

## **TRANSFER PRICES IN ROMANIAN ECONOMY**

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**ABSTRACT:** *Transfer prices are a delicate subject and of major importance in jurisdictions to which they belong, as they are often used as a means of exploiting tax legislation. In proceedings of tax inspection and financial control carried out by the tax authorities, a special place is occupied by the transactions between affiliated entities with Romanian companies. The purpose of the tax inspection is: combating tax evasion and tracking these transactions to be carried out at market prices. The article aims to present how transfer prices affect the value of an enterprise, but also the methodological aspects relating to tax inspection and the necessary documents in order to deciphering the mode of transfer pricing in Romania.*

**KEY WORDS:** *transfer prices, tax inspections, company value, arms` length principle, advance pricing agreement, transfer prices file.*

**JEL CLASSIFICATION:** *F65, H26.*

### **1. INTRODUCTION**

Transfer prices represent a pertinent subject and through this article I want to highlight the practical implication of transfer prices in contemporary economies. These have a strong impact both on affiliated enterprises and on the states where these enterprises carry out their activity. Transfer prices can affect any company in their group, because they offer planning opportunities, but in the same time require different compliance obligations depending on the requirements of each jurisdiction.

At the moment, in Romania, there is a visible emphasis over this subject, because transfer prices are seen by transnational companies as fiscal optimization, and the state wishes to adopt new protective measures for receipts from taxes, especially measures to somehow avoid outsourcing the tax base of contributors to affiliated entities, in order to obtain a more favorable tax regime.

These measures involve some tax audit transfer pricing issues, to see behavior affiliates in the activities, in order to combat tax evasion.

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## 2. THE INFLUENCE OF TRANSFER PRICES ON COMPANY VALUE

Over the years, transfer prices had represented a sensitive subject of national and international interest. The problem of transfer prices is extremely complex; they have appeared in a context where small groups of companies present in several states (multinational companies) perform economic activities in those states.

The evolution of transfer prices is closely tied to the development of commercial relationship between the states and to the appearance of first multinational groups that operate in different states. The first multinational company appeared in the 1600's by the founding of East India British Company-1600 and East India Dutch Company - 1602 (Patroi, et al, 2013, pp.2). The first state that introduced transfer prices regulations was Norway, in 1911 (OECD, 2011, p.8).

OECD (Organization Guidelines for Economic Cooperation and Development) issued the first report on transfer prices in 1979. In 1984, OECD issued a new version of the report, and in 1995 issued the first version of OECD guidebook regarding transfer prices, version updated later in 2010. Transfer prices are the prices that unfold form transactions between companies that belong to the same group or affiliated companies, and have a major importance on the value of an enterprise. The value of an enterprise is the result of its commercial strategies, its recorded turnover, the updated cash-flow and the capitalization of profits. This enterprise value is in fact the expression of a solid business.

Transfer pricing is a commercial reality and represents the prices at which goods or services are sold or bought, noting that both the seller and buyer are controlled by the same entity or by shared entities. Establishing transfer pricing is also a problem for global operations that involve running some actions with costumers (including marketing, price setting and risk management activities) related to a particular financial product or a financial product line, in several tax jurisdiction and/ or via several participants.

In order not to affect the value of a company, it is necessary for the concluded transactions to respect the market prices, but if these transactions are not in the "market interval", the activity is considered non-transparent, because the profits are not correctly reflected. Transfer prices represent an international fiscal problem, and for companies to function in optimal conditions, OECD directives have established "arm's length" principle and made it the basic principle of transfer pricing theory. The company value is influenced by transfer pricing in that they can lead to the growth of the profit paid by the group to jurisdictions with reduced taxes, or contrary, they can reduce the profit where taxation is high - so called process of "erosion of tax base and move profits".

Usually the company value can be characterized and compared only with the transactions of an independent part, and can be determined by factors such as used assets, assumed risk or functions performed by each member of the group in an intra-group transaction as well as the correct application of an appropriate economic method, provided in treasury regulations.

Transfer prices are the prices at which transactions are made between companies that belong to the same group and are frequently used by the large companies for fiscal

“optimization”, favoring certain subsidiaries, especially those from countries with softer taxes. It is known that transfer prices are seen as a legitimate business opportunity for transnational companies, and are frequently used to financially distort the transaction result and to avoid taxes. Worldwide, companies seek to attenuate the risks associated with transfer prices in a proactive manner – to reduce the risk of a faulty audit or to prevent a double or a triple taxation, as the result of implementation of a wrong strategy. Lately, fiscal authorities expose the necessity of preparing an ample documentation regarding transfer prices in transactions made by Romanian companies with entities of the same group. Transfer price is ultimately used to determine if the taxable income across borders is considered to be at the arm’s length principle and if it fits within the calculated range.

Fiscal procedure code of 2016 establishes, inter alia, that “all companies performing transactions with affiliated parties will be forced to make a transfer prices file, and not only those who are required to follow this procedure during a fiscal inspection, as happens in present. In order to respect the arm’s length principle, the taxpayer engaged in transactions with affiliates must prepare transfer pricing documentation. At the request of a central tax authority, the taxpayer is obliged to present the transfer prices documentation. The transaction amount to which the taxpayer is obligated to make a transfer prices documentation, terms for its preparation, the content of the file and the conditions in which the file is requested is to be approved by order of ANAF President” (Fiscal Procedure Code, art 102, para. 2, no. 547 of 23 July 2015).

The value of affiliated companies is influenced by the development of transfer prices documentation, because every company knows its assumed risks and the assets used in the group, as to sustain if affiliates have sense and economic content and whether the transaction occurred at market prices. Transfer prices can influence business activity, not only through fiscal implications, but also through the impact they have on affiliated companies, on cash flows, over investment decisions, but also on performance indicators of companies such as group transaction as well as the correct application of an appropriate economic method, provided in treasury regulations.

### **3. TAX AUDIT – HOW TO KEEP TRANSFER PRICES IN ALLOWED LIMITS**

In Romania, transfer prices are a milestone both for contributors and for fiscal authorities and the problem taxpayers face is that there are different approaches of tax inspectors, and therefore we face distinct results of fiscal control.

Lately, we can see an increase in the influence of transfer prices on economic activity at companies in Romania, as well as enhancing the attention given by the tax authorities to transfer prices. It should be specified that the transfer prices have a major importance in the tax risk management of a company because it can affect: the owed tax, the cash flow, investment decisions, performance indicators and the custom value. Transfer prices also can generate income/expenses adjustments, which may lead to an economic double taxation. They can also be seen by transnational companies as an opportunity to deliberately and artificially avoid to pay the income taxes.

Currently, in Romania there are specific legal requirements, which stipulate that transfer prices must be realized at market prices, thus respecting the arm's length principle. To perform an inspection, fiscal authorities must make an analysis of the legal framework governing the scope, of how this unfolds that certain fiscal inspection as well as the finalizing methods and their consequences. This inspection implies two types of participants who occupy antagonistic positions regarding the intended purpose: tax payers and tax authorities.

According to Fiscal Procedure Code of Romania, a specific case is represented by performing a tax audit within tax payers (Romanian legal entities), which conduct economic operations and transactions with Romanian affiliated companies and nonresidents. In order to perform a fiscal inspection in this field, you must consider several factors, because this process can be quite complex and of long continuity both for authorities and for the taxpayers.

For an efficient fiscal inspection, fiscal authorities should respect a series of measures, according to the report issued by JTPF (Joint Transfer Pricing Forum EU) at EU level, on transfer prices, as follows (Code of behavior EU JTTFP – Annex 1):

- Taxpayers must carry documentation for transfer prices before the fiscal inspection;
- Between taxpayers and fiscal authorities should be a collaborative relationship based on transparency and communication, and is indicated for taxpayers to cooperate with the authorities and to provide them the information needed to make a detailed analysis of transfer prices, using minimum resources;
- Development by fiscal authorities of several criteria for identifying the main risks related to transfer prices, transactions carried out by taxpayers as well as founding some specialized departments within tax administrations, to determine the level of resources that must be allocated for inspections, in specific cases;
- To develop a work plan agreed both by tax authorities and taxpayers, which should contain and present all the steps to be taken during transfer prices tax audit, serving as a guide over the entire process.

Lately, fiscal controls tightened up, both in our country and in the whole Europe, especially in the field of transfer prices. The tax authorities wish to implement new rules to prevent unjustified fiscal optimization by the transfer of the income in jurisdiction with low taxes, the so called "tax havens". To fight tax evasion, the authorities propose several measures (Patroi et al, 2013):

- To remove interpretable tax practices;
- To strengthen the rules regarding foreign companies controlled by residents;
- To combat harmful tax practices by strengthening the transparency and the economic substance;
- To prevent the abuses by conventions for the avoidance of double taxation;
- To analyze transfer prices related to intangible assets, risks and capital, and other high-risks transactions;
- To review transfer prices documentation.

These companies will have the obligation to transmit all information to tax authorities on the allocation of the income, economic activities developed, and taxes paid internationally.

It should be noted that when a tax audit takes place, tax authorities should not start from the presumption that any transaction between affiliates is based on fiscal considerations reflected in profits manipulation.

From A.N.A.F perspective, intra-community fraud fighting will amplify the intensification of the actions of transfer prices by performing a fiscal risk analysis in order to identify the affiliates which produce structural losses, in order to include them in the control program. The fiscal verification carried out by competent authorities consists in comparing the incomes declared by affiliated legal entities and their real incomes, determined based on the fiscal situation. The audit is performed taking into consideration the documents and the available information of the central fiscal authority, which have a special importance in order to determine the tax situations, notifying these certain companies. After completing the transfer prices file check, normally, a preliminary fiscal audit report is issued; report where conclusions and opinions of the tax inspection team regarding documentation related to transactions are noted. If fiscal authorities notice a significant difference between the declared income of the company and the income from the tax situation base, the authorities continue the inspection by communicating a verification notice.

The fiscal inspection ends by drafting a tax inspection report, mentioning the communication of the results will occur within 7 days starting from the completion date of this report.

As a summary, the transfer prices tax audit involves the following activities:

- Identify affiliated companies and prepare the working plan;
- Analysis of transfer prices documentation;
- Analysis of compliance with the market value principle of the transactions with affiliates;
- Resolve litigation and communicate the results.

Therefore we can say that “transfer prices represent the –ending point- of ingenuity of operations in tax legislation” (Patroi, et al, 2013), because it represent the link between the existing tax rules in different national markets.

#### **4. TRANSFER PRICES FILE VERSUS ADVANCE PRICING AGREEMENT**

In fiscal inspection, in order to determine transfer pricing, besides fiscal reprocessing methods, are used two exculpatory key documents: the transfer prices file and the advance pricing agreement. According to OECD Guidelines these two documents have both advantages and disadvantages, but each taxpayer chooses the document that fits better his business.

*“In order to establish transfer prices, taxpayers that conduct transactions with affiliates are obliged, as a request of the competent fiscal authority, to make the transfer prices file and to present it within the established time limits” (Procedural Tax Code, Art.79, par. 2).*

These represent the taxpayer's defense ahead the fiscal inspector and transfer prices adjustment, and must be updated every time when changes occur. Transfer prices file is an extremely important document, its purpose is to reflect the way transfer prices were established for transactions with non-resident affiliates, in order to certify whether they were established at uncontrolled transactions price level.

Conditions for requesting this file and its contents were approved by Order of the President ANAF no. 222/2008, no. 129 of 19 February 2008. However, there is a question: what happens if the taxpayer does not prepare or present the transfer prices file in time to fiscal authorities? "*... the refusal to submit the file, the incomplete filing of the transfer dossier by the deadline set by the tax authorities or the realization of transactions with the subsidiaries without a justified amount for the invoiced transfer prices, attracts the taxpayer's penalty with a fine between 12,000 and 14,000 RON*", according to the regulations stipulated in Annex 3 of the normative reference system previously estimated. Transfer prices file is also the document that records whether the arm's length principle is respected or not, principle that states the market value as a factor for transfer prices.

A very useful mention for the tax inspection, in terms of practical relevance, is to be found in art. 5 of ANAF President Order nr.222/2008, according to which, if the taxpayer applies for advance pricing agreements (APA is establish in art.42, of O.P. ANAF), issued by ANAF (National Agency for Tax Administration), is no longer necessary to prepare and to present the transfer prices file for the transactions and for the periods at which the agreement refer. Advance pricing agreement is an administrative ANAF document in order to solve a request from the taxpayer, establishing the conditions and methods to be determined over a certain period, the transfer prices for transactions between affiliates.

Using an advance pricing agreement brings a fiscal certainty to the taxpayer concerning transfer pricing methodology that has to be applied. Every advance price agreement has both advantages and disadvantages, but from my point of view, the biggest advantage is that it can be an opportunity both for tax administrations and for taxpayers because it offers the possibility to consult and collaborate in a non-conflictual spirit and environment. The advance pricing agreement is an act that could loosen the relations between tax authorities and taxpayers, providing a predictable framework for determining transfer prices. In the same time, advance pricing agreement substantially reduces or eliminates double taxation possibility, economic or juridical non-taxation, because all relevant countries participate. One possible reason of concern is that APA can allow the tax administration to study closely the transactions, because the authorities can abuse during their verification practices, taking into consideration the information obtained. Besides the above mentioned aspects, there are some possible traps which can occur when an APA is not properly managed. In Romania, the number of advance pricing agreement concluded until present are just a few, therefore the publication of an activity report cannot be justified.

In the Romanian state, there is an increased incidence of litigation in the field of transfer pricing, and tax authorities often question transfer pricing policies applied to transactions with companies. The transfer prices adjustments imposed by authorities had in most cases important effects on the fiscal positions of the targeted Romanian

entities, and the taxpayer's complaints were rejected, in many cases even by resorting to court solutions. Thus, given the increasing number of tax audits, it will be more difficult to reduce litigation and the number of disputes on transfer prices will increase significantly. Therefore, it is essential for multinationals to consider a more pro-active approach to controversial management, including concluding advantageous pricing agreements that could generate litigation.

All companies must respect all the transfer pricing legislation and to elaborate the necessary documents for any tax inspection. A proper documentation should take into account this aspect on transfer prices both in terms of risk and opportunities. It should be specified that if a Romanian company owns an advance price agreement, it must not make a transfer prices file for the transactions and the periods covered by the agreement, the tax authorities will make a report only of the advance price agreements. If the Romanian company doesn't have an advance price agreement, then it must make and provide transfer prices documentation to authorities. Transfer prices are important for the business global strategy of a company, but in the same time, these prices can be used as tools for handling the fiscal result.

As a summary, for transactions performed by resident legal entities and affiliated non-resident companies, these must have an advance pricing agreement, or to prepare a transfer pricing file and to provide it to tax authorities.

## **5. CONCLUSIONS**

As a conclusion, following the above presentation, I consider that the Romania's interest in transfer pricing issue should be increased, because lately this phenomenon is developing, especially in Eastern Europe countries, which proves that is an important subject in the economic life, that should not be ignored. These have a major impact on the multinational companies value, both through tax implications and the influence they have on cash flows, on investment decisions, but also their influence on the performance indicators of a company as profitability, stock shares image (in the listed companies) and the growth of founding costs asked by banks/investors.

Lately, the legal framework in Romania had a permanent evolution, the alignment with international standard were respected and thus, transfer pricing controls are strengthened. Significant steps to combat the use of transfer prices for illicit purposes are made, in order to avoid tax evasion, multinational Romanian companies are facing the risk of adjusting their fiscal result due to practiced transfer prices investigation.

At the same time, choosing a proper documentation reflects the effective method of establishing transfer prices, carried out by non-resident affiliates, as to certify if they were established at the price level in uncontrolled transactions. In any tax audit, competent authorities request the taxpayer's documents to certify that the value of the transaction is done at market price, both for transfer prices file or the advance price agreement. All companies must comply fully with transfer pricing legislation and documentation required to develop any tax audit. A proper documentation must consider this aspect of transfer pricing both in terms of risk and of opportunity.

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