TAX ASPECTS OF TRANSFER PRICE REGULATION: PERSPECTIVE OF IMPLEMENTATION IN THE REPUBLIC OF MOLDOVA

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Abstract: *Within the past years, transfer pricing has become a significant issue to the tax authorities as well as broader business audience. In this context, studying the opportunity of implementation of such a mechanism in The Republic of Moldova it is a very important theme to discuss. Furthermore, based on the international experience (Croatia, The Czech Republic and Romania), in this paper is analyzed the most lacks which should be taken into consideration.*

Key-Words*: transferring prices, taxes, Republic of Moldova, developing countries*

1. INTRODUCTION

Transfer pricing [7] is the set of mechanisms which is used to attach prices to goods or services which are traded between two divisions of the same company. The classic example involves one division (the "selling division", or "SD") which produces a component which is required by another division (the "buying division", or "BD"). The component is used by the BD in the manufacture of a product which it sells on the open market.

In case all of this sounds a bit abstract, let's consider a simple example of a company in which the SD manufactures car engines and the BD manufactures cars. A couple of things are obvious:

- The BD needs the output of the SD, because the BD needs car engines in order to make cars. Alternatively, the BD may be able to buy engines from an external supplier if, for example, the BD and SD cannot agree on a transfer price for the engines.
- The SD can sell its output either to the BD or to external customers (in this case, these external customers would be other car manufacturers, many of which would be only too happy to buy in a ready-made engine).

The transfer price represents a source of revenue to the SD, and a cost to the BD. Therefore, there is potential for inter-divisional conflict (or at least a need for inter-divisional negotiations) since the SD will want to maximize the transfer price while the BD will want to minimize it.

2. GENERAL OVERVIEW

So, transfer prices serve to determine the income of both parties involved in the cross border transaction. The transfer price therefore tends to shape the tax base of the countries involved in cross-border transaction.

Furthermore, increased globalization of production has not only made the subject more difficult, but has also generated more situations where forensic economists must come to grips with it in order to perform calculations necessary for certain tax, valuation, and litigation-related tasks [5].

Under a high level of scrutiny, establishing appropriate transfer pricing policies is a difficult task. Various economic factors must be considered, as illustrated by the recent litigation involving multinational corporations that we will review.

Perhaps the most vexing concern is the need for multinationals to solve the "corporate transfer pricing problem" by establishing transfer pricing policies and practices that [1]:

1. satisfy the needs of the business with respect to strategy and internal incentives;
2. result in an efficient use of resources;
3. provide an appropriate transfer pricing answer from a tax perspective.

So, arriving at a solution to this problem is exacerbated in the case of financial services transactions, where recent transfer pricing legislation fails to provide adequate guidance. The impact of transfer pricing, however, is felt well beyond the confines of the individual firm, and can affect the economy at large.

To increase domestic tax revenues and prevent perceived abuses of the tax system, global taxing authorities implemented stringent documentation requirements that multinational corporations must meet in order to detail the prices that they are charging for intrafirm transfers. In 2007, the Norwegian Ministry of Finance published draft documentation requirements concerning transfer pricing, with a view towards improving the ability of the Norwegian tax authorities to assess companies' transfer pricing compliance [3]. In India, the result of a 2007 tax court ruling highlighted the latitude being provided to local tax examiners in bringing transfer pricing issues to court, and also placed the onus on taxpayers to perform thorough benchmarking analyses [2].

Increased globalization of corporate production added a new twist to the transfer pricing problem that made the subject of greater importance to forensic economists.

Tax authorities do not always catch or challenge such tax-avoidance practices, especially if the practice raises the taxable base of subsidiaries in their jurisdiction. Furthermore, tax rate differentials may influence transfer-pricing even when transfers are not across international borders. And if the transfer product is a mineral or energy substance, subject to *ad valorem* state severance taxes, there is again a clear incentive to fix a lower transfer price. If a corporation's transfer-pricing policy artificially raises or lowers subsidiary profit, use of subsidiary financial and accounting records by analysts becomes problematic. [5]

The aim of using transfer pricing scheme is to usually reduce a multinational group's worldwide taxation by shifting profits from associated entities in higher tax countries to associated entities in relatively lower tax countries through either under-charging or over-charging the associated entity for intra-group trade. The net result is to maximize an international enterprise's after tax profits. For example, if an international enterprise has a tax rate in the residence country of the parent company of 30% and it has a subsidiary entity resident in another country with a tax rate of 20%, the parent has an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30% to 20%. If the parent company shifts $100 million of taxable profits to its subsidiary, it will make a tax saving of $10 million. This may be achieved by the parent being over-charged for the acquisition of property and services from its subsidiary. [6]

There is very necessary to determine the proper method to measure transfer pricing impact. Several acceptable transfer pricing methods exist, providing a conceptual framework for the determination of the arm's length[1] price. No single method is considered suitable in every situation and the taxpayer must select the method that provides the best estimate of an arm's length price for the transaction in question.

In particular, the OECD Guidelines outline five methods to determine the arm's length nature of transfer prices [8]:

- **Comparable uncontrolled price (CUP) method**; which is based on the comparison of prices charged in a controlled transaction to the price charged in an uncontrolled transaction in comparable circumstances for comparable products and services.
- **Resale price method (RPM)**; which is based on the resale price at which a product purchased from a related party is sold to an independent enterprise. The transfer price of the inter-company transaction is calculated by deducting the resale price margin from the resale price in the uncontrolled transaction.
- **Cost plus method (CPM)**; which uses the costs incurred by the supplier of property/services in a controlled transaction. A mark-up taking into consideration the functions performed, risks assumed and assets employed is added to the costs to determine the arm's length price in the controlled transaction.
- **Transactional net margin method (TNMM)**; which examines the net profit margin relative to an appropriate base (e.g. cost, sales, assets) realized from a controlled transaction.
- **Profit split method (PSM)**; which is based on identification and appropriate split of the profit realized by related entities from a controlled transaction.

The CUP, RPM and Cost plus methods are usually called "traditional transaction" methods and the last two are called "profit-based" methods although as noted above, there is growing acceptance of the practical importance of the profit-based methods.

All these methods are widely accepted by national tax authorities, as it is shown well in Table 1, based on Deloitte Report [4].

Table 1 An overview of acceptable transfer pricing methods in EU and non EU European countries

Country	Methods	Country	Methods
Austria	CUP, RPM, CPM, TNMM, PSM	**Belgium**	CUP, RPM, CPM, TNMM, PSM
Czech Republic	CUP, RPM, CPM, TNMM, PSM	**Denmark**	CUP, RPM, CPM, TNMM, PSM
Finland	CUP, RPM, CPM, TNMM, PSM	**France**	CUP, RPM, CPM, TNMM, PSM
Germany	CUP, RPM, CPM. TNMM, PSM are accepted by authorities under certain conditions.	**Hungary**	CUP, RPM, CPM
Ireland	Non specified	**Italy**	CUP, RPM, CPM, PSM, Invested Capital Profitability, Economic Sector Gross Margin
Netherlands	CUP, RPM, CPM, TNMM, PSM	**Norway**	CUP, RPM, CPM, TNMM, PSM
Poland	CUP, RPM, CPM, TNMM, PSM	**Russia**	CUP, RPM, CPM
Spain	CUP, RPM, CPM, TNMM, PSM	**Sweden**	CUP, RPM, CPM, TNMM, PSM
Switzerland	CUP, RPM, CPM, TNMM, PSM	**UK**	CUP, RPM, CPM, TNMM, PSM

Made by author based on the [4]

There has been a widespread view, historically, that the OECD Model was most appropriate for negotiations between developed countries and less suitable for capital importing or developing countries. In general, it can be

[1] The arm's length principle is the condition or the fact that the parties to a transaction are independent and on an equal footing

said that the UN Model preserves more taxation rights to the source state (i.e. host State of investment) or capital-importing country than the OECD Model and the UN Model has been embraced by many developing states as the basis of their treaty policy. Some developed countries also adopt some UN Model provisions, and at times it has influenced changes to give aspects of the OECD Model a greater source country orientation.

3. COMPARATIVE ANALYSIS OF MOLDOVAN POSITION

Based on the PricewaterhouseCoopers 2011 Report [9], the arm's-length principle has been set forth in Moldovan tax law since 1998 (for the comparison, for example, in Romania this principle was set in 1994 and in Czech Republic – in 1996). Transfer pricing regulations, however, are currently at an initial development stage. Nevertheless, the government's medium-term tax policy provides that formal transfer pricing documentation requirements shall be introduced in the Moldovan tax law starting in 2012.

As a general rule, under Moldovan tax provisions, the transactions concluded between related persons are taken into consideration only if the interdependence of these persons does not influence the outcome of the transaction. The arm's-length principle applies to transactions with both resident and non-resident related parties.

According to Moldovan tax law, a company is considered the taxpayer's related party if one of the following conditions exists: (a) The company controls the taxpayer; (b) The company is controlled by the taxpayer; (c) Both the company and the taxpayer are under common control of a third party.

From a tax perspective, control is the ownership (either directly or through one or more related persons) of 50% or more in value of the capital or voting power of one of the companies. For this purpose, an individual will be treated as owning all equity interest that is owned directly or indirectly by members of his or her family.

Two individuals are related parties if they are spouses or relatives up to the fourth degree.

According to the Croatian General Tax Act, related entities are legally independent companies which, in their mutual relations, fall into one of the following categories:

- Two or more companies, of which one company holds a majority share or majority decision-making interest in the others;
- Two or more companies, of which at least one company is dependent and one is controlling; companies that are part of the same "concern" (Group);
- Companies with common shareholders;
- Companies linked by special contracts in accordance with the Companies

Act or that have arrangements such that profits and losses can be transferred between them.

Based on Czech tax legislation, parties are regarded to be related if one party participates directly or indirectly in the management, control or capital of the other, or where a third party participates directly or indirectly in the management, control or capital of both of them, or where the same persons or their close relatives participate in management or control of the other (excluding situations where one person is the member of supervisory boards of both parties). Participation in management suffices to assume a relationship, even without equity ownership. Participation in control or capital means ownership of at least 25% of a company's registered capital or voting rights. Individuals are related if they are close relatives. Parties are also deemed to be related if they enter into a commercial relationship mainly for the purpose of reduction of the tax base (or increase of a tax loss).

According to the Romanian tax legislation, two legal entities are related parties provided that:

- One entity holds directly or indirectly (through the shareholding of related entities) a minimum of 25% of the number/value of shares or voting rights in the other entity or it effectively controls the other entity; and
- One entity holds directly or indirectly (through the shareholding of related entities) a minimum of 25% of the number/value of shares or voting rights in the two entities.

An individual is a related party with a legal entity provided that he/she holds directly or indirectly, including the shareholding of related entities, a minimum of 25% of the number/value of shares or voting rights in the legal entity or it effectively controls the legal entity (unfortunately the legislation is silent on the meaning of "effective control"). Two individuals are related parties provided that they are spouses or relatives up to the third degree.

Burden of proof in Republic of Moldova is not regulated by lows in transfer pricing operations, but domestic law provides that taxpayers have the burden of proof over the arm's-length value of transactions with related parties. In Croatia, burden of proof lies with the taxpayers (as well as in Czech Republic or Romania).

4. CONCLUSIONS AND RECOMANDATIONS

It is very important to realize that there are some particular challenges that should be faced by developing countries (like is Republic of Moldova), as [6]:

1. Lack of comparables

One of the foundations of the arm's length principle is comparative pricing. Proper comparability is often found difficult in practice, a factor which in the view of many weakens the continued validity of the principle itself. The fact is that the traditional transfer pricing methods (CUP, Resale price, Cost plus) directly rely on comparables. These comparables have to be close in order to be of use for the transfer pricing analysis. It is often in practice extremely difficult, especially in some developing countries, to obtain adequate information to apply the arm's length principle for the following reasons: (a) In developing countries there tends to be fewer organized players in any given sector than in developed countries; finding proper comparable data can be very difficult; (b) In developing countries, the comparable information may be incomplete and in a form which is difficult to analyze because the resources and processes are not available. In the worst case, information about an independent enterprise may simply not exist. Databases relied on in transfer pricing analysis tend to focus on developed country data that may not be relevant to developing country markets (at least without resource and information-intensive adjustments), and in any event, are usually very costly to access; (c) In many developing countries the economies of which have just opened up or are in the processing of opening up, there are many "first movers" who have come into existence in many of the sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables.

Given these issues, critics of the current transfer pricing methods equate finding a satisfactory comparable to finding a needle in a haystack. Overall, it is quite clear that in developing countries finding appropriate comparables for analysis is quite possibly the biggest practical problem faced currently by enterprises and tax authorities alike, but the aim of this Manual is to assist that process in a practical way.

2. *Lack of knowledge and requisite skill sets*

Transfer pricing methods are complex and time-consuming, often requiring time and attention from some of the most skilled and valuable human resources in both MNEs and tax administrations. Transfer pricing reports often run into hundreds of pages with many legal and accounting experts employed to create them. This kind of complexity and knowledge requirement puts tremendous strain on both the tax authorities and the taxpayers, especially in developing countries where resources tend to be scarce and the appropriate training in such a specialized area is not readily available.

3. *Complexity*

Rules based on the arm's length principle are becoming increasingly difficult and complex to administer. Transfer pricing compliance today typically involves huge and expensive databases and high-level expertise to handle. Transfer pricing audits need to be performed on a case-by-case basis and are often complex and costly tasks for all parties concerned. In developing countries, resources, monetary and otherwise, may be limited for the taxpayer (especially a SME) who has to prepare detailed and complex transfer pricing reports and comply with the transfer pricing regulations, and may have to be "bought-in". Similarly the tax authorities of many developing countries do not have sufficient resources to examine the facts and circumstances of each and every case so as to determine the acceptable transfer price, especially in cases where there is a lack of comparables. Furthermore, the transfer pricing audits tend to be long drawn, time consuming may be contentious and may ultimately result in "estimates" fraught with conflicting interpretations. In case of disputes between the revenue authorities of two countries, the current available prescribed option is Mutual Agreement Procedure (MAP). This too can possibly lead to a protracted and involved dialogue, often between unequal economic powers, and may cause strain on the resources of the companies in questions and the revenue authorities of the developing countries.

4. *Growth of the "intangible economy"*

The fact is that the Internet is a disruptive medium; it has completely changed the way the world works by changing how information is exchanged and business is transacted. Physical limitations, which have long defined traditional taxation concepts, no longer apply and the application of international tax concepts to the internet and related e-commerce transactions is sometimes problematic and unclear.

The issue of effectively dealing with intangibles is especially critical for some developing countries where the prime driver for growth has been the Information Technology industry which has seen a huge growth curve over the last decade creating millions of jobs. The different kind of challenges thrown up by fast-changing web-based business models cause special difficulties. From the viewpoint of many developing countries, it is essential for them to be able to tax the profits on certain intangible-related transactions, such as e-commerce and web-based business models, because of the perceived economic connection of the transaction with that country.

5. *"Location savings"*

Some countries (usually developing countries) take the view that the economic benefit arising from moving operations to a low-cost jurisdiction, i.e., "location savings", should accrue to that country, where such operations are actually carried out.

Accordingly the determination of location savings, and its allocation between the group companies (and thus, between the tax authorities of the two countries) has become a key transfer pricing issue in the context of developing countries. Unfortunately, most international guidelines do not provide much guidance on this issue of location savings, though they sometimes do recognize geographic conditions and ownership of intangibles.

The final conclusion is that Republic of Moldova is prepared to the implementation of transfer pricing mechanism, based on the present tax regulation law. But, it is very important to take into consideration that there are some risks which are connecting with this action.

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