

Transfer Pricing in the European Union

Gheorghe MATEI

University of Craiova
ghematei@yahoo.com

Daniela PÎRVU

University of Pitesti
ddanapirvu@yahoo.com

Abstract. *The transfer pricing mechanism is a tool commonly used to transfer the tax base from countries with high taxation in countries with low taxation. In the European Union, this financial operations generate significant tax revenue losses. In an attempt to limit the handling of corporate tax systems, many public authorities have introduced regulations on transfer pricing, but the effectiveness of these rules has proved limited, and they contributed to the increasing complexity of tax laws and to the appearance of additional costs for companies. A solution to the solving of the transfer pricing problem in the European Union is represented by the introduction of the common consolidated corporate tax base.*

Keywords: transfer pricing; tax evasion; compliance costs; tax laws; fiscal consolidation.

JEL Codes: G3, H2, H3.

REL Codes: 10I, 11E.

1. Introduction

The role of transnational companies in the world economy has grown significantly in recent decades. This situation partly reflects the trend of national economies integration and the technological progress (especially in the field of communications).

The internal financial corporation's system offers the possibility of some imperfections exploitation, resulting from differences in national regulations of countries. In order to avoid barriers and restrictions on transactions, corporations frequently used the tax arbitrage: the reduction of the fiscal "burden" by transferring tax profits located in countries with high taxes in countries with low taxes (Munteanu, Horobet, 2005).

Currently, a large number of corporations have been structured to avoid the taxation in various jurisdictions in which it operates. The ability of corporations to use tax havens and offshore centers as part of their strategy to avoid the taxation has increased significantly in recent years and this is against the principle of fair competition and corporate responsibility. According to a study by the Organisation for Economic Cooperation and Development (OECD) at the end of 2008, tax havens have attracted worldwide assets worth USD 5,000-7,000 billion, but the exact amount of the capital transferred is difficult to determine precisely, because in these jurisdictions govern a certain degree of confidentiality. Although there are no clear figures about the extent of international tax evasion in the European Union (EU), however, a value was estimated: between 2% and 2.5% of EU GDP, i.e. between EURO 200 and 250 billion.

According to a report by the Economic and Monetary Affairs Committee in 2009, the international tax evasion has generated following specific situations:

- about one third of the 700 largest corporations in the United Kingdom did not pay anything in the corporate income tax in 2005 and 2006;
- 25% of US companies that hold assets worth over USD 250 million or income exceeding USD 50 million per year is not paid, also no income tax between 1998 and 2005;
- the largest French corporations currently pay a tax of 8% in average real benefits, even though the official corporate tax rate is around 33%.

The study "Promoting Transparency and Exchange of Information for Tax Purposes" by the OECD in 2010 estimated that tax avoidance practices used by corporations generate tax revenue losses of about USD 100 billion for the US economy and several billion Euros for many EU countries.

2. The transfer pricing mechanism

The transfer pricing mechanism is a tool often used by corporations to avoid high taxation in certain countries. This can be illustrated by a simple example: the branch of a multinational company builds a car at a real cost of 30,000 Euros, sold on the market at a price of 50,000 Euros. In a high tax rate, say 30%, manufacturing company should pay a tax of 6,000 Euros (20,000 Euros \times 30%). To avoid paying taxes in the producing country, the subsidiary sells the car for 40,000 euro to another branch (located in a more relaxed tax area) that will put the product on the market. Suppose that in this country corporate tax rate is 10%. The income tax of the companies group will be 4,000 Euros (10,000 euro \times 30% + 10,000 euro \times 10%), achieving a significant saving of resources. For the producing country, however, this situation creates a significant loss of tax revenue.

Transfer pricing is a term that refers to prices charged in transactions between affiliated organizations (sale and purchase of tangible and intangible assets, provision/procurement of some services, including administrative, financial, leasing, etc.). Transfer pricing is set at the transnational corporate decision-making structures, and can perform the following role:

- reduction in corporate income tax payments or duties;
- transferring income from countries with bans or limitations on profit repatriation.

The corporate policy regarding transfer pricing is based on many factors, such as:

- fiscal aspects of countries involved in the cross-border activity of member companies of the group;
- currency legislation;
- political and economic risks (for example, legislative changes, currency devaluation, etc.);
- price level in the host country etc.

Generally, transfer pricing involves establishing prices of goods and services traded between members of the group companies for tax purposes: the reduction of the tax on profits to the group of companies. By decreasing (increasing) prices of intra-group transactions, the corporation manages to fix the most of the benefit in the most permissive tax jurisdictions.

After interviewing a number of 850 companies with cross-border activities in 24 countries worldwide, Ernst & Young organization achieved, in 2008, a study that clearly highlights the growing of transfer pricing issues importance. The authors estimated that about two thirds of global transactions take place between affiliated organizations, such as transfer pricing at a level

that maximize the tax benefits is a strategic interest objective for the multinational companies policy.

To highlight the importance of transfer pricing issues in the European Union, Weichenrieder Alfons (2007) has developed a model of correlation between the level of taxation on profits and the profitability of affiliated organizations. Analysing the situation of foreign corporations with subsidiaries in Germany, the author found that an increase of corporate tax rate in the origin country by 10 percentage points causes an increase of subsidiaries profitability (artificially generated through transfer pricing) with a half percentage point.

3. International rules governing transfer pricing

Repeated transfer pricing practices of transnational corporations have generated efforts to define the phenomenon and its regulation. The OECD has realized since 1979 a report on transfer pricing mechanism used by transnational companies, and in 1995 wrote the transfer pricing guide addressed both transnational companies and fiscal administrations.

The issue of transfer pricing is becoming increasingly important in the globalized economy, as more companies expand their business beyond the borders of the origin country, making transactions of goods and services within the group. In principle, transfer pricing rules recommended by OECD provide the following conditions that a transaction must meet to fall under the transfer pricing regulations:

- a) the existence of cross-border transactions;
- b) the transaction take place between two affiliated entities;
- c) the transaction will be subject of a good, service or any other thing with economic value.

Since transfer pricing may also have other purposes than tax avoidance, fiscal authorities should not automatically assume that companies with cross-border activity is trying to manipulate profits, especially as, in some cases, it is very difficult to accurately determine the price market. Fiscal Affairs Committee of the OECD has created a set of rules to reduce the risk of misinterpretation or abuse regarding the taxation of some operations in groups of companies, implementing the so-called "arm's length principle". The OECD Model Tax Convention explains the essence of this principle: "[When] conditions are made or imposed between... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise

and taxed accordingly”. So, it tries the adjustment of corporate profits by reporting intra-group transactions to the conditions should be governed the relations between independent firms in comparable transactions and in a similar context. The principle of “arm's length” put independent firms and those associated with an egalitarian plateau in terms of taxation, avoiding the creation of advantages and disadvantages that could distort the competitive position of each type of entity (Bişa et al., 2005). Applying the principle has proved efficient in situations where they can make comparisons with other similar transactions made between independent entities. There are many situations where this principle is difficult: for example, if multinational groups active in the production of highly specialized goods.

According to the transfer pricing guide developed by the OECD, there are five methods for determining them, divided into two main groups: traditional methods based on analysis of the transaction (“Transactional Traditional Methods”) and methods based on analysis of profit (“Transactional Profit Methods”). Transactional traditional methods are based on comparing prices, while transactional profit methods are based on comparing transactions between related entities and between unrelated entities through analysis of profit from that transfer.

Methods for determining transfer prices based on transaction analysis are:

A. Comparable Uncontrolled Price (CUP) is based on the price compare of transaction analyzed with prices of other independent entities, when comparable goods or services are sold.

For the transfer of goods, products, merchandises or services between related entities, the market value is that price which would be agreed independent entities, under the conditions of some comparable markets in terms of commercial for the transfer of identical or similar goods or merchandises, in comparable amounts, at the same point in the chain of production and distribution and in comparable conditions of payment or delivery. In this regard, to establish the market value may be used to:

- comparing the prices agreed between the entities affiliated with the prices agreed as between independent entities for comparable transactions (internal comparison of prices);
- comparing the prices agreed between independent entities for comparable transactions (external comparison of prices).

B. Resale Price (RP): the market price is determined on the resale price of products and services to independent entities, less distributing costs and a profit rate.

This method is applied starting from the resale price of a product purchased from an affiliate organization to an independent entity. This price is

then reduced by an adequate gross margin (resale price margin) representing the value of which the last seller of the group will try to cover sales costs and other operating expenses based on operations and to make an adequate profit.

The method takes into account the following aspects:

- factors relating to the period of initial purchase and resale, including those regarding the changes in the market in terms of costs, exchange rates and inflation;
- changes in the situation and the degree of wear of the goods – subject to the transaction, including the technological changes in a particular field;
- the exclusive right of the reseller to sell certain goods or rights that might influence the decision on a change in the price margin.

C. Cost Plus (C+) is based, to determine the normal market price, on the increase of main costs with a profit rate similar to the activity field of the taxpayer. The starting point is costs of the manufacturer or the service provider.

Where goods or services are transferred through a larger number of affiliates, this method will be applied separately for each stage, taking into account the role and specific activities of each affiliated entity.

Methods based on analysis of profit are:

D. Profit Split (PS) involves calculating the net profit margin obtained by a person from one or more transactions with affiliates and the estimation of this margin on the net profit margin obtained by the same person in transactions with entities independent or on the margin obtained in comparable transactions by independent entities.

This method entails a comparison of certain financial indicators of organizations affiliated with the same indicators obtained by independent organizations operating in the same area.

E. Transactional Net Margin (TNMM) is used when transactions are interposed between the affiliated organizations, so it is not possible the identification of comparable transactions. This method involves the estimation of the profit obtained by affiliated organizations from one or more transactions, and sharing those profits between the affiliated organizations in proportion with the profit that would have been obtained by independent organizations. The division of profits must be made through an adequate estimate of revenues and costs incurred as a result of one or more transactions by each organization. Profits must be divided so that they reflect the activities performed, risks assumed and assets used by each of the affiliated parties.

Establishing the most adequate method for determining transfer prices is envisaged, in principle, the following elements:

- a) the method that is closest to the circumstances in which prices-subject to free competition are set in comparable markets in terms of trade;
- b) the method for which information regarding the actual activity of affiliated organizations involved in the transaction – subject to free competition is available;
- c) the precision with which we can make adjustments to achieve comparability;
- d) the circumstances of the individual case;
- e) the actual activities of various affiliated entities;
- f) the method used must match the circumstances of the taxpayer's business and market;
- g) the documentation that the taxpayer can provide.

The circumstances of the individual case taken into account in the examination of the market price are these: the type, the condition, the quality and degree of novelty of merchandises, goods and services transferred; the market conditions that goods, merchandises or services are used, consumed, treated, processed or sold to independent entities; the activities and stages of production and distribution of entities involved; the clauses contained in contracts regarding obligations, payment terms, discounts, guarantees, risk taking; the special conditions of competition.

When comparable uncontrolled transactions can be determined, the price comparison method is the most direct and sustainable way to apply the “arm's length”. Also, the fiscal authorities in most countries found in the price comparison method the most sustainable way to determining price transactions between related companies. Using transactional profit methods should be limited in case of exceptional circumstances, when there is no information or there is insufficient information for applying one of the traditional methods of transfer pricing.

4. Transfer pricing problem in the European Union

Current systems of corporate income taxation in the Member States allow firms with cross-border activity to avoid the taxation due to the existence of a significant differences between corporate income tax rates and rules under which each subsidiary is subject of taxation depending on its activity in the host state. The economic integration has complicated the corporate tax problems and diminished the fiscal administration's ability to monitor commercial flows and cash flows for companies with cross-border activity. The economic globalization also reduces the capacity of fiscal administrations to verify the accuracy of transfer prices used by taxpayers, through the significant increase

of foreign companies revenues and their diversification. To avoid the possibility of manipulating corporate tax systems through transfer pricing, fiscal authorities impose requirements concerning the preparation of some documentation related to transfer pricing, increasingly more onerous. Thus, companies are faced with the situation where they need to develop complex documentation on transfer prices in all countries where it operates, so they are much more likely to incur penalties for noncompliance with the requirements of fiscal authorities. In addition, the application of different methods for determining the correct transfer price is becoming increasingly complex and costly, given that new technologies and business structures (implying a greater emphasis on the firm's intangible assets) created difficulties in identification of comparable uncontrolled commercial transactions necessary for the correct transfer pricing. There are also substantial differences in the rules for applying the methods of transfer pricing between Member States so that EU companies face with uncertainty regarding the prices of intra-group transactions, because they could be considered unacceptable by fiscal authorities at a later audit (European Commission, 2005). The transfer pricing adjustment, made after the fiscal authorities audit, can lead to double taxation risk. For example, the double taxation through transfer pricing occurs when a fiscal authorities of a Member State unilaterally adjust the price for a sale achieved between companies of the same group, without this adjustment to be offset by a corresponding adjustment in the Member State in which the purchase was made. Although, researchers conducted by the European Commission suggests that the number of disputes between fiscal authorities and corporations regarding transfer pricing adjustments is quite limited in the Member States, business representatives have complained that often litigation costs are so high that the acceptance of double taxation is a less expensive option (Ernst & Young, 1999).

Specifically, the costs that corporations have to commit for compliance of the tax liabilities regarding transfer pricing are following:

- the company's obligation to determine transfer prices under the “arm's length, which means the finding comparable uncontrolled transaction prices, the development of documentation and the justification of these prices at any controls by fiscal authorities;
- the protect against the risk of double taxation if transfer pricing are adjusted (bringing proceedings against the tax authorities, determining transfer pricing, etc.).

According to estimates by the European Commission in 2001, compliance costs regarding the transfer pricing of European companies accounted for about 4 to 5.5 million per year, i.e. 1.9% of corporate income taxes payable (European

Commission, 2005). Estimates were made on the basis of an analysis of 700 companies from 14 countries. Other authors have found that these costs would amount to 2% -4% of corporate income taxes paid by companies (Lanno, Kevin, 2002). The organization Ernst & Young' study in 2008, made at a sample of international corporations, reveals that 39% of subjects of the research believed that the transfer pricing is their biggest fiscal problem, because in recent years, fiscal authorities have granted a greater attention on the mechanism for determining transfer prices used by corporations. Thus, 52% of the companies that participated in the study have been subjected in the past six years, of an transfer pricing investigation by fiscal authorities, while 27% of them have proceeded to transfer pricing adjustments. Under these conditions, 53% of those companies' representatives stated that, in recent years, the costs of compliance regarding transfer pricing have increased significantly.

Since many of issues concerning the tax treatment of transfer pricing are obstacles for the activities on the internal market, limiting the efficiency, effectiveness, transparency and simplicity, the European Commission proposed in 2005 a set of rules for partial resolution of European companies difficulties, encountered by them in connection with the preparation of transfer pricing documentation.

Thus, in 2006, the EU has adopted a code of conduct for documentation that affiliates companies in Member Countries must prepare in connection with transfer prices used in intra-group transactions. This code is intended to standardize the documentation that corporations must submit to fiscal authorities when the way of determining prices for cross-border intra-group transactions is checked. In February 2007, the European Commission made a statement which it summarized the results of Joint Transfer Pricing Forum activities, bringing additions of the code of conduct, specifying procedures regarding the dispute avoidance and orientations for Advance Pricing Agreements within the European Union.

The measures listed above have the potential to help the reduction of corporate compliance costs regarding the transfer pricing documentation, but not entirely resolve the transfer pricing problem. For this reason the European Commission has repeatedly reaffirmed the need of the corporate income tax base consolidation as a solution for solving the transfer pricing problem. At the same time the European Commission pointed the need to ensure a good governance in tax matters among Member States as an essential tool to combat the cross-border tax evasion and fraud and to provide a financial base for public spending.

The European Parliament also recently stated that the introduction of a common consolidated corporate tax base would help resolve issues of double

taxation and transfer pricing in the EU. Until finalizing a legislative proposal in this regard, the European Parliament recommend the Commission to move the emphasis of the inspection on transfer pricing transaction to the company, in order to diminish the ability of corporations to handle corporate tax systems through the transfer pricing mechanism. In this respect, comparable profits method is suggested for the transfer pricing determination because it focuses on the comparison of benefits obtained by companies for each industry. Thus, the decrease of a branch profits well below the sector average could be the evidence of a transfer pricing used by company to avoid taxation.

In recent years, the outward opening of South-Eastern Europe economies and the increasing of the political stability in the region has encouraged the establishment of European corporations' subsidiaries in the respective states. If in these states there is no a transfer pricing legislation (Table 1) and it practiced low corporate tax rates, the risk of intensifying the phenomenon of avoiding the imposition by using the transfer pricing mechanism increases significant.

Table 1

Issues relating to the transfer pricing legislation and the rate of corporation tax in the countries of South-eastern Europe

	National legislation follows the principles of the OECD	National legislation complies with "arm's length"	National legislation requires the development of a documentation	Rate of corporation tax in 2010 (%)
Azerbaijan	-	-	-	20
Bulgaria	x	x	-	10
Croatia	partly	x	-	20
Czech Republic	x	x	x	19
Estonia	x	x	x	21
Hungary	x	x	x	19
Kazakhstan	x	partly	for some taxpayers	20
Latvia	x	x	-	15
Lithuania	x	x	x	15
Macedonia	partly	x	-	10
Poland	x	x	x	19
Romania	x	x	x	16
Russia	partly	partly	-	20
Slovenia	x	x	x	20
Slovakia	x	x	x	19
Ukraine	partly	x	-	25

Source: PriceWaterhouseCoopers, Transfer Pricing Perspectives, 2010.

On the other hand, even in some Euro Zone countries there is no regulations regarding transfer pricing (Malta) or no requirement to achieve a transfer pricing documentation (Luxembourg).

5. Conclusion

Since the transfer prices have important implications for the budgets of Member States, there is an increasing complexity of tax issues for both fiscal administrations and corporations that are forced to respect different tax rules in the countries where working. The different national tax rules generate interest conflicts between fiscal administrations and corporations, and lack of administrative coordination between fiscal jurisdictions can support the capital flight from some countries and the loss of tax revenue.

The protection of national tax revenue has become a major target for the financial policy of all Member States but especially of states with a high level of taxation. In this context, the introduction of a common consolidated corporate tax base in the European Union can be a useful tool for limiting the migration of tax base between countries through transfer pricing, ensuring, at the same time, increasing the efficiency of the corporate income tax by a significant simplification operations regarding the declaration of the profit by corporations. The consolidation of the tax base will allow the determination of the taxable income for the group of companies, so the transactions price will have no influence on corporate income tax paid by companies. Because the costs of compliance with fiscal authorities requirements regarding the transfer pricing are becoming larger, this measure is supported by representatives of European business.

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