upper quartile	11.6%	13.0%	9.9%
Indicators in relation to affiliated parties			
	2017	2018	2019
Operating income (1)	5,500,000	6,100,000	5,940,000
Operating expenses (2)	5,560,000	5,900,000	5,930,000
Operating result (3)=(1)-(2)	(60,000)	200,000	10,000
Cost effectiveness rate (4)=(3)/(2)	-1.1%	3.4%	0.2%
Adjustment required	YES	NO	YES

Source: authors' processing based on the case study

It can be seen that for 2017, the rate of return on total costs calculated for transactions with affiliates is -1.1%, given that the lower quartile of the comparability interval for the sample of selected independent companies is 3.4%, the upper quartile 11.6% and the median value 7.6%. As a result, the tax authorities adjusted the taxable revenues achieved by SC ABC SRL in 2017 to the level of the median.

The market analysis for 2018 shows that the rate of return on total costs is 3.4%, located at the level of the lower quartile of the comparability interval. Thus, it is not necessary to adjust the income realized by the entity in 2018.

For 2019, the total cost-effectiveness rate calculated for related party transactions is 0.2%, while the lower quartile of the comparability range for the selected sample of independent companies is 2.4%, the upper quartile 9.9% and the median 7.5%. Consequently, we proceeded to the adjustment of taxable income obtained from the

sale of finished products to affiliates at the median level. Thus, for 2019, the taxable income resulting from these transactions was increased by applying the median to the operating costs allocated to affiliates.

In the following table (table no. 3) we will present the statement of income and expenses resulting from transactions with affiliates and the values adjusted accordingly, according to the findings set out above.

Table no. 3 Income statement before and after adjustment

Income adjustment calculation from the production and sale of finished products to affiliates	2017	2018	2019
Revenues from the sale of finished and semi-finished products to affiliates (5)	5,390,000	-	5,821,200
Production costs allocated to affiliates (6)	5,448,800	-	5,811,400
Revenues adjusted to market value (7)=(6)*(1+median)	5,682,591	-	6,130,923
Additional income set (8)=(7)-(5)	292,591	-	309,723
Additional profit tax (9)=(8)*16%	46,815	-	49,556

Source: authors' processing based on the case study

Based on these data, we observe that the revenues from transactions with related parties, representing 98% of the total operating revenues presented in table no. 2, are re-estimated based on the rate of return on total costs at the median of the comparability interval for the sample of selected independent companies. Therefore, for the year 2017 they are increased by 292,591 lei, and for the year 2019 by the amount of 309,723 lei. Consequently, the result is an additional profit tax due by SC ABC SRL in the amount of 96,370 lei for the two years.

Conclusions and perspectives of the research

The ongoing concerns of harmonizing regulations in the field of international transactions bring a significant benefit, both in terms of the evolution of the legislative framework and from conceptual and methodological point of view. Although, in the first instance, actions aimed at ensuring the transparency of activities carried out and tightening the requirements for documenting transactions may be perceived by multinational entities as consuming financial, human and time resources, they prove to serve their interests. Moreover, their purpose is to provide a common regulatory framework for both affiliated entities and tax administrations.

Through this scientific approach we capture the evolving trend in the regulatory sphere, which emerged in response from the OECD to economic pressures. As a result, we can conclude that, since its inception in 2013, the BEPS Action Plan has pursued key fiscal issues in order to restructure international tax systems to meet the standards of a modern, globalized economy.

Another aspect under investigation is the relationship between taxpayers and tax authorities. Based on the analysis of the case study presented, we can conclude that it is of major importance that the transfer pricing directives and regulations have a unitary understanding and application, so as to avoid conflict situations between the parties, abusive tax planning practices or abusive tax treatments.

The prospects for future research lie in the fact that the actions initiated by OECD through the BEPS Plan are being implemented, so their application at national level is an area of interest for specialists. Another direction may be to capture the opinion of transfer pricing specialists on the implementation of BEPS measures in our country. Also, the perspective of comparing the degree of harmonization of tax legislation between different countries with the OECD guidelines can be a topical and interesting issue in the literature.

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