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TRANSFER PRICING – A NEW TAX CHALLENGE FOR MULTINATIONAL COMPANIES

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Abstract:

In our increasingly digitalized economy characterized by a high number of international transactions and a high speed of information exchange between jurisdictions, there are many challenges that can arise - in different domains of economic activity - from this context, challenges that our society has to manage and overcome. Among these, we can mention a current problem, namely the one related to the transfer pricing mechanism in the context of intra-group transactions of the multinational companies, which used improperly by them, can be an instrument for illegal transfer of their profit in low-tax jurisdictions, evading this way from their tax obligations. In the context of these facts, the fair transfer pricing mechanism can be seen as having a very significant role in creating an ethical and fair environment for this kind of transactions, helping to combat and reduce the tax evasion and money laundering levels on a global scale, as well as being one of the main solutions to tackle the base erosion and profit shifting (BEPS) phenomenon. This paper aims to create – using the observation, analysis and deduction research methods - a clear image for the readers, giving them the possibility to understand the meaning, the role and the implications of the transfer pricing mechanism in the economic international environment and in the social life of the citizens.

Key words: transfer pricing mechanism, arm's length principle, market value principle, multinational company, intra-group transactions, tax haven, double taxation.

JEL classification: E62, F23, M16

1. INTRODUCTION

Being one of the most important problems tackled by the BEPS Action Plan - the most representative international regulation on combating and managing the effects of the BEPS phenomenon - the transfer pricing mechanism acquired a global importance, being at present among the most complex tax issues linked to international business, because the way it is practiced, significantly influences the entire international economic environment. On the one hand, this mechanism can be seen as a supervisory instrument on intra-group transactions used by the tax authorities to prevent unlawful transfer of profits into jurisdictions with non-rigid tax systems, they having the authority to intervene if they consider that a transaction did not comply with the arm's length principle or market value principle provisions. On the other hand, the mechanism can be seen as an instrument used by multinational companies to concentrate their profits into low-tax jurisdictions, increasing this way the profit at group level and reducing their tax obligations, making this by establishing an uncorrelated price to the market value for an intra-group transaction.

Therefore, *the importance and the actuality* of this paper is given by the quite high frequency at which such events as mentioned above occur and by the huge amounts of money that are lost and don't reach their rightful beneficiaries - the citizens. This situations happen because there are still gaps and loopholes in the international legal framework regarding this subject that competent bodies are working to solve, because the existing system of tax supervision can't identify all the cases of money laundering and tax evasion and last but not least, because we live in a world that is self-oriented and therefore, many multinationals concentrate on their own profit, even if that means to violate the rights of others.

The purpose of this paper is to study the conceptual elements of the transfer pricing mechanism that are essential for its understanding, to highlight the way the transfer pricing mechanism works in the context of complying or non-complying to the arm's length principle, how it is influencing the international transactions and therefore the global economy as a whole.

To achieve this purpose, the authors set the following objectives:

→ to identify and to approach the conceptual basic notions related to the subject of research;

→ to deepen the knowledge through practical illustrations related to the subject of research;

→ to identify the implications and the influences on a company's financial indicators of the transfer pricing mechanism and in case of double taxation.

The research methodology used in this paper is based on observation, analysis and comparison methods and also on studying many specialized scientific articles and various regulations in the field, such that its content to give real, fair and qualitative information regarding the subject of study.

2. CONCEPTUAL BASIC NOTIONS ON TRANSFER PRICING

As we already mentioned, the transfer pricing mechanism is a cause of international interest, especially for the tax authorities that are interested in obtaining as much tax income as possible – of course in the legal limits – for the national budgets, supervising the companies' economic activity through receiving periodic reports and by organising audit missions that verify the fairness of the transfer pricing file. From the perspective of a company, their main interest is to make as much profit as they can and to pay as little taxes as possible – even though that means to break the law - and they can do that by unethical implementation of the transfer pricing mechanism which results in tax evasion situation, being known that corporate tax is perceived by companies as an unproductive withdrawal of own funds without obvious consideration (Kramarova, 2021). Governments could have invested these lost amounts of money in developing the educational system, the infrastructure, the public services, the environment protection and any other domains of economic activity that could add value to the life of their citizens and of the society as a whole.

We can say that transfer pricing mechanism refers to the terms and conditions of the international transactions within the multinational companies, more exactly, it refers to the prices practiced by them in the transactions that have as subject the transfer of goods and services to companies within the group, in order to distribute revenues and costs to each component (Rogers and Oats, 2022). Because the value and the level of these prices are not decided by independent individuals or group - that could guarantee the compliance to the requirements of the arm's length principle and of the market value principle – there is the risk that these prices would not reflect the true value of the traded goods or services and that is why many international regulations were issued by the Organization for Economic and Co-operation Development (OECD) to enforce the procedural framework of this domain (European Commission). The transfer pricing it is not in itself an illicit practice, but it is considered like this when it becomes manipulative or abusive through the using of different unethical methods available for the companies (Tax Justice Network).

The transfer pricing mechanism is based on a very important principle that needs to be applied by every multinational company and this refers to the arm's length principle. Its name comes from the idea that when two people are close (affiliated) to each other, they tend to hug each other, but according to the arm's length principle these people should behave like they don't know each other – they are independent - and during the negotiations they should just shake their hands, keeping themselves at an arm's length distance (Transfer Pricing Services, 2021). Therefore, the compliance to this principle means that national or international transactions within the group should be made at the same price as the transactions with companies that are not part of the group. This principle is regulated also in the first chapter of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (OECD, 2017), being accepted and appreciated by the majority of multinational companies because it eliminates the possibility of a subjective or protective behaviour from their bussines partners, fact that encourages a fair competitiveness in the international market.

We can mention also the principle of market value, another principle that has a significant role in establishing a correct transfer pricing list. It highlights the necessity that every value of the traded goods or services within the group to be associated and compared to the existent market value of the same category of goods or services, value that has to be taken into account when establishing the price of a transaction and when creating the transfer pricing files.

We consider that is also very important to know how the associated/affiliated entities are defined by the speciality literature. Therefore, article 9 of the *Model Tax Convention on Income and on Capital: Condensed Version 2017* presents the situations when we can discuss about the existence of the associated/affiliated entities (OECD, 2017):

→ an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise from the other Contracting State;

→ the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

Therefore, we can say that the transfer pricing mechanism significantly influences the tax base in every country that is opened to the international transactions and investments. If the multinational companies do not take into account the provisions of the legal framework regarding this subject, there will be huge amounts of their profit that will remain untaxed, affecting the budgets of the countries that have been harmed by these practices and therefore, the quality of life of the citizens.

3. TRANSFER PRICING MECHANISM IN THE CONTEXT OF COMPLIANCE WITH THE MARKET VALUE PRINCIPLE

The terms of a transaction between two independent companies are strongly influenced and determined by two major components of the capital market: the supply and the demand. This context generates a situation of conflict of interests because the seller wants to sell at the highest price possible and the buyer wants to buy at the lowest price possible, the final price being set somewhere in the middle to satisfy both sides, so that we can say that the transaction was made according to market value and arm's length principles. When we talk about transactions between affiliated or associated parties, we know that there are many common interests, fact that would rule out the influence of the market supply and demand. That is why the multinational companies are obliged to apply the arm's length principle and the market value principle in their intra-group transactions (AZETS, 2020).

As we already mentioned, the transfer pricing mechanism it is not in itself an illicit way to make intra-group transactions, but a current legal and efficient way to manage and supervise this kind of transactions, but it can become illicit when there is no compliance to the provisions of the legal framework in the field. However, many multinational companies are interested in promoting transparent and fair transactions, even though there will always be some that are more interested in promoting their own interests and wealth that are not in accordance with the ethic, moral and legal norms. In the below figure we can see the transfer pricing mechanism in the case of compliance with the market value and with the arm's length principles, having a direct impact on the main performance indicator of a company: the profit.

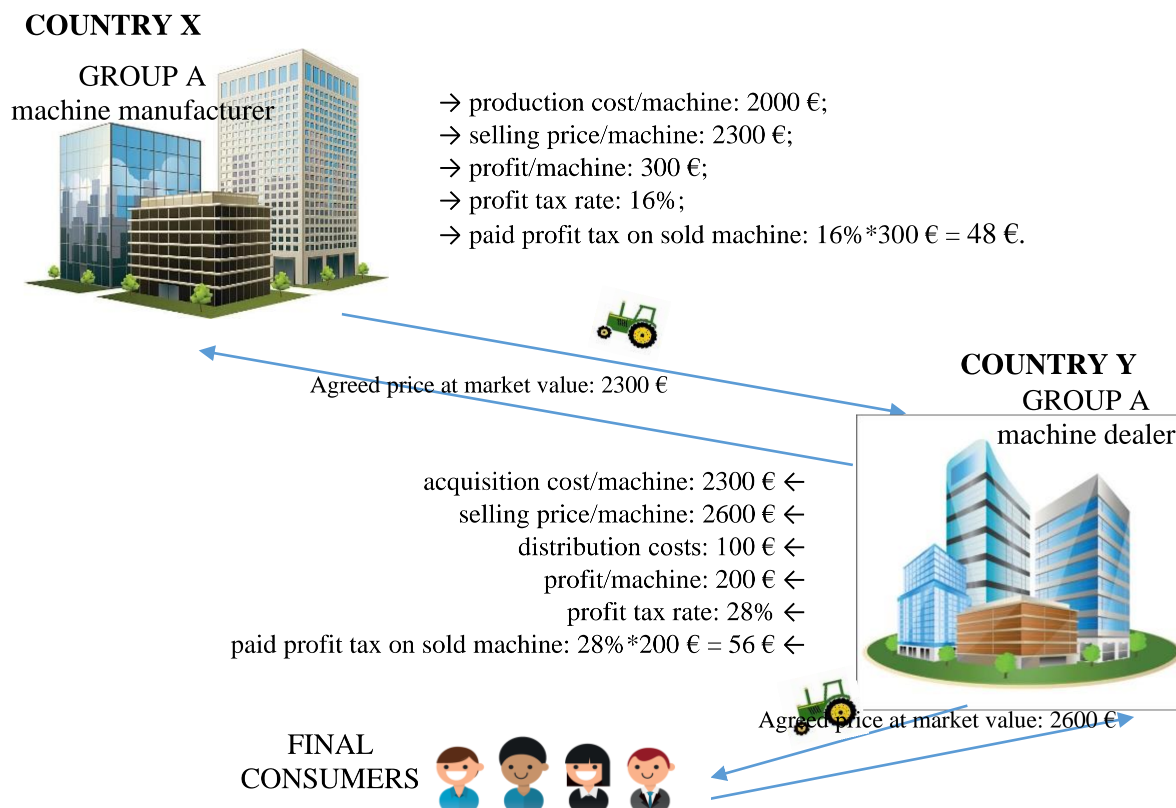

Figure no. 1. Transfer pricing mechanism – case of compliance with the market value principle

Source: data processing according to https://tpguidelines.com/the-arms-length-principle/

In the figure above, we can see that the transaction was made according to the market value and arm's length principles' provisions because the profit is equally divided between the two companies of the same group, except that in the case of the company from country Y there are added the distribution costs that decreases the profit to 200€/machine, compared to 300€/machine obtained by the company from country X. Because the two companies carry out their activity on different states' territory, there are different tax systems that they have to comply and therefore different profit tax rates. We can see that even though the company from country Y obtained a lower profit/machine than the machine manufacturer from country X, it pays a higher tax rate than this one, respectively 56€/machine compared to 48€/machine paid by the company from country X.

Therefore, we can appreciate that the group's companies made this transaction according to the ethical and legal requirements, because they did not try to evade from their tax duties from the country with a more rigid tax system and they did not concentrate their profits in the country with a lower profit tax rate. Surely that in this case they have had a transfer pricing file to use in the trans-border transactions with affiliated parties, which makes the entire profit of the companies to be taxed according to the jurisdiction's law where they operate and the money to go to the rightful beneficiary – to the government and then to its citizens, in different forms of services provided by it.

4. TRANSFER PRICING MECHANISM IN THE CONTEXT OF NONCOMPLIANCE WITH THE MARKET VALUE PRINCIPLE

The companies can choose to comply or not comply to the legal requirements regarding the transactions within the group with affiliated/associated parties, but on their own risk as the consequences will not be long in coming sooner or later. The noncompliance to the legal provisions generates an increase of the tax evasion phenomenon and of the illicit financial flows (IFF) that

many times are determined by the misinvoicing of the goods or services that are subject of the transaction, the price of the transaction being set without taking into account the market value. We can define the misinvoicing as being an illicit method of cross-border money transfer, by deliberately falsify - by at least one of the parties - the value, volume, quality or nature of the goods or services that are subject of an international transaction (Global Financial Integrity – GFI, 2020). According to GFI, the misinvoicing is the main cause of IFF, being an accessible method for the majority of felons and appearing in the international transactions between affiliated or independent parties.

Beyond the fact that by improper practice of the transfer pricing mechanism the companies can transfer their profit into tax havens, avoiding this way being taxed, there are also other reasons that could determine this behaviour of the companies. Depending on the pursued reasons or purposes, companies can resort to misinvoicing because it is a very little controlled domain by the authorities, less than 2% of the shipping goods containers being searched annually to verify the veracity of customs invoices (GFI, 2020). In the table below, we can see some of the motives that determine the companies not to apply in a proper way the transfer pricing mechanism, using misinvoicing as the main instrument.

Table no. 1. Common motives for trade misinvoicing

Over-invoicing		***Under-invoicing***	
import	*export*	*import*	*export*
- to shift money abroad (evade capital controls, shift wealth into a hard currency, etc.); - overstating the cost of imported inputs to reduce income tax liability; - to avoid anti-dumping duties;	- to exploit subsidies for exports; - to exploit drawbacks (rebates) on exports;	- to evade customs duties or value-added taxes; - to avoid regulatory requirements for imports over a certain value;	- to shift money abroad (evade capital controls, shift wealth into a hard currency, etc.); - to evade income taxes (lowering taxable income levels); - to evade export taxes;

Source: https://secureservercdn.net/45.40.149.159/34n.8bd.myftpupload.com/wp-content/uploads/2020/03/GFI-Trade-IFF-Report-2020-Final.pdf?time=1591369946

Therefore, companies can have many benefits from noncomplying with the legal requirements regarding the transfer pricing mechanism, but they come with a price, because once the illicit behaviour is discovered by authorities, various sanctions can be applied and the companies will have to refund the entire amount of money that represents the prejudice, plus the corresponding interest. There can be situations when the value of the prejudice is so high, that it could cause the restriction of the activity or even the bankruptcy of the companies in question, because it is very possible that they could not handle the high demand for liquid assets that came at once. Therefore, we can appreciate that these illegal operations are very risky and that the decision-making personnel should be more aware of the consequences in the case of materialization of risks.

In the below figure, we will illustrate the transfer pricing mechanism in the case of noncompliance with the requirements of the value market principle.

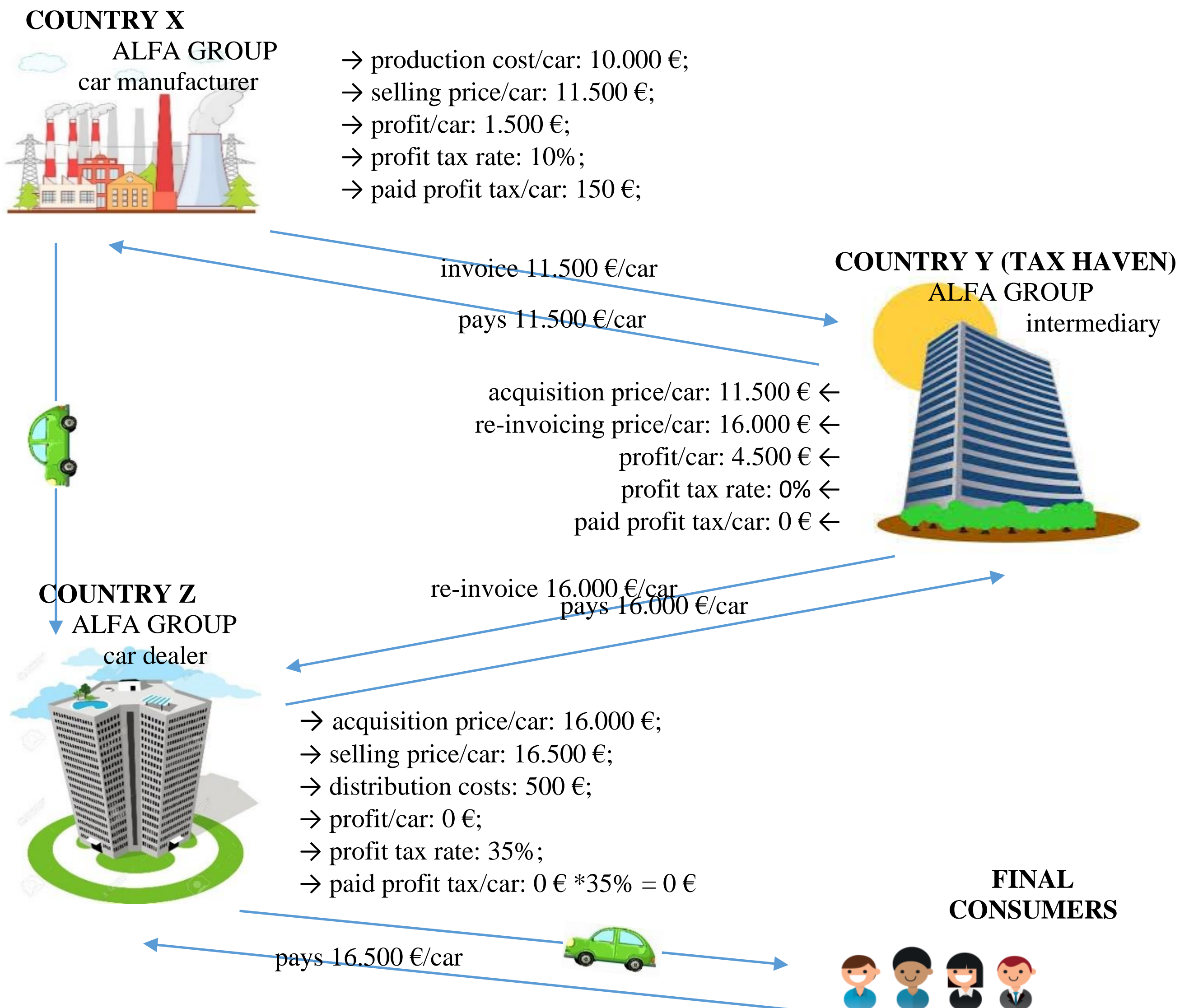

Figure no. 2. Transfer pricing mechanism – case of noncompliance with the market value principle

Source: data processing according to https://tpguidelines.com/the-arms-length-principle/

We can see the complexity of an illicit transfer pricing mechanism by applying the misinvoicing method, the price of the traded goods being set in such a way that the biggest profits to be obtained in the country Y that has a zero corporate tax rate and the smallest profits to be obtained in the country with the highest corporate tax rate. We can observe that the goods were actually transferred to the car dealer, but the invoice was made by the car manufacturer towards the intermediary company located in a tax haven which re-invoiced the goods to the car dealer in such a way to obtain the highest level of profit of all group's companies involved in the transaction. To obtain such results, there is need for a careful planning from the management of the group, which also implies their awareness of the illegal character of the transaction.

5. DOUBLE TAXATION OF THE RESULTS IN THE CONTEXT OF TRANSFER PRICING

Besides the fact that the transfer pricing mechanism represents a control and verification method of the intra-group transactions, it brings with it a disadvantage – the risk of double taxation

that appears when the same goods or financial results are taxed at two levels: individual and corporative or in two different countries (Palmer, 2019). In the case of transfer pricing, we can talk about the double taxation when the competent tax authority requests a value adjustment (plus or minus) of a transaction between affiliated parties because - after an audit mission and evaluation of the transfer pricing file - they consider that it was not made according to the legal provisions.

Among the available international instruments for the elimination of double taxation, we can mention the Mutual Agreement Procedure (MAP) provided by the tax treaty applicable between the countries where the companies that take part to the transaction carry out their activity and The Arbitration Convention signed in 1990 that is applied in all the member states of the European Union (EU) (Gibert and Daluzeau, 2017) and for which was issued a Code of Conduct by Joint Transfer Pricing Forum (European Commission, 2019a).

We can define the MAP as a mechanism of the competent authorities to discuss about the cross-border taxation of a transaction or of a specific situation, in order to coordinate their approach of the matter for the benefit of the involved taxpayers (Randall and Boon Law, 2017). Solving the double taxation situations via MAP supposes a complex process that can take between two and three years to be solved. In the case that a taxpayer is subject to an additional tax in one country because of a transfer pricing adjustment of the value of the goods or services traded with an affiliated party from another country, it may request the competent authorities to reduce or withdraw the adjustment and/or to the competent authorities from the other country to allow a corresponding adjustment of the income of the related party (OECD). If no solution has been found in two years by using MAP, it will be applied an arbitration procedure by setting objectives to be achieved in a certain period of time and the identified solution will be imposed to the responsible competent authorities that has to make sure that the double taxation situation is eliminated (Gibert and Daluzeau, 2017).

According to the European Union (EU) Joint Transfer Pricing Forum, at Community level, there is a constant increase in the number of submitted requests for resolution of double taxation situations considering the MAPs under the Arbitration Convention (AC), as it follows: in 2018 were initiated 727 cases, in 2019 were initiated 839 cases and in 2020 there were initiated 961 cases. . We can see that there is an increase with over 100 cases from year to year, which we consider to be a significant number According to the same source, the highest number of cases was registered in Germany and in Italy and the lowest in countries like the Baltic ones, Cyprus, Croatia, Romania and others. Regarding the statistics from the perspective of the solved cases in these years, it is as it follows: in 2018 there were solved 674 cases, in 2019 were completed 752 and in 2020 there were completed 637 cases. (European Commission, 2019b; European Commission, 2021; European Commission, 2022).

To have a better understanding on how a double taxation situation appears, we will have the following hypothetical example: the X Company with the headquarters in Romania produces furniture – couches – and sells them to the affiliated Y Company from Germany. The transaction was made according to the data from the table below.

Table no. 2. Individual and group level indicators

- EUR -

Indicator	*Company X (RO)*	*Company Y (DE)*	*Total*
Sales revenue	320	400	720
Production and distribution costs	260	-	260
Aquisition cost	-	320	320
Distribution cost	-	10	10
Gross profit	60	70	130
Profit tax	60*16% = 9,6	70*15% = 10,5	20,1
Net profit	50,4	59,5	109,9

After auditing the value of this transaction, the authorities consider that the selling price of the couches was not in compliance with the market value principle and decide to make an adjustment: from 320 € to 340 €, adjustment who's impact can be seen in the following table.

Table no. 3. The reflection of the transfer pricing adjustment

- EUR -

Indicator	*Company X (RO) - before the adjustment -*	*Company X (RO) - after the adjustment-*	*Company Y (DE)*
Sales revenue	320	340	400
Expenditures	260	260	330
Gross profit	60	80	70

We can see that after the adjustment, the gross profit of the Company X increased from 60€ to 80€, fact that influences the profit tax level which it has to pay to the government. There is also an increase of profit at the group level: from 130€ to 150€. Therefore, this value of 20€ is taxed twice: once in Romania and once in Germany. To eliminate this double taxation situation, the income of the Company Y should be decreased by 20€ because after the value adjustment, the acquisition price of the furniture should have been 340€, not 320€ how remained in its accounting registers and therefore, the company should have paid less corporate tax.

Some of the main aspects that are reconsidered by the tax authorities and determine them to suggest and apply some adjustments of the transactions between related parties refer to the method used for calculation, the considered nature of the transaction, the interest deductibility, the customs value of the imported or exported goods or services that was declared, the party that should be evaluated for conformity to arm's length principle and of course many other considerable motives that stay behind significant base erosion operations. As Choon Beng and Xiaoyue (2022) stated in their paper that one of the main reasons behind the fact that many transactions between Chinese companies and their foreign related parties do not comply fully to the arm's length principle is that the calculations are made based on predicted data and the real ones turn out to be different, therefore retrospective year-end transfer pricing adjustments are required.

Although the attention and the interest of the tax authorities in finding illicit behaviour regarding the transfer pricing transactions is to be appreciated, not every suggested adjustment was approved in a court of law, like in the cases described by Karppinen (2021) in his paper. In one of this cases, the Supreme Administrative Court of Finland revoked the decision of the tax authorities which meant the change of the transaction's nature between a Finnish company and it's mother company located in Luxemburg - regarding an intercompany loan of 15 million - from a liability in taxation to an equity investment in taxation, in which case the interest expenses could no longer be deducted from the tax base. If this adjustment had approved by the court's decision, it would have meant that the interest expenses valuing 1.34 million should have been added to the company's taxable income, which would have resulted in more tax to be paid. Not this is the case for the Coca-Cola Company, which in November 2020 lost its case against the tax authorities through the decision of the United States (US) Tax Court, being therefore obliged to do an additional tax payment of $3.3 billion in connection with their intercompany licensing arrangements that left high profits in their foreign affiliates (Hazzard-Herzing, 2021).

Studying the literature regarding this kind of cases, we can find that the law courts do not have a strong precedent on which to base their pro or against adjustment decision, making the ruling a bit more difficult, although many of them make reference to the OECD Transfer Pricing Guidelines in their judgement. Therefore, we can appreciate the significant role, the importance and the efficiency – especially for the multinational companies - of the existing international instrument for managing the double taxation situations. The power of interstate tax negotiation, the promptness in solving the tax matters and the number of existing bilateral tax treaties, could be a selection criteria for the location of the next investment of an investor. We can say that the proper

instruments were identified for managing the double taxation situations, but there still is room for optimizing the existing procedures, especially regarding the time needed for solving them.

6. CONCLUSION

In the context of an increasingly interconnected world, where transnational transactions have become something you meet at every turn, it is normal to occur new problems and challenges as in an environment that is oriented towards growth, development and innovation, therefore no matter how many obstacles will appear in the matter of transfer pricing, we can be sure that our society will find its way to overcome them and to find a viable and concrete solution. As we have seen, there can be problems of different nature from the perspective of the responsible party: the companies and their intention and orientation towards tax evasion and minimisation, the legislative authorities which due to lack of precedent or omissions could not create a comprehensive, clear and without loopholes legal framework and the tax authorities which have the responsibility of evaluation and interpretation of the intra-group transaction. Therefore, the behaviour of each one of these parties is determining certain problems: companies - revenue loss for state authorities, legislative authorities - lack of guidance for companies and also for judges in the context of a lawsuit, giving the likelihood of misinterpretation and tax authorities - the possibility of a wrong and improper judgement of the analysed transactions and also of an unjustified aggressiveness. Given these facts and the one that the transfer pricing domain does not have a solid maturity due to lack of precedent, we have a considerable number of adjustment requests as the EU Transfer Pricing Forum stated in its statistics and certainly there are other thousands in the whole world, meaning we have a high incidence of this phenomenon, which comes also with a high cost: time, personnel and money.

Considering all this information, the research aimed to present in a simple way the functionality of the transfer pricing mechanism, so that every reader can understand its role and implications in the international business environment. We have learned about the basic conceptual notions regarding the researched subject, we have deepened our knowledge on transfer pricing by analysing case studies regarding the functionality of the mechanism in different contexts and we have also seen its possible impact – depending of the nature of situation - on the financial indicators of a company. Therefore, we can say that the paper’s purpose and objectives were achieved through a methodical and detailed approach of the proposed research topics.

The transfer pricing mechanism remains a significant topic for the global debates and initiatives in tax matters, being one of the main international instruments used to prevent and combat the tax evasion and money laundering phenomenon, but in the same time, we consider that it has its loopholes that still allow the manifestation of this kind of situations that have a negative impact on both global and national economies, influencing also the quality of life of ordinary citizens.

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