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Transfer pricing documentation – an efficient measure for combating the base erosion and profit shifting?

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Abstract

The setting up of groups of companies has become a large scale phenomenon, dominating the global economy. These groups have set up subsidiaries in different countries, leading to the occurrence of issues regarding the taxation of the results within the group, and to the development of the transfer pricing concept, respectively. This concept has been used over the time by multinational corporations to move their profits in low-tax jurisdictions. For this reason, globally, there have been concerns regarding the adoption of a legislation that could combat the base erosion and profit shifting. This article analyses whether the adoption of a legislation which provides the transfer pricing documentation requirement represents an efficient measure for the blurring of the base erosion and profit shifting phenomenon. The research was performed at the level of the member countries of the Organisation for Economic Co-operation and Development. The article also aims to clarify certain aspects regarding transfer pricing and to provide a practical approach of the associated mechanisms. The novelty, originality and impact of the article on the accounting profession are represented by the fact that the transfer pricing concept is relatively new for the specialists from Romania and also for the tax authorities.

Keywords: *transfer pricing, arm's length principle, affiliation relationships, double taxation of results, manipulation of results, transfer pricing documentation*

JEL Classification*: M40*

1. Introduction

The history of transfer pricing begins, most probably, in the interwar period. After the First World War, when tax rates began to rise, countries like the United States have paid a special attention to the allocation of profits between companies. As a consequence of these concerns, in 1930, the US became the country that used for the first time the *arm's length principle.* According to this principle, companies should ask themselves *which would be the price set by an independent company operating in a competitive market to provide comparable services?* After the Second World War, the United States, based on the arm's length principle, developed and adopted the first regulations regarding the transfer pricing (Mirjam, 2015). Subsequently, other countries such as Australia, Germany, Indonesia, Italy and Japan have been interested by the transfer pricing subject and have adopted legislation in this respect (Lohse, Riedel and Spengel, 2012). Moreover, for the global development of transfer pricing regulations, in 1979, the Organisation for Economic Co-operation and Development (OECD) has published a report which regards the allocation of profit and costs between related companies. In 1994, the US revised the transfer pricing regulations, and as a reply, the OECD has published in 1995 the document *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* which has been revised in 2010 (OECD, 2010).

In Romania, the transfer pricing concept has been mentioned for the first time in the Tax Code in 1994, but only in 2000 there has been written the legislation regarding the application of the arm' s length principle. Although 'it has been over a decade since, the specialists believe that this legislation is still *"ambiguous and too cursory"* and the companies do not pay enough attention to transfer pricing aspects (Corlaciu and Tiron, 2014). However, it is expected that with the entry into force on January 1st, 2016 of the new tax legislation, according to which the transfer pricing documentation will be compulsory, companies will address this subject with care and the specialists in finance and accounting will show more interest regarding the analysis and documentation of transfer prices.

This article aims to analyse whether the adoption of rules regarding the transfer pricing documentation represents a measure which discourages the practice of multinational companies to move their profits through the transfer pricing mechanism in low-tax jurisdictions. In addition, there are presented a series of conceptual and practical judgments regarding transfer pricing, as well as some associated aspects: the affiliation relationships within the group, the complying with the arm's length principle and double taxation of results at group level.

Moreover, recently there was noted that the tax authorities began to perform transfer pricing tax audits more frequently, especially with respect to the transfer pricing documentation. In this context, the article has importance in the finance and accounting professions, since in addition to presenting legislative changes in transfer pricing and their mechanism, it encourages professionals in finance and accounting to assign greater importance to the transfer pricing documentation and clarifies practical aspects.

2. Literature review regarding transfer pricing

The price at which goods or services are transferred between companies within the same group determines the way in which the profit is shared between entities and therefore it influences the amount of taxes paid by each company. For this reason, the transfer pricing subject is very important for groups of companies (Sansing, 2014).

Some researchers consider that the transfer prices could by represented by the remuneration received by the parent company for the provision of certain services to its subsidiaries. Transfer prices are also represented by the remuneration received by a subsidiary as a result of the transactions carried out with another subsidiary of the group (Smith and Eden, 2001).

For other researchers, the transfer prices represent only a tool used by multinational companies to reduce their global corporate income tax. Peralta (2006) has considered that due to the fact that own entities in different countries, the multinational companies could take advantage of the differences in corporate income tax rates, by manipulating profits in different ways. Transfer pricing manipulation is the most common profit manipulation method.

Devereux (2006) has studied the impact of taxation on the location of capital, companies and profits. After analysing the data, the author has concluded that the corporate income tax rate has an important role regarding the decisions taken by the multinational companies, more specifically regarding the decision related to the location of the taxable profits.

Bartelsman and Beetsma (2003) have analysed several OECD countries in order to determine if the levels of corporate income tax rates lead to profit shifting that is not influenced by the actual activity of the companies. Results of the study showed that a one percent increase in the corporate income tax rate of a country reduces the taxable profits of multinational companies from that country with 3%. The authors present BMW as an example of profit shifting outside Germany; the company's corporate income tax paid in Germany, as a percentage of the corporate income tax paid worldwide, has decreased from 88% in 1998 to 5% in 1991 and reached 16% in 1993. The Chief Financial Officer of BMW was the one who publicly admitted that they tried a "real" shifting of the costs in countries with higher taxes.

Clausing (2000) has analysed the impact of tax minimization on intra-group transactions. The author has taken into account the transactions between US parent companies and their subsidiaries from other countries in the period 1982 - 1994 and noticed that there is a clear link between the level of taxes and intra-group transactions. The results showed that, during the analysed period, the trade balances of the US were less favourable than those of the countries with lower taxes, which strengthened the theoretical premise that US multinationals seeking to minimize their global tax burden practice lower prices for the exports to affiliates in countries with lower tax rates, and charge higher prices for imports from the affiliates situated in those countries, respectively.

Chan (2005) has performed a study to determine whether the transfer pricing regulation may prevent the transfer pricing manipulation. The results of the study have demonstrated that the government regulations influence the decision regarding the transfer pricing setting within a multinational company. In conclusion, the author underlines that the authorities should set regulations and penalties if they are interested in solving the problems related to the manipulation of profits through transfer pricing.

3. Research methodology

The research was motivated by the belief that, starting with the amendment of the Romanian transfer pricing legislation on January 1st, 2016, the transfer pricing will become a subject of great interest to the experts in finance and accounting. In this context, one of the objectives of the research is represented by the identification and analysis of the transfer pricing key aspects, including the recent amendments of the Romanian transfer pricing legislation. To achieve this goal, the qualitative research methodology was used. In this respect, a representative number of research papers from the international literature were analysed, especially from the database of IBFD (International Bureau of Fiscal Documentation). In this database exclusively items from the field of international taxation are included.

Another objective of the research was to provide a practical approach to the transfer pricing mechanism. In this respect, there was performed a quantitative research which used the case study as a research tool.

The quantitative research was also used to highlight that the adoption of rules regarding the documentation of transfer pricing represents a measure which discourages the practice of the multinational companies to move their profits in low-tax jurisdictions, through the transfer pricing mechanism. Based on the *Global Transfer Pricing Review Report-2014*, conducted by KPMG, there was obtained a database containing the OECD countries that have introduced the transfer pricing documentation requirement in the national legislation, during 2000-2013. The research was conducted during this period because according to a study performed by Lohse, Riedel and Spengel (2012), most countries have adopted regulations regarding the transfer pricing documentation during 2000-2009. The analysis was not extended to the period 2014-2015, because the required statistical data are not yet available. Further, there was analysed the impact which the adoption of regulations providing the transfer pricing documentation requirement has on the budget revenues collected from corporate income tax in the year of adoption, compared with the year previous to that in which such regulations were adopted.

4. The relationship of affiliation and the arm's length principle - the basics of transfer pricing

The basics of transfer pricing are the relationship of affiliation and the arm's length principle.

The relationship of affiliation in the context of transfer pricing

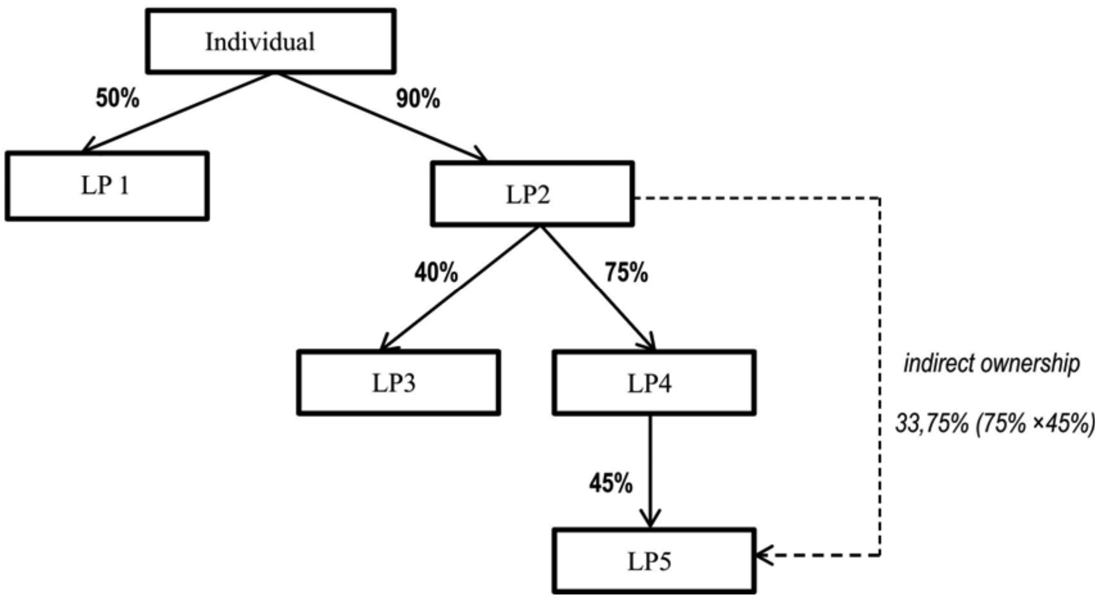
The Romanian legislation defines transfer pricing as the prices at which the transfer of goods or services is performed between related parties. As a consequence, the companies pay special attention to the relationship of affiliation, which raises numerous controversies in the accounting practice.

A legal person is affiliated with another legal person if it owns that legal person, directly or indirectly, in a proportion of minimum 25% or if it effectively controls that legal person. Two legal persons are also related parties if there is a third person who owns both legal persons, directly or indirectly, in a proportion of minimum 25% or if it effectively controls those legal persons. The Law no. 571/2003 does not explicitly mention if the third person can be a legal person or an individual. In this respect, the Law no. 227/2015 regarding the Tax Code, which entered into force on January 1st, 2016, amends the definition of related parties in order to clarify the affiliation relationship between two legal entities owned by an individual.

Case study – the affiliation relationship between two legal entities

Taking into account the definition of the affiliated persons mentioned above, hereinafter there is presented a practical example that aims to highlight all situations in which two legal persons can be considered related parties. In this regard, the analysis is performed based on the Figure 1:

Figure 1. The analysis of the affiliation relationship between two legal entities



Source: Own processing

Based on the figure above, the following situations could be noticed:

- LP2 *owns* LP3 and LP4 *directly*, in a proportion of minimum 25% ⇒ LP2 is affiliated with LP3 and LP4. The same reasoning applies to the affiliation relationship between LP4 and LP5;
- LP2 *owns* LP5 *indirectly,* in a proportion of minimum 25% ⇒ LP2 is affiliated with LP5;
- LP2 *owns* both LP3 and LP4 *directly*, in a proportion of minimum 25% ⇒ LP3 and LP4 are affiliated entities;
- LP2 *owns* LP3 *directly,* in a proportion of minimum 25% LP5 and *owns indirectly,* in a proportion of minimum 25% ⇒ LP3 and LP5 are affiliated entities;
- The individual *owns* LP1 and LP2 *directly*, in a proportion of minimum 25% ⇒ LP1 and LP2 are affiliates;

- The individual *owns* LP1 *directly*, in a proportion of minimum 25%, and *indirectly owns* LP3, in a proportion of minimum 25% ⇒ LP1 and LP3 are affiliates. The same reasoning applies to the affiliation relationship between LP1 and LP4 and between LP1 and LP5.

When analysing the affiliation relationship between two legal entities, the effective control should also be taken into account (besides the percentage of ownership of 25%). A company can be owned in a proportion of less than 25% by an entity that carries on its effective control, in this case the two companies being related parties.

The concept of effective control is not yet defined in the national legislation, this subject being delicate even within the international legislation. Starting from the idea of exercising effective control, in practice there have been situations in which the tax authorities have considered two companies being related parties, since they had the same administrator or one of them was the sole provider of the other.

The arm's length principle

The arm's length principle represents the basis of the transfer pricing analysis. It requires prices set out in transactions carried out between related parties are equal to the prices set out in transactions carried out between independent persons, in similar economic circumstances.

A practical approach of the arm's length principle could be achieved based on the following example.

<u>*Case study – the arm's length principle*</u>

Company RO manufactures brand X cars in Romania and sells them to the affiliated company BG in order to be resold on the Bulgarian market. For the production and delivery of a car RO bears costs in the amount of EUR 4,000. BG purchases the cars from RO at the price of EUR 4,300 per car and sells them on the Bulgarian market at the price of EUR 4,400 per car, incurring distribution costs in the amount of 25 EUR per car. The supply chain is illustrated in the Figure 2:

Figure 2. The supply chain

Source: Own processing

If the price charged by non-affiliated companies for selling brand X cars is between EUR 4,290 per car and EUR 4,410 per car, then the price of EUR 4,300 per car charged by RO in order to sell the cars to BG complies with the arm's length principle. The setting of the range of values regarding the price charged by the non-affiliated companies is performed on the basis of comparability studies.

According to the information in Table 1 the profit obtained at group level would be of EUR 375 per car, from which EUR 75 will be taxed in Bulgaria and EUR 300 in Romania.

Therefore, the transfer price determines the part from the profit that will be taxed in each country. Taking into account that in Romania the corporate income tax rate is higher than the corporate income tax rate from Bulgaria, the group may try to manipulate the transfer prices in order to move the profit from Romania to Bulgaria. In this regard RO could sell the cars to BG using a price of EUR 4,100 per car and obtaining a lower profit. Furthermore, the acquisition cost of BG would be diminished, BG obtaining a higher profit. According to the Table 2, the gross profit gained by the group remained at the value of EUR 375 per car, transfer prices impacting the global corporate income tax of the group and the net profit.

Table 1. Transfer pricing mechanism – the complying with the arm's length principle

- EUR-

	RO	BG	Total
Sales revenues	4,300*	4,400	8,700
Production and delivery costs	(4,000)	-	(4,000)
Cost of acquisition	-	(4,300)*	(4,300)
Distribution costs	-	(25)	(25)
Gross profit	300	75	(375)
Corporate income tax	48 (300*16%)	7.5 (75*10%)	55.5
Net result	252	67.5	319.5

* Transfer pricing

Source: Own processing

Table 2. Transfer pricing mechanism – the non- complying with the arm's length principle

- EUR -

	RO	BG	Total
Sales revenues	4,100	4,400	8,500
Production and delivery costs	(4,000)	-	(4,000)
Cost of acquisition	-	(4,100)	(4,100)
Distribution costs	-	(25)	(25)
Gross result	100	275	375
Corporate income tax	16 (100*16%)	27.5 (275*10%)	43.5
Net result	84	247.5	331.5

Source: Own processing

As can be observed, the profit shifting from Romania to Bulgaria was achieved using a transfer pricing that does not comply with the arm's length principle (it is not situated within the range of the prices charged by non-affiliated companies). In this situation, the tax authorities adjust the transfer prices so that these prices are situated within the range of prices charged by non-affiliated companies, this leading to additional corporate income tax, as well as to interest and late payment penalty. Moreover, a transfer price adjustment may determine the double taxation of results at group level.

5. Double taxation of results in the context of transfer pricing

For a better understanding of the double taxation of results we will continue the example presented above. It will be assumed that within a tax audit, the tax authorities find that the price charged by RO in order to sell the cars to BG does not comply with the arm's length principle and as a consequence the tax authorities decide the adjustment of the transfer prices at the level of company RO, with EUR 250 per car, the selling price being of EUR 4,350 per car.

The impact of this adjustment on the result of the Romanian company is presented in Table 3.

Table 3. Double taxation of results

-EUR-

	RO – before adjustment –	RO – after adjustment –	BG
Sales revenues	4,100	4,350	4,400
Costs	(4,000)	(4,000)	(4,125)
Result	100	350	275

Source: Own processing

After the adjustment of the selling price from EUR 4,100 to EUR 4,350, the result of the Romanian company increased from EUR 100 to EUR 350, with direct impact on the corporate income tax that should be paid by this company in Romania. The profit obtained by the group before the adjustment of the selling price was of EUR 375 (100 + 275), while the profit obtained after the adjustment was in the amount of EUR 625 (350 + 275). Therefore, the group is finding itself in a position to tax the amount of EUR 250 twice - once in Romania and once in Bulgaria, resulting in a double taxation of the profit obtained by the group.

To avoid the double taxation, the authorities from Bulgaria should perform a corresponding adjustment (i.e. to reduce the taxable income of the Bulgarian company with EUR 250 for tax purposes), in order for the group to not be taxed twice for the same profit (Luca, 2009). In this respect, the Romanian company or the Bulgarian company may ask the tax authorities for the initiation of the mutual agreement procedure, as follows:

- *Mutual agreement procedure provided by the Double Taxation Convention* established between Romania and Bulgaria. At this stage, the tax authorities of the two countries examine the circumstances leading to double taxation and try to find a solution in order to avoid the double taxation.

  This procedure could be requested within three years from the issue date of the tax decision that provides a transfer pricing adjustment which determines a double taxation of results at the group level. It may be requested only if the Double Taxation Convention established between the two countries provides the possibility to initiate this kind of procedure.

- *Mutual agreement procedure under the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (EU Arbitration Convention),* applicable for EU Member States.

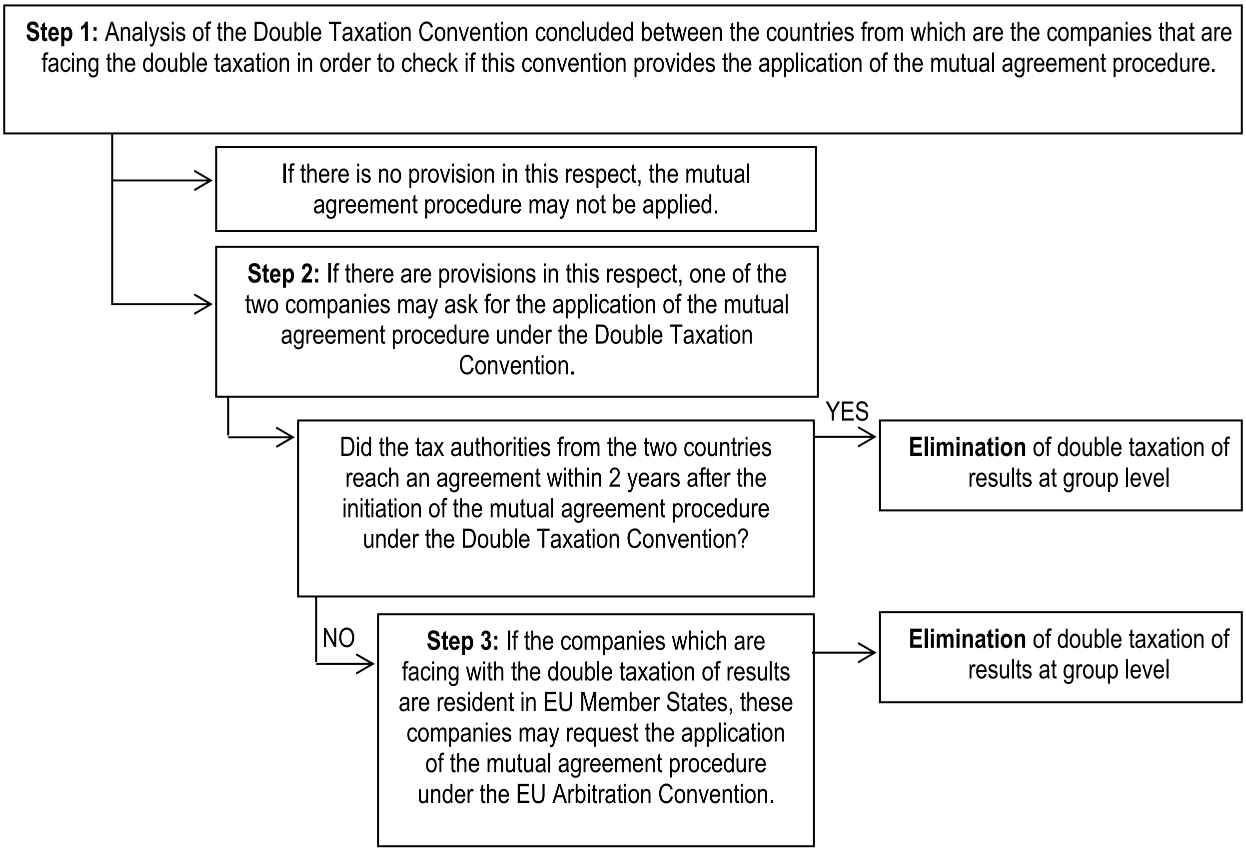
  This procedure may be requested if, within 2 years after the initiation of the mutual agreement procedure provided by the Double Taxation Convention, the competent authorities do not reach an agreement in order to eliminate the double taxation.

  Thus, according to the Arbitration Convention, an independent advisory committee (the arbitration panel) will be set up, which will analyse the situation and will propose its own solution. If the Romanian tax authorities and the Bulgarian tax authorities continue to have divergences, the solution of the arbitration panel shall be final and shall become a binding solution (van Vlem et al., 2014).

  Dispute resolution under the EU Arbitration Convention should not be initiated and may be suspended if RO or BG is subject to “serious penalty”. The term “serious penalty refers to commission of any criminal act in relation to the tax evasion law, the accountancy law, the company law, or the tax legislation. It also refers to administrative sanctions against acts such as the refusal to present the accounting records, or to submit the tax returns/informative statements, upon the request of the tax authorities, etc.

Summarizing, the steps to avoid the double taxation of results at group level is illustrated in Figure 3:

Figure 3. Steps to avoid double taxation



Source: Own processing

6. The transfer pricing documentation requirement – a measure for blurring the phenomenon of manipulation of results

One of the objectives of this article is to demonstrate that the adoption of rules regarding the transfer pricing documentation represents a measure which discourages the practice of multinational companies to move their profits through the mechanism of transfer pricing, in low-tax jurisdictions.

The sample used in order to perform the research was represented by the OECD member countries. In this respect, the research took into account the following steps:

- Because the research took into consideration the period 2000-2013, we have excluded from the sample countries that have introduced the transfer pricing documentation requirement in their national legislation before 2000 or have not introduced such a requirement until 2013. This step was performed based on the *Global Transfer Pricing Review Report -2014*, conducted by KPMG;
- For the remaining countries in the sample until this stage of research, there was identified the year in which the transfer pricing documentation requirement was adopted within the national legislation;
- The next step was to exclude from the sample countries for which the corporate income tax rate was not constant during the period spanning from the year before the adoption of the transfer pricing documentation requirement and the year of adoption.

In this respect it was considered that the change in the corporate income tax rate may distort the results of the research due to the impact that it might have on the budget revenues derived from corporate income tax;

- The last stage of the research was represented by the identification, based on statistics published by the OECD, of the budget revenues obtained from corporate income tax by the countries maintained in the sample and the identification of the share of these revenues in GDP in the period spanning from the year before the adoption of transfer pricing documentation requirement and the year of adoption. In addition, at this stage, two countries were excluded from the sample since the statistical data needed for the research were not available for these countries.

Table 4 shows the countries which were excluded from the sample, while Table 5 shows the budgetary revenues obtained from corporate income tax by the countries maintained in the sample and the evolution of the share of these revenues in GDP in the period between the year before the adoption in the national legislation of transfer pricing documentation requirement and the year of adoption of this requirement.

Table 4. Countries excluded from the sample

<table>
<tr><th>Country</th><th>Reason for exclusion from the sample</th><th>Country</th><th>Reason for exclusion from the sample</th></tr>
<tr><td>Australia</td><td rowspan="9">The transfer pricing documentation requirement was introduced in the national legislation before 2000</td><td>Ireland</td><td rowspan="5">The transfer pricing documentation requirement was not introduced in the national legislation until 2013</td></tr>
<tr><td>Canada</td><td>Korea</td></tr>
<tr><td>Denmark</td><td>Luxembourg</td></tr>
<tr><td>Italy</td><td>New Zeeland</td></tr>
<tr><td>Japan</td><td>Switzerland</td></tr>
<tr><td>Mexico</td><td>Estonia</td><td rowspan="6">The corporate income tax rate was not constant during the analysed period</td></tr>
<tr><td>Poland</td><td>Israel</td></tr>
<tr><td>UK</td><td>Slovenia</td></tr>
<tr><td>USA</td><td>Spain</td></tr>
<tr><td>Austria</td><td rowspan="5">The transfer pricing documentation requirement was not introduced in the national legislation until 2013</td><td>Netherlands</td></tr>
<tr><td>Belgium</td><td>Portugal</td></tr>
<tr><td>Chile</td><td>Hungary</td><td rowspan="3">Statistical data needed for the research is not available</td></tr>
<tr><td>Czech Republic</td><td rowspan="2">Slovakia</td></tr>
<tr><td>Iceland</td></tr>
</table>

Source: own processing based on KPMG (2014)

Table 5. Evolution of the budget revenues obtained from corporate income tax by countries from the sample

Country	Year of introduction in national law of the transfer pricing documentation requirement	Budget revenues derived from corporate income tax (bln. euro) in:		Share in GDP of budget revenues derived from corporate income tax (%) in:	
		t_0	t_1	t_0	t_1
Finland	2007	5.62	6.96	3.25	3.73
France	2010	27.73	41.31	1.43	2.07
Germany	2003	21.72	27.25	0.99	1.23
Greece	2008	5.70	5.88	2.43	2.44
Norway	2008	25.04	31.71	11.02	12.14
Sweden	2007	11.35	12.26	3.46	3.52
Turkey	2008	6.40	7.88	1.63	1.78

Source: own processing based on OECD statistics

*t_0 = the year before adopting the transfer pricing documentation requirement

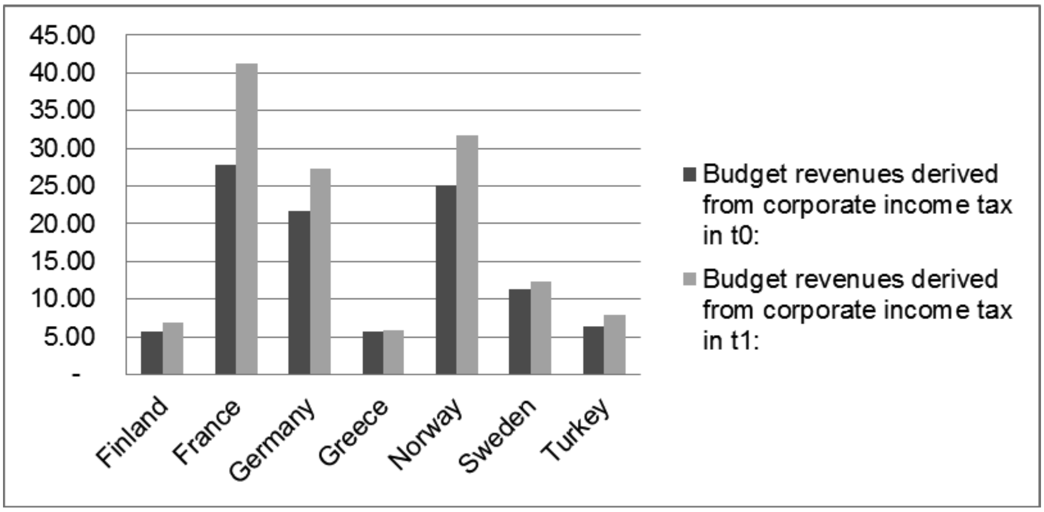
*t_1 = the year of the adoption of the transfer pricing documentation requirement

As can be observed from the Table 5, most countries have introduced in their national legislation the transfer pricing documentation requirement in 2008. It should be noted that Romania has also adopted this requirement in 2008.

Additionally, it can be noticed that for all countries included in the sample, the budget revenues derived from corporate income tax have recorded a positive trend during the period between the year prior to the adoption of the transfer pricing documentation requirement and the year of adoption. There can also be noted that the share of those revenues in GDP increased during this period.

Figure 4 shows the evolution of the budget revenues derived from corporate income tax in the period under review.

Figure 4. Evolution of the budget revenues derived from corporate income tax



Source: own processing

Given the above, it can be concluded that the adoption in the national legislation of transfer pricing documentation requirement by the OECD member countries in the period 2000-2013, determined the increase of the revenues budget collected from corporate income tax. In other words, the hypothesis that the transfer pricing documentation requirement represents a measure for combating the base erosion and profit shifting was proved to be true. However, due to small sample size and duration of the analysis, the value of the results is limited. Perhaps a increased relevance would be achieved in the case of a study performed for all countries that have in their national legislation the transfer pricing documentation requirement, regardless of the period in which such a requirement was adopted and the evolution of the budget revenues derived from corporate income tax and if such a study were to be realized for a longer period of time.

7. Conclusions

The results show that the budget revenues collected from corporate income tax have registered an increase in the year in which the transfer pricing documentation requirements have been adopted, compared with the year before the effective adoption of this requirement. In other words, the transfer pricing documentation requirement discourages the practice of the multinational companies to move their profits through transfer pricing mechanism in low-tax jurisdictions. For this reason, globally, there are numerous transfer pricing concerns, these concerns often causing changes in national legislations. Thus, countries such as Australia, Denmark, France, UK, Netherlands, Poland, Mexico, Spain and South Korea have recently communicated that they are going to implement or have already implemented new transfer pricing documentation regulations, as a measure which is leading to the blurring of the phenomenon represented by the manipulation of transfer pricing and profit shifting.

In Romania, starting with 1 January 2016, the preparation of the transfer pricing file by companies which are performing transactions with related parties is mandatory. The deadline regarding the preparation and presentation of the transfer pricing file will be set out by an order issued by the National Agency for Fiscal Administration. Also, this order will set out the amount of transactions for which companies have the obligation to prepare the transfer pricing file. Currently there is no such amount, companies finding themselves in a position to bear higher costs in order to analyse the transaction within the transfer pricing file, compared to the profit generated by the transaction. As an alternative to the transfer pricing documentation, the Romanian legislation allows companies to conclude advance pricing agreements (APA) with the tax authorities. These APAs establish the conditions and methods in which the transfer prices will be determined over a fixed period. The difference between a transfer pricing file and an advance pricing agreement is that transfer pricing documentation analyses transactions which have already taken place between related companies, while the advance pricing agreement analyses transactions that will be carried out in the future.

Even if the new regulations related to the obligation of preparing the transfer pricing file, adopted by Romania since 2016, represent a progress for fighting the base erosion and profit shifting phenomenon, taking into account the global concerns, it is expected that in the near future the Romanian transfer pricing legislation will be amended significantly.

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