MECHANISM TRANSFER PRICING AND THE NEED INTRODUCTION COMMON CONSOLIDATED CORPORATE INCOME TAX TRANSNATIONAL

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Abstract:

Transfer pricing mechanism is a tool commonly used to transfer the tax base in countries with high tax countries with lower taxation. In the European Union the financial operations generate tax revenue losses. In an attempt to limit manipulation by corporate tax systems, many public authorities have introduced transfer pricing rules, but these rules has shown limited efficacy, however, contribute to the increasing complexity of tax laws and the emergence of additional costs for companies.

This paper deals with the concrete examples, the solution to solving the problem of transfer pricing in the European Union by the introduction of common consolidated corporate income tax.

Keywords: *transnational corporations, transfer pricing, tax revenue, tax regulations, effectiveness.*

JEL Classification: M40, M41

INTRODUCTION:

The mechanism of transfer pricing is a tool often used by corporations to avoid high taxation in some countries. This can be illustrated by a simple example [4] branch of a multinational company builds a car at a real cost of 10,000 euros, sold on the market at a price of 50,000 euros. In conditions of high tax rates, for example 10%, the company would have to pay a production tax of 6,000 euros (EUR 20,000 × 10%). To avoid paying taxes in the country of production, the branch sell car for 40,000 euros to another group company (positioned in a more relaxed tax), which will place the product on the market. Suppose that in this country the corporate tax rate is 10%. At the group level tax will be paid 4,000 euros (EUR 10,000 EUR 10,000 × 10% × 10% +), achieving a significant saving of resources. For the state in which the production activities but this generates tax revenue losses. Transfer pricing is a term that refers to the prices charged in transactions carried out between related organizations (sale and purchase of tangible and intangible assets, provision / purchase of services, including administrative, financial, leasing, etc.). Transfer prices are established decision-making structures of transnational companies can fulfill the following role [4]:

- Reduction in income tax payments or duties;
- Transferring income countries with bans or limitations on repatriation of profits.

Corporate Politics in transfer pricing is based on numerous factors, among which we mention [4]:

- Fiscal aspects of the countries involved in cross-border activities of the member companies of the group;
- Foreign legislation;
- Political and economic risks (eg, the possibility of changing the law, devaluation of domestic currency.)
- The price level in the host country, etc.

Typically, transfer pricing involves setting prices of goods and services traded between members of the group companies for tax purposes: tax reduction in the group of companies. The decrease (increase) prices undergoing intra-group transactions, the corporation manages to fix most of the benefit of the more lenient tax jurisdictions.

After questioning a number of 850 companies with cross-border activities in 24 countries, Ernst & Young organization conducted in 2008, a study that clearly shows the growing importance of transfer pricing issues worldwide. The authors estimated that about two thirds of global transactions are conducted between affiliated organizations, such as transfer pricing at a level that allows an objective to maximize the tax benefits of strategic policy multinationals.

To highlight the importance of the European Union trasfer pricing, Alfons Weichenrieder (2007) conducted a pattern of correlation between the level of corporate tax and the profitability of companies in a group. Analyzing the foreign corporations with subsidiaries in Germany, the author found that increasing the corporate tax rate in the home by 10 percentage points causes an increase in profitability of subsidiaries (artificially generated through transfer pricing) by half a percentage point .

METHODS PRACTICED ON TRANSFER PRICING:

The repeated practices of transnational corporations in the field of transfer pricing have led efforts to define the phenomenon and its regulation. OECD has developed since 1979 a report on transfer pricing mechanism used by transnational companies, and in 1995 drew up the guidelines on transfer pricing addressed both transnational companies and administrations.

Transfer pricing issues is becoming increasingly important in the globalized economy, as more companies expand their business activities beyond the borders of the home, making transactions of goods and services within the group. In principle, the rules recommended by the OECD transfer pricing following conditions require that a transaction must meet to fall under transfer pricing regulations [7]:

a) the existence of cross-border transactions;

b) the transaction take place between two related entities;

c) the transaction be designed to a good, service or any other thing of economic value.

Since transfer pricing may have purposes other than tax avoidance, tax authorities should not automatically assume that firms with cross-border activity trying to manipulate profits, especially since in some cases it is very difficult to determine accurately the price market.

Committee on Fiscal Affairs of the OECD has developed a set of rules to reduce the risk of misinterpretation or abusive taxation of transactions within groups of companies, implementing the so-called "arm's length MAIN" [4]. The OECD Model Tax Convention explains the essence of this principle: “When conditions are imposed or between commercial and financial relations between the two associated companies, relations which differ from those which would be made between independent firms, then any profits which would be achieved by one of the companies in the absence of these conditions may be included in the taxable profits of that company and taxed accordingly” [4]. It tries so adjust corporate profits by reporting intercompany transactions on terms that would have governed relations between independent companies and comparable transactions in a similar context. The “arm's length” put on the independent associated companies at levels equal footing in terms of taxation, avoiding the creation of advantages and disadvantages that could distort the competitive position of each entity type [4].

Implementing proved effective in situations where comparisons can be made with other similar transactions carried out between independent entities. There are many situations where this principle is difficult: for example, in the case of multinational groups operating in highly specialized production of goods.

According to the guidelines on transfer pricing prepared by the OECD, there are five methods for their determination, divided into two main groups [7]:

- Traditional methods based on the analysis of transaction ("traditional transactional methods") and
- Methods based on the analysis of profit ("transactional profit methods").

Traditional transaction methods are based on comparing prices, while focusing on transactional profit methods are based on comparisons between transactions between related entities and between unrelated entities on the basis of the profit from that transfer.

Methods for determining transfer prices based on transaction analysis are [7]:

A. **Method of comparing prices** (eng. Comparable Uncontrolled Price - CUP) is based on the transaction price comparison analyzed the prices of other independent entities that, when sold comparable products or services. For the transfer of goods, products, goods or services between related parties, market value is the price that would be agreed upon independent entities existing under comparable markets in terms of trading for the transfer of goods or identical or similar goods , in amounts comparable to the same point in the production and distribution chain, and under comparable conditions of payment or delivery. In this regard, in determining the market value may be used:

- Price comparison prices agreed between the related parties agreed as between independent entities for comparable transactions (internal comparison of prices);
- Compare prices agreed between independent entities for comparable transactions (foreign comparing prices).

B. **Resale price method** (eng. Resale Price - RP) that the market price is determined based on the resale price of products and services to independent entities decreased by marketing costs and a rate of return. This method is applied starting from the price at which a product purchased from a related party is resold to an independent entity. This price is then reduced by an appropriate gross margin (the resale price margin) representing the value of the last seller of the group will try to cover selling expenses and other operating expenses by operations and to make an appropriate profit.

You must consider the following issues:

- Factors related to the time between the initial purchase and resale, including those related to changes in the market in terms of costs, exchange rates and inflation;

- Changes in the condition and wear of the goods subject to the transaction, including the technological changes in a particular area;

- Reseller exclusive right to sell certain goods or rights that may influence the decision on a change in price margin.

C. **The cost-plus method** (eng. Cost Plus - C +) is based, to determine the normal market price, the main costs increase at a rate similar to the industry profit of the taxpayer. The starting point is the cost of the manufacturer or service provider.

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

Methods based on analysis of profit are:

D. **Net margin method** (eng. Profit Split - SP) involves calculating the net profit margin obtained by a person from one or more transactions with affiliates and estimate this margin based on the level achieved by the same person in transactions with entities Independent or on margin obtained in comparable transactions by independent entities. This method involves a comparison of certain financial ratios derived from the same indicators derived affiliates and independent organizations working in the same field.

E. **Method dividing profit** (eng. Transactional Net Margin - TNMM) is used when transactions between affiliates are interposed so that it is possible to identify comparable transactions. This method involves the estimation of profit affiliated organizations from one or more transactions, and sharing those profits between affiliates in proportion to the profit that would have been obtained by independent organizations. The division of profits should be done by an appropriate estimate of revenue and costs incurred as a result of one or more transactions by each organization.

Profits must be shared to reflect work performed, risks assumed and assets used by each Party Disclosures.

In order to determine the most appropriate method for determining transfer prices are taken into account, in principle, the following:

a) method that is closest to the circumstances in which they are subject to free competition in the market prices of comparable commercial terms;

b) the method for which data are available for work conducted by affiliated organizations involved in transactions subject to free competition;

c) the precision with which you can make adjustments to achieve comparability;

d) the circumstances of the individual case;

e) the actual activities of the various affiliated entities;

f) the method must match the circumstances of the market and the business of the taxpayer;

g) documentation that may be provided by the taxpayer.

The circumstances of the individual case to be taken into account in its market price are: type, status, quality, and degree of novelty of the goods, the goods and services exchanged; market conditions on the goods, the goods or services are used, consumed, treated, processed or sold to independent entities, activities and stages of production and distribution chain entities involved; clauses in contracts of transfer of obligations, payment terms, discounts, warranties, risk taking, the special conditions of competition.

Where comparable uncontrolled transactions can be determined, the method of comparing prices is the most direct and sustainable way to apply the "arm's length". Also, the tax authorities in most countries prices found in the most sustainable method of comparing the means of determining the price of transactions between affiliated companies. The use of transactional profit methods should be limited to exceptional circumstances when there are times when they are insufficient data to apply one of the traditional methods of transfer pricing.

Estimates and comparisons across countries of the European Union:

The European Commission estimates that, in 2001, the compliance costs incurred transfer pricing European companies accounted for around 4-5.5 million per year, ie 1.9% of tax payable [8]. 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 the corporation tax paid by companies [3]. Study organization Ernst & Young in 2008, carried out on a sample of international corporations reveals that 19% of research subjects believed that transfer pricing is the most important issue fiscal faced because in recent years, the tax authorities have granted much greater attention to the way in which corporations based transfer prices. Thus, 52% of the companies that participated in the study were subjected to in the last six years, an investigation by the tax authorities in transfer pricing problem and 27% of them have proceeded to transfer pricing adjustments. Under these conditions, 51% of their respective companies representatives stated that in recent years, the costs of compliance with the specific requirements of transfer pricing increased significantly [8]. Since many of the issues relating to the tax treatment of transfer pricing are obstacles to the activities taking place on the domestic market, limiting the efficiency, effectiveness, transparency and simplicity, the commission proposed in 2005 a set of rules for solving partial difficulties European companies face in relation to the preparation of transfer pricing documentation.

Thus, in 2006, the EU has adopted a code of conduct regarding the documentation related companies in member countries must prepare in connection with transfer pricing used in intra-group transactions. This code aims to standardize documentation that corporations must submit to the tax authorities when checked how prices were formed cross-border intercompany transactions. In February 2007, the European Commission made a statement which summarized the results of work of the working group of experts in the field of transfer pricing (eng. Joint Transfer Pricing Forum), making additions to the code of conduct specifying procedures related to avoiding and dealing transfer pricing disputes and guidelines for Advance Pricing Agreements (eng. Advance Pricing Agreements) within the European Union. The measures listed above have the potential to help reduce compliance costs related to transfer pricing documentation that corporations have to bear, but not entirely resolve transfer pricing issues. For this reason, on several occasions, the Commission reaffirmed the need to strengthen the corporate income tax base as a solution to the problem of transfer pricing. At the same time, the European Commission stressed the need for good governance in tax matters in the Member States, as a key means to combat cross-border tax evasion and avoidance and to ensure a financial basis for public expenditure.

The European Parliament has recently stated that the introduction of a common consolidated corporate tax would address issues of double taxation and transfer pricing in the EU. Pending the completion of a legislative proposal in this regard in order to diminish the ability of corporations to manipulate the tax system through transfer pricing mechanism, the European Parliament calls on the Commission to shift the emphasis inspection on transfer pricing of the transaction to the company. In this respect, comparable profits method is suggested for transfer pricing because it focuses on comparing the benefits obtained by companies for each industry. The lower subsidiary profits well below the sector could be used by the corporation proof of transfer pricing to avoid taxation. In recent years, the opening of economies of Southeast Europe to the outside and increasing political stability in the area encouraged the establishment of subsidiaries of European corporations in the respective states. To the extent that the level of these countries there is no transfer pricing legislation and practice low corporate tax rates, the risk of intensifying the phenomenon of avoiding taxation by using transfer pricing mechanism by European corporations increase significantly.

On the other hand, even in some euro area countries there is legislation on transfer pricing regulations (Malta) or no requirement to achieve a transfer pricing documentation (Luxembourg).

CONCLUSIONS:

Current systems of corporate income taxation in the European Union member states allow companies to avoid taxation of cross-border activity due to significant differences between corporate tax rates and rules according to which each subsidiary is subject to tax based on its activity in the territory of host.

Economic integration of complex corporate tax issues and diminished capacity of tax administrations to track trade flows and revenue streams of companies with cross-border activity. The significant increase in revenues from companies abroad and diversify their economic globalization also reduces the capacity of tax administrations to verify the accuracy of the transfer prices used by taxpayers. To avoid the possibility of manipulating corporate tax systems through transfer pricing, tax authorities impose requirements concerning the preparation of documents related to transfer pricing, increasingly onerous. Thus, companies are faced with the situation where you have to prepare complex documentation on how to transfer pricing in all countries within which economic activities are more at risk of incurring penalties for non-compliance with the requirements of the tax authorities. In addition, application of various 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 intangible assets of the company) created difficulties identify comparable uncontrolled commercial transactions necessary to transfer pricing correctly. There are also substantial differences in the rules for applying the methods of transfer pricing between Member States, so that European companies face uncertainty as to whether the prices at which the transactions were related to intra-group transfers are not accepted by the government tax audit at a later [8].

Transfer pricing adjustments, the tax authorities audit performed may result in the risk of double taxation. For example, double taxation through transfer pricing tax occurs when a Member State unilaterally adjust the format for a sale price achieved between companies of the same group, without this adjustment to be offset by a corresponding adjustment in the Member State which the purchase was made. Although research conducted by the European Commission suggests that the number of disputes between tax authorities and corporations on transfer pricing adjustments is quite limited in the Member States, business representatives have complained that often the costs involved with litigation that are so large that acceptance variant of double taxation is less expensive [8].

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