
The business perspective on transfer pricing and related legislation

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Abstract

The Romanian legislation transfer on pricing was adopted following the models established by the Organization for Economic Co-operation and Development (OECD) Guidelines and the European Union Forum on transfer pricing. The first detailed legal regulations regarding the content of the transfer pricing file and the deadline for its submission were published in the Official Journal of Romania in 2008.

The objective of the research is to identify and analyse the perception of the business environment in Romania on transfer pricing issues, covering topics such as the influence of the transfer pricing law in creating a competitive business environment, how the competent fiscal authority implements the legislation, the need for companies to turn to an external consultant, as well as other related topics.

Keywords: *Transfer pricing, competitive business environment, transactions with affiliates, additional tax liabilities, specialized consulting, double taxation avoidance model.*

JEL Classification: E64, M42, M48

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Introduction

The arm's-length principle was first introduced in the national tax law in 1994, followed by the development of the legislative framework regarding transfer pricing achieved in 2004, when the definition of related parties, the arm's length principle and the transfer pricing methods were introduced in the Tax Code. This applies to all transactions with related parties, including transactions between a foreign legal entity and a company established in Romania. Recent amendments to the Tax Code clarify the possibility to investigate transactions between Romanian affiliated parties in order to determine the transfer prices.

What many companies still do not realize is that transfer pricing represents the future of financial audit and that tax controls will focus ever more on this sector.

Pak and Zdanowicz (1994), quoted by Kingsley and Zabihollah (2008), realized since 1994 that transfer pricing is the most important international tax issue perimeter that governments and multinational companies involved in international trade are facing.

Companies from Romania that have direct or indirect related party transactions must understand that the strategy of transfer pricing practices within the group must respect the arm's length principle, but also that the transactions must be analysed from the point of view of the added value created and the benefits for the parties involved, as stated by Mckinley and Owsley (2013): determining a company's transfer prices requires identifying where value is created in an organization and transferred across group members.

A perspective on transfer pricing risk identification and its measurement is presented by a consultant of a multinational company in the OECD Guidelines on "Dealing Effectively with the Challenges of Transfer Pricing". He is pointing out the importance of tackling in business the arm's length principle and how to measure it. It also emphasizes the added value that the level of training of the financial department in transfer pricing and also the cooperation with external consultants can bring to the company.

The most recent study on the awareness of the companies in Romania regarding the importance of understanding the challenges related to transfer pricing was conducted by Ernst & Young (2013). The results of the study confirm that the Romanian entities consider

transfer pricing as one of the most important issues that they will face in the future. However, the study by Ernst & Young highlights a growing level of knowledge of the Romanian tax authorities regarding transfer pricing, developing more thorough analyses of transfer pricing documentation.

Another study on the perception of professionals in Romania in the field of accounting/auditing, on some specific aspects of transfer pricing, was conducted by Corlaci and Tiron-Tudor (2014). Based on the questionnaire used, the authors concluded that the respondents considered that transfer prices are important to the overall business strategy but, at the same time, transfer prices may be used as tools of manipulation of the fiscal result.

The Romanian Tax Code provides a general description of the arm's-length principle, which is consistent with the Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations issued by the OECD (OECD, 2010).

The objective of the transfer pricing documentation is to evaluate the extent to which a company in Romania carries out transactions with an affiliated entity in another Member State in accordance with the market value and also to meet the requirements for transfer pricing rules which are in force in Romania. In case of disputes, the responsibility of proving that the transfer prices used do not respect the arm's length principle falls to the tax authorities.

1. Research methodology

During the planning and implementation of the research activities aimed at identifying the perceptions of the Romanian business environment in relation to transfer pricing, a questionnaire was designed, which consisted of 18 questions. Out of these, 17 are closed questions with predefined single answers, the last being an open-answer question meant to identify the degree to which the respondent is familiar with transfer pricing. The questionnaire was built using the funnel technique (Chelcea, 2007, p.259), which involves structuring the questions so as to observe a shift from general to particular aspects of the research topics.

The questions used in the questionnaire were divided into four categories, as it follows:

1. The first four questions are designed to identify the company's profile, business segment, ownership structure and whether they were subject to a tax audit on transfer pricing. Pre-coded questions with a broad spectrum of answers and also simple "Yes or No" questions were used, in order to shape the profiles.
2. The following six questions are designed to outline the perception and ability of the respondent in preparing the transfer prices documentation and its importance within the economic context. Because this issue is complex and opinions can vary in intensity, there were used questions with answer ranging on a scale from 1 to 10, where 1 reflects a low degree of influence, and 10 reflects a very high degree of influence.
3. The remaining questions with predefined answer options were designed to outline the respondents' opinion on how the tax law in the field of transfer pricing are applied by the tax authorities.
4. The last question is an open -answer one and it serves to identify the degree to which a respondent is familiar with transfer pricing and his/her view in relation to the topic presented.

The target group consisted of companies from different areas of activity and different sizes (small, medium and large taxpayers). The companies that have been requested to answer the questionnaire were selected using various contacts made on the business-oriented social networking platform, LinkedIn. The target group was offered the possibility of providing the answers anonymously or by stating the name of the company.

The questionnaire was made with Microsoft Word and the responses were aggregated using Microsoft Excel (the graphs were prepared using Microsoft Excel).

The responses were collected from 1 March 2015 to 31 October 2015.

2. Analysis and interpretation of the results

Approximately 500 persons were contacted to complete the questionnaire by e-mail, through the LinkedIn platform and through questionnaires submitted and filled at the registered office/place of business of the respondents. By the end of October 2015 there have

been recorded a number of 70 responses, mostly from the large taxpayers.

The results will be presented divided according to the categories of questions mentioned above.

2.1. Identifying the profiles of companies to which the respondents belong

To ensure a representative sample, most companies that answered the questionnaire had to be classified as large taxpayers, 50% of companies should have had at least one shareholder/partner who held more than 25% of the value/number of shares or of the voting rights and from at least 20% of the respondents the transfer pricing documentation should have been requested by the fiscal authorities.

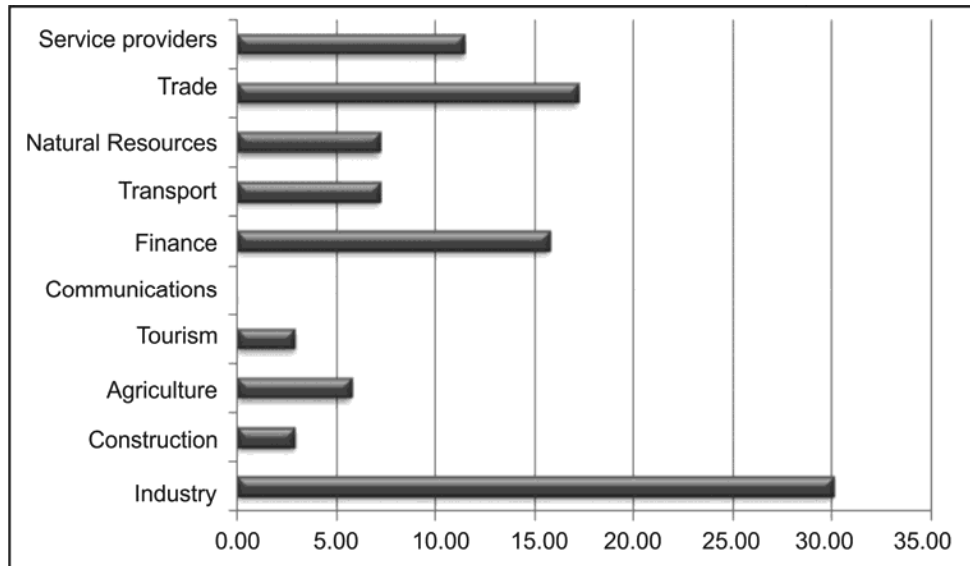
According to the centralized results of the questionnaire, 32.86% of the respondents are small taxpayers, 28.57% are medium taxpayers and 38.57% are large taxpayers, according to the selection criteria applicable for the year 2015. Also, we noticed that 62.86% of the companies have at least one person that holds more than 25% of the value/number of shares or voting rights. If there are no legal or physical persons that hold at least 25% of a company, the company was automatically labelled as independent.

Figure 1 provides information regarding the profile of companies that answered the questionnaire.

According to **Figure 1** we notice that the sample is made up of: 30% companies which operate in industry, 17% in commerce, 15% in finance, 11% are service providers and 27% in other areas. In all of the areas covered in the questionnaire there may occur transactions between affiliates that are subject to transfer pricing regulations and the arm's length principle, even if we talk about industry and commerce where there are transactions between affiliates (purchases and sales of finished products, semi-finished products or raw materials) or if we refer to the financial institutions or services providers.

In order to determine if the sample of the companies is representative to the study it was necessary to identify the number of companies which previously prepared a transfer pricing documentation for the entire activity or just a certain type of transactions. Thus, based on the answers received, we can conclude that more than 20% of the companies were required to prepare the transfer pricing documentation prior to the date of the questionnaire.

Figure 1. Companies' profiles



Source: compiled by the author.

According to the information received for the first four questions, which aimed to collect preliminary information on the representativeness of the analysed sample, we conclude that the respondents can provide answers based on their professional experience within the company, related to transfer pricing.

2.2. Perception and aptitude in relation to the need for preparing the transfer pricing file

Most respondents who answered the questionnaire replied that if it is necessary to prepare a transfer pricing documentation they would turn to a specialized consulting company (65.71%), while 31.43% would assign the task to the company's financial department and the rest (2.86%) would use other resources. At the same time, confirming the result of the previous question, most of the respondents who answered the questionnaire (71.43%) believe that it is necessary to have a special software license to obtain the comparability sample needed to compile a transfer pricing file. The programs that were mentioned are AMADEUS and ORBIS, which are used by specialized consultants in order to obtain comparability samples used to prove that the arm's length principle was observed.

To the question regarding the positive impact of transfer pricing legislation on the development of a competitive business environment, 55% of respondents answered that there is a connection between the two (by marking out the fields from 6-10 on a scale from 1 to 10 where 1 represents low influence and 10 represents very high influence).

Analysing the perception regarding the competitive environment, we decided to quantify the impact of transfer pricing legislation, as an additional "burden" that must be managed by the company. Most of the respondents (22.86%) have provided the answer 5 (on a scale of 1 to 10), thereby adopting a neutral position. Also, 10% of the respondents felt that transfer pricing legislation is not a "burden" for the company, while 12.86% felt that they will be forced to allocate important resources to this activity.

Since in related party transactions it is necessary to apply the arm's length principle, 41.43% of the respondents believe that transfer pricing legislation may affect to some extent the transactions with its affiliates (the respondents marked the answers 5, 6 and 7). Regarding the other respondents, 20% considered that transfer pricing legislation does not affect in any way the transactions with affiliates and 10% believed that it has a great influence on group transactions.

Since many large companies, especially those in manufacturing, purchase raw materials, semi-finished products or finished products from affiliates, we assessed the perceptions regarding the quality and conformity of the products or services if they were provided by an entity from the group. Most of the respondents (21.43%) have provided the answer 5 (on a scale of 1 to 10), thereby adopting a neutral position. Also, 11.43% felt that quality is not ensured if the products/services are purchased within the group, while 14.29% said that the quality of products/services is ensured if the purchases are within the group (out of these, only three companies in the industry chose the answer 10 – very high influence).

In terms of the transfer pricing influence in diminishing the “tax base erosion and profit shifting”, 37.14%¹ out of all respondents felt that the current legislation (Romanian Tax Code in force in 2015) has little influence, while 31.43% adopted a neutral position. The remaining 31.43% considered that the legislation has a strong influence in increasing voluntary compliance of companies. Some companies tend to use transfer pricing to increase group profits reported in low tax jurisdictions and reduce group profit where taxation is high.

To the question “To what extent transfer pricing legislation restricts a company’s rights in relation to

affiliates?”, 72.86%² of respondents marked the first four fields, recognizing that legislation does not force them to respect a certain profitability margin within the company, but is mainly influenced by the economic environment and very little by legislation.

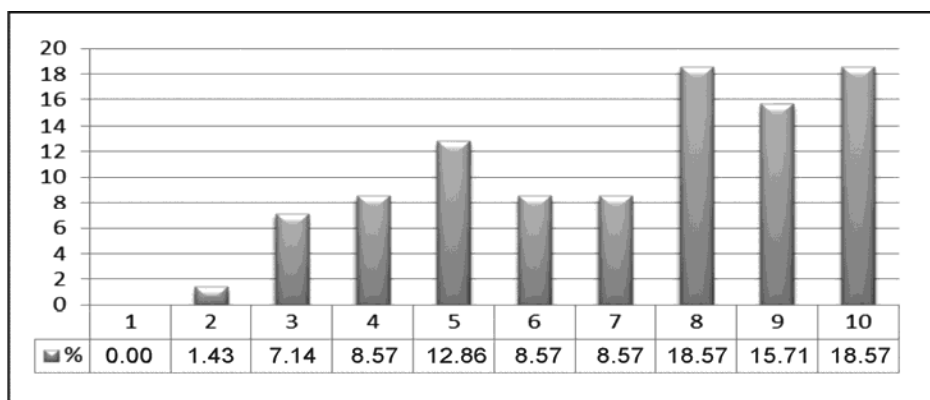
In 2015, transfer prices became a new tool to increase revenues for the state budget, with a significant increase in additional amounts established of 217 mil. EUR (ANAF, 2015), by verifying the way in which the arm’s length principle was applied.

Although during the last year the number of tax audits conducted on transfer pricing compliance in relation to affiliates increased, only 35.71% of respondents believe that transfer pricing is a new “leverage” of attracting additional revenues to the state budget, while 20% maintain a neutral view on this topic.

Regarding the influence of establishing a minimum threshold for transaction value below which the reparation of the transfer pricing documentation is not necessary, more than 72.86% of respondents consider this measure to be beneficial for the economic environment, and also an efficient legislative framework.

However, most respondents believe that the current transfer pricing legislation is ambiguous, concise and open to interpretation. The opinions of respondents are presented in Figure 2.

Figure 2. Centralised data for the question – Do you consider that transfer pricing legislation in its current form, is ambiguous and summary? (1 – strongly disagree; 10 – fully agree)



Source: compiled by the author

¹ The percentages were calculated as follow: 37.14% for the marked field 1, 2 and 3 of the questionnaire; 31.43% for marked fields 4, 5 and 6 from the questionnaire; 31.43% marked fields 7 to 10.

² The percentage 72.86% was calculated from the marked fields 7 to 10 of the questionnaire, where 1 represents low efficiency and 10 represents high efficiency

2.3. The perception regarding the enforcement of transfer pricing legislation

Out of all the respondents, 40% (respondents who provided answers ranging from 8 to 10) believe that the tax authorities do not have sufficient technical knowledge in the area of transfer pricing, applying the law somewhat abusively, while 18.57% (respondents who provided answers ranging from 1 to 3) consider that the tax authorities have sufficient technical knowledge in the area of transfer pricing. Also, 14.29% wished to remain neutral on the proposed topic, probably because they never had contact with tax authorities on transfer pricing issues.

Out of all respondents, 27.14%¹ believe that transfer pricing is not yet an exact science, while only 5.71% believe that the science is well founded. Also 67.14% also provided answers in the range 4 to 7, opting for a neutral opinion on the matter.

2.4. Identifying the degree to which the respondents are familiar with the double taxation convention

Because the last question was an open-answer one, below there is a selection of the three best received answers:

1. In general, an adjustment in terms of transfer pricing will lead to double taxation. The taxpayer is entitled to apply the Arbitration Convention (if it serves his best interest to do so).
2. Transfer pricing adjustments may conflict with the convention regarding the avoidance of double taxation as long as the price of the purchases from the affiliates does not reflect the market value and the price adjustments made affect the income tax;
3. It depends on the prices used in intra-group transactions.

Indeed, a transfer pricing adjustment enters into conflict with the Double taxation convention and can modify the taxable income of affiliated companies (directly or indirectly) from another country. When the company has

¹ The percentages were calculated as follow: 27.14% for the marked field 1, 2 and 3 of the questionnaire; 67.14% for marked fields 4 to 7 from the questionnaire; 5.71% marked fields 8 to 10.

been informed by the tax authorities of a Member State that its income or expenditures will be adjusted, it has the right to require and enforce the Arbitration Convention and to initiate the mutual agreement procedure.

The Convention Model regarding income taxes and taxes on capital provides the mechanism that allows the competent authorities to consult each other and resolve the broader issues of transfer pricing, not only the legal problems associated with the double taxation, but also the economic ones, and in particular those resulting from the inclusion of group profits (OECD, 2010).

Based on the answers centralized we conclude that only 10% of the respondents have above-the-average knowledge on transfer pricing, expressing the opinion that that an adjustment of the taxable value of a company in a group may conflict with the convention for the avoidance of double taxation and that it is the company's choice if it will take measures to reduce the tax base, in the case of companies where have been identified transactions that do not observe the arm's length principle.

Conclusions

The current study was conducted through a questionnaire, on a sample of companies from all the taxpayer categories and a broad spectrum of industries. The questionnaire was constructed using the funnel technique and the questions were grouped into four distinct categories in order to assess the companies' profiles, their perception and ability regarding the need to prepare the transfer pricing documentation, the way transfer pricing legislation is enforced and to what extent the respondents are familiar with the double taxation convention.

Based on the centralized results we consider that the sample is representative, because most companies that answered the questionnaire are included in the class of large taxpayers. Over 60% of companies have at least one shareholder/partner that holds more than 25% of the value/number of shares or voting rights and some of the respondents were previously put in a position to prepare the transfer pricing documentation.

Because the transfer pricing strategies require detailed knowledge of national legislation and the OECD models, 65.71% of respondents replied that they would resort to a specialized consulting firm. Also, 71.43% of the

respondents think that they need a special software license to access a database in order to establish the comparability sample and to set arms' length prices of different types of transactions charged with their affiliated entities.

Complementing the fiscal legislation with a minimum threshold for the value of transactions below which the transfer pricing documentation should not be mandatory is considered by 72.86% of the respondents as potentially beneficial for the economic environment and an effective legislative addition. The new tax code in force starting with January 1st 2016 includes provisions regarding the implementation of thresholds by type of transactions above which it is required to prepare the transfer pricing documentation, and to provide proof that the arm's length principle is observed.

Regarding the above-average knowledge of both the legislation on transfer pricing and the provisions of the Convention to avoid double taxation, we conclude that only 10% of respondents have the necessary knowledge

about the fact that an adjustment to the taxable base in the case of inspection on transfer pricing may lead to a request to reduce the tax base of companies where there have been identified transactions that do not observe the arm's length principle.

The present research is limited because of the small number of respondents who answered the questionnaire (70). Yet, we consider that a presence of 38.57% of large taxpayers in the sample ensures a high degree of representativeness of the sample. At the same time, this scientific approach was focused on specific issues, known both by the people in the companies' financial department, and by their managers or administrators.

The present study can be a starting point for future research aimed at analysing the evolution of the approaches regarding the transfer pricing from the business environment point of view, based on the legislative changes in the field, from the Tax Code in force starting with January 1st, 2016.

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