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STUDY ON THE ROLE OF TRANSFER PRICES IN CONSOLIDATION OF THE TAX BASE AND IN DETERMINING THE TAXABLE PROFIT OF THE GROUP OF COMPANIES

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Abstract

In a globalized economy in which more and more companies are operating, expanding their activity in different fields and by setting up different groups of companies, covering different markets, the issue of transfer pricing is not only important, but also necessary in considering the implications that they have not only on the profitability of the companies, but also on the budgets of the states of which they are part. In this paper we aimed to analyze the not easy issue of transfer prices, exemplifying through case studies, the choice and use of various valuation methods that aim to strengthen the tax base and determine the taxable profit within the group of companies in a way that is as correct as possible and that does not have fiscal consequences on them. The methods used were: the price comparison method, the plus cost method, the resale price method and the profit sharing method. The study highlighted that the application of the methods is based on the characteristics of the entities, the characteristics of the transactions subject to analysis and the comparability of the data. But regardless of the applied method, the preparation of the transfer pricing file is useful both for the fiscal authorities and for the entities, considering the fact that they can contribute to the increase of the company's profitability and to the assurance of competitive advantages.

Key words**:** *transfer prices, taxation, profitability, fiscal group*

INTRODUCTION

Globalization is a complex phenomenon in which geographical distances are no longer a determining factor in establishing economic, political, social or cultural relations [1]. In turn, economic globalization is a gradual integration of national economies into a process that continues to diminish the importance of borders for economic activities, and financial globalization makes the economies of the world's states interdependent due to the existence of many channels through which it is transmitted, which makes international tax authorities concerned with strengthening control frameworks and correcting financial imbalances. And transfer pricing is such a measure, but it is more than a fiscal challenge that has been regulated by the OECD, which published the document "Transfer Pricing Recommendations for Financial Transactions". These recommendations, although mandatory, represent references that target a wide category of financial transactions (intra-group loans, hedging operations, cash-pooling mechanisms, etc.) [8], [2]. Transfer pricing is in fact a business opportunity based on strategic decisions taken within a company, being an important tool that underlies revenue growth and measuring the performance of activities [7].

Therefore, at the level of the European Union, as a result of the increasing complexity of fiscal aspects, the legislative initiatives aimed to simplify both the point of view of tax administrations and the point of view of corporations, which had to comply with tax rules from the countries with which they carried out economic activities.

Because there are different tax rules at national level, conflicts of interest may arise between tax administrations and corporations, and a lack of administrative coordination

between tax jurisdictions may lead to capital outflows and loss of tax revenues.
Member States' national fiscal policies seek to protect national tax revenues, especially in countries with high taxation, and one of the tools to limit these effects is transfer pricing. This also ensures the increase of the efficiency of income taxation as a result of the significant simplification of the way of declaring the profit that is obtained by the corporations. In this way, the level of prices at which intragroup transactions are made will no longer influence the profit tax due.
Although the application of the transfer pricing mechanism aims at the proper taxation of profits made globally, most countries, in trying to protect the tax base have applied the "market value principle" when assessing transfer pricing and which involves valuing group prices ratio of prices applied to each category of transaction, for companies acting independently in the market, without being part of a group.
In addition to its advantages, however, economic globalization reduces the ability of tax administrations to verify the accuracy of transfer pricing. And the recommendation of the rules regarding the transfer prices, and their implementation makes the companies have to elaborate complex documentation regarding the formation of the transfer prices in the countries where they carry out economic activities [9].
The application of various transfer pricing methods is increasingly complex and costly, on the one hand due to the difficulties of identifying uncontrolled comparable transactions and on the other hand due to the multiple training rules applicable at EU level, which make transfer pricing documentation one of the important tax issues facing companies.
In Romania, the legislation on transfer pricing has existed since 2008, but the obligation to prepare the transfer pricing file was introduced in 2016, and since 2020 National Agency of Fiscal Administration (ANAF) has set up a department that performs risk analysis and deals with the verification of transfer pricing, which that the issue of transfer pricing should get more concern from both companies and state institutions. Because the taxation of multinational groups is a topic of discussion in the Romanian and European public space, the tax authorities check the way in which the companies that are part of these groups comply with the legislation in force. We must also take into account the fact that a policy to prevent and combat a phenomenon is less expensive and much more efficient than the costs generated by the globalization of its consequences [6].
It even makes the risk of transfer pricing exist, it is associated with many more opportunities related to efficient tax planning and management. That is why in this field we can talk about a transfer pricing management that has its advantages and must be applied by companies. However, the adoption of decisions must be done at a global and consistent level so as to allow companies to avoid the different interpretations that exist at the level of national tax authorities, thus avoiding inconsistency. Secondly, a cost efficiency can be ensured in the conditions in which it starts from a global strategic analysis [5]. Third, this global approach will allow companies to better manage the risks that are associated with tax costs. And last but not least, the global analysis also allows the improvement of the performance measurement method.

MATERIALS AND METHODS

The methods that are applied in testing the conformity of transfer prices with the market value principle, and which are also provided in the Fiscal Code, are: price comparison method, resale price method, cost plus method, net margin method, profit sharing method, other methods.
Methods are used both by companies for tax planning purposes, but also for documenting the transfer prices they practice, and tax authorities use them to test the market value of transactions that take place between people and are the basis for determining real profits, that is, those that would have been obtained in the absence of an affiliation relationship between the parties [3].

The method of comparing prices consists in comparing the prices used in transactions between affiliated parties and which are called "controlled prices", with the prices used in transactions between independent parties which are called "uncontrolled prices" and which represent the key factor of this method internal or comparable external.

Internal comparables apply if any of the related parties carries out transactions with independent parties, with the same category of product or services, in economic conditions that are comparable (Figure 1).â

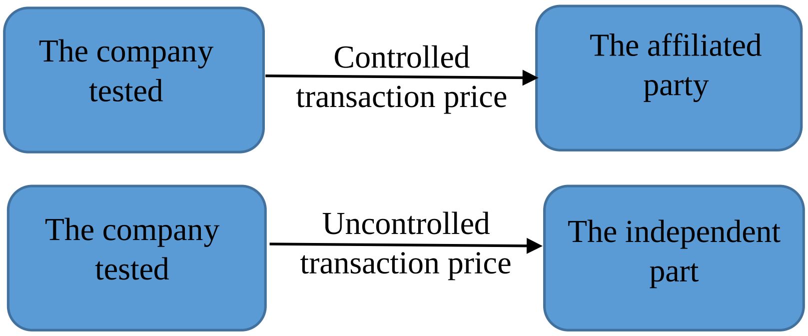

Fig. 1. Internal controllables
Source: own processing.

External comparables apply in situations where we have information on prices charged in transactions that take place between independent, unaffiliated parties that trade the same category of product or service (Figure 2).

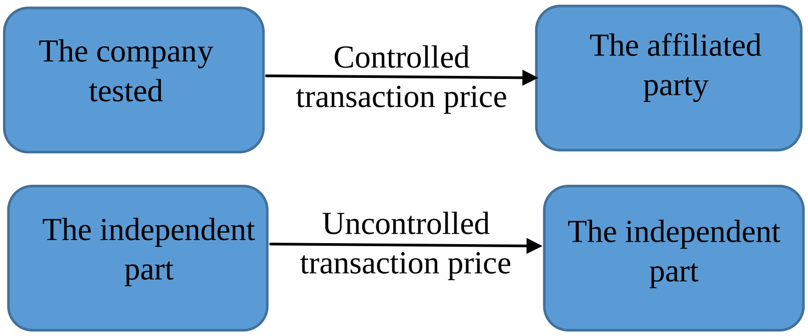

Fig. 2. Externally controllables
Source: own processing.

The cost plus method is a method that applies especially to entities that carry out production or service activities and involves the use of accounting information on production costs and revenues from the sale of products or services. The method involves comparing the gross margins related to the costs obtained by the economic entity in its relationship with related parties, with the gross margins related to uncontrolled transactions, allowing aggregations of homogeneous product categories. It uses the same categories of controllable, internal (Figure 3) and external (Figure 4).

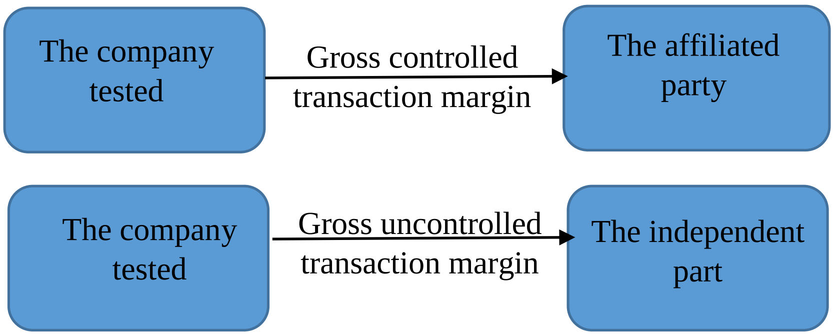

Fig. 3. Internal controllables
Source: own processing

Given that financial statements, even those that meet international financial reporting standards, do not allow an accurate comparison, due to the fact that the determination of gross margin is influenced by the cost categories used in its calculation, the use of external comparables is not used current [4].

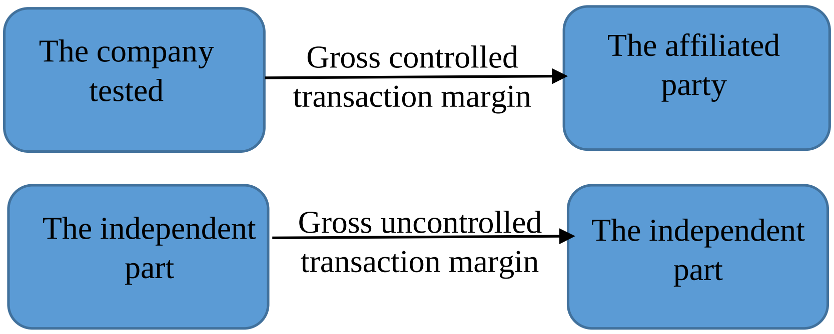

Fig. 4. Externally controllable
Source: own processing.

In the case of using internal comparables, the gross margins can be calculated in the same way as in the case of transactions between the company and the affiliated parties, which makes the method more accessible.

The resale price method is used in resale activities and is used in the case of production activities and services, assuming the observance of the same principle as in the case of the cost plus method. Gross margin is determined based on data from the statutory financial statements, which means that external comparables can be used, and profitability is determined taking into account revenues, not expenses, and profitability indicators are determined at the level of net margin [10]. Given that net margins are used, the selection of comparables is more permissive due to the fact that in addition to differences in the characteristics of products or services, minor differences in the functional profile are allowed.

The profit sharing method is used in the case of interconnected activities that do not allow separate valuation. The method has a high degree of subjectivity because these situations are rarely encountered in practice.

RESULTS AND DISCUSSIONS

In order to exemplify the application of the methods of testing the conformity of transfer prices, the case study involved the analysis of the data provided by the financial statements of some groups of economic entities, as well as the data provided by their management accounting. Alpha is in a relationship with Betha, which is a supplier of goods, and

Ghama, a third-party company, which is also a supplier of goods. Alpha is a distributor of goods for other categories of economic entities, without carrying out market prospecting activities. The analysis will involve: determining the method of compliance of transfer pricing; determining the sales margin, determining the commercial profitability rate. Considering the activity characteristics of the company, the procedure used will be that of internal comparability. In order to determine the Commercial Profitability Rate, that is the profitability of sales, we will start from the management accounting data that are centralized in Table 1.

Table 1. Determining the Commercial Profit Rate

Analyzed quality criteria	Betha	Ghama
Turnover (thousand lei)	6,480	9,720
Expenditure on products (thousand lei)	5,503	7,815
Gross margin (thousand lei)	977	1,905
Transfer price (thousand lei)	5,503	7,815
Commercial profitability rate (%)	15	20

Source: own processing.

Given that the commercial rate of return on transactions between Alpha and Betha is 15% and the rate of commercial return on transactions between Alpha and Ghama was 20%, an adjustment is expected, following a fiscal control, for the rate profitability in the relationship between Alpha and Betha from 15% to 20%. Therefore, the recalculated profit will be 1,296 thousand lei, and the additional profit tax will be 207.36 thousand lei.

The following case study analyzes the situation of transfer prices within the company Avantaj S.A., a start-up founded in 2017.

The company carries out custom production activity, purchasing raw materials from the New Era Company based in France, which delivers the finished products. Some of the products obtained are sold to customers in Romania. The price of the services provided to New Era is calculated on the basis of the tariff/piece. The analysis period is 2018-2019. In Romania, the transfer of goods is made both with transfer of ownership and without transfer of ownership. The data in the Profit and Loss Account are presented in Table 2.

Table 2. Profit and loss account for Avantaj Company

Indicator	2018	2019
Revenue from services rendered (thousand lei)	8,164	7,867
Revenues from the sale of products (thousand lei)	1,170	1,162
Total operational income (thousand lei)	9,334	9,029
Expenditures on raw materials and consumables (thousand lei)	429	356
Energy and water costs (thousand lei)	195	260
Personnel expenses (thousand lei)	1,456	1,703
Depreciation expenses (thousand lei)	4,654	4,990
Other operational expenses (thousand lei)	3,085	1,460
Total operational expenses (thousand lei)	9,793	8,769
Operational result (thousand lei)	-459	260
Result from the financial activity (thousand lei)	126	135
Gross result (thousand lei)	-333	395
Profit tax (thousand lei)	0	66
Net result (thousand lei)	-359	329

Source: own processing.

The statement of income, expenses and operating result is presented in Table 3.

The chosen method will be that of the net margin because the company not providing services to third parties will not be able to find data on transactions between independent entities, therefore the method of price comparison is excluded. Since the transactions between Avantaj and New Era can be analyzed separately, without the use of these and fixed assets, then we will not be able to use the profit sharing method either. And because there is no perfect comparability between the company's transactions and the transactions of independent entities for comparisons, we did not choose the cost-plus method either. Therefore, the analysis will be performed using the net margin method, which involves determining profitability through Net Cost Plus (NCP).

It is found that the level of operating profit (Net Cost Plus) is 3.11% in 2019, and in 2018 the value is negative, the loss rate being 4.93%.

Furthermore, the level of operational profit is compared with the interquartile range obtained for comparable companies.

Table 3. Profit and loss account for Avantaj Company

Indicator	**2018**	**2019**
Operational income (thousand lei)	9,334	9,029
Operational expenses (thousand lei)	9,793	8,769
Operational result (thousand lei)	-459	260
Net cost plus (NCP) (%)	-4.69	2.96

Source: own processing.

The interquartile range is a tool used to eliminate some of the differences between the tested entity and the calculated results. However, neither the fiscal legislation of the European Union nor that of Romania expressly provides for the manner of conducting the comparison made between the results of the analyzed entity and the calculated interquartile range. Therefore, there were no restrictions on the use of data for several years.

Table 4. Comparison of NCP with interquartile range values

	2018	**2019**
Minim (%)	0.03	0.05
Q1 (%)	2.35	3.44
Median (%)	3.52	4.58
Q3 (%)	5.87	7.63
Maxim (%)	12.45	22.44

Source: own processing.

The minimum is represented by the lowest value of the profit level in the comparison sample used, the median is the middle value of the sample, and the maximum is represented by the highest value in the sample.

The two quartiles, Q1 and Q2 represent the values below which, respectively, above which 25% of the comparison sample falls.

Based on the calculated data, they will identify the risks that may affect the company Avantaj, respectively the highest risk (Table 5), as well as the lowest risk (Table 6).

Table 5. Identifying the highest risk for Avantaj Company

Indicator	**2018**	**2019**
Q1 (%)	2.35	3.44
Median (5)	3.52	4.58
Q3 (%)	5.87	7.63
NCP (%)	-4.93	3.11
Difference of result (thousand lei)	343	140

Source: own processing.

In this case, the highest risk for the entity is that of adjusting the rate of return at the level of the median rate, which will lead to the adjustment of expenses and differences in results of 343 thousand lei in 2018 and 140 thousand lei in 2019, which will involve the payment of an additional tax in each of the two years.

Table 6. Identifying the lowest risk for the Avantaj Company

Indicator	**2018**	**2019**
Difference of result (thousand lei)	314	117

Source: own processing.

The lowest risk occurs when the company decides to adjust the rate to 3.2% for 2018 and 4.3% for 2019, which brings an adjustment of the tax due, lower than in the first option.

Giving this example, we may consider that in case of agricultural companies, whose profile expose them to the climate factors both the vegetal and animal sector, where productions are uncertain, prices for farm inputs are higher and higher and production costs as well, price level of the agricultural products depends on various factors, first of all on the demand/offer ratio, product quality, contractual risks, and market opportunities. Price/cost ratio is a conditional factor which determines efficiency and profitability at the product level in agriculture.

CONCLUSIONS

Due to the importance of transfer pricing, groups of entities are much more concerned with this issue and have begun to pay much more attention to the management strategy applied to transfer pricing globally, in order to improve performance.

Proper documentation of transfer pricing has the advantage of providing an overview of the market in which the group operates, but also offers the advantage of understanding how a business operates within the group or the specific relationships between the parties affiliated, which will lead to the identification of opportunities related to tax planning of economic entities.

Or this fiscal planning can be reflected by the improvement of cash flows, by the performance indicators and by the possibility of realizing the development plans.

Although the preparation of the transfer pricing file is not an easy task, if the principles of preparation are observed and the appropriate methods of comparison are chosen, transfer pricing can lead to increased efficiency of the activity and even to ensure a commercial advantage over competing companies.

Each of the methods has its advantages and disadvantages, they have certain characteristics that underlie their choice. Thus, the decisive factor in choosing the price comparison method is the similarity of the products that are subject to analysis from the point of view of the transactions made; the cost plus method requires the identification of the categories of expenses that will be the basis for determining the costs; the resale price method is based on and applied in relation to the similarity of functions, risks and contractual terms; the net margin method has the advantage that it is less influenced by the differences that occur at the time of trading and that directly influence the price. At the same time, net margins are less sensitive to some functional differences that occur between controlled and uncontrolled transactions compared to gross profit margins, thus allowing the identification of both uncontrolled transactions and comparable companies.

In conclusion, the choice of the method differs from one company to another, and the opportunity to choose one of the methods is influenced by the characteristics of the analyzed transactions.

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