Transfer Pricing and FDI

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Abstract: FDI analysis is usually performed within the frame of the win-win hypothesis. However, we believe that certain circumstances (MNEs following their own business objectives, lack of appropriate regulations, non-observance of the arm's length principle) may generate disproportionate advantages at the level of FDI stakeholders. The disequilibrium between reinvested profits and repatriated profits may be viewed as a proof of such disproportionate advantages of stakeholders involved in FDI. In addition to figures showing the comparison between reinvested and repatriated profits, as well as the way in which such indicators vary e.g. in case of abnormal business conditions (global economy collapse), we try to show that lack/misuse of transfer pricing regulations may generate even more disequilibrium, the MNEs using intra-group transactions as an additional way of repatriating non-taxable/low tax profits.

Keywords: foreign direct investment; tax; transfer pricing; multinational enterprises; profit repatriation

JEL Classification: F21; F23; H25; K34

1. Introduction

The present paper investigates potential correlations between profit repatriation, transfer pricing regulations and the level of corporate income tax collection by the government of the host country, with focus on Romania.

To begin with, we have presented an overview of the transfer pricing regulations worldwide, following which we have described the transfer pricing principles adopted in the Romanian legislation. The paper contains also an analysis of figures representing profits reinvested and repatriated during the period 2007-2011 in relation to Romanian FDI entities. To conclude, we have shown how MNEs may attempt to repatriate non-taxable/low tax profits by non-observance of the transfer pricing regulations and how the host country may secure the appropriate collection of tax.

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2. Transfer Pricing Regulations

Overview of Existing Transfer Pricing Regulations Worldwide

In the frame of an increased integration of national economies and technological progress, particularly communication, an increasing role of multinational enterprises (“MNEs” hereinafter) in international trade has been recorded. In such context, practical difficulties arise for tax administrations regarding the allocation of profits between different tax jurisdictions particularly when referring to highly integrated group operations. On a related note, practical difficulties arise also at the level of MNEs, the latter being liable to comply with diverse and complex tax administrative requirements, leading most frequently to a greater administrative burden and higher compliance costs. Regarding the taxation of MNEs, governments’ major point of concern regards nowadays the proper adoption/application of transfer pricing regulations in the domestic tax legislation. In case of EU member states, the intention is to align, for now at least under a non-formal way, the transfer pricing regulations and related documentation requirements.

Transfer pricing refers in principle to a set of tax regulations regarding profit allocation methods used in order to split income and expenses, and therefore profits (or losses, as applicable) between entities characterized by an affiliation relationship. The concept of transfer prices refers to the prices applied under controlled commercial and financial circumstances between related (controlled) parties. Companies falling under the related party definition are most likely linked either by a significant share capital holding or control by one company in the other or by such a holding/control exercised by a third person (the holding/control must not be exercised directly). Branches and subsidiaries are a common example of entities considered under the control of a single corporation, the parent company. Certain tax jurisdictions consider entities to be under common control if they share family members on their boards of directors. Under the OECD doctrine, as a consequence of such holding/control relationship, conditions may be imposed or made in the commercial and financial relations between affiliated enterprises so that they would differ from those applicable in case of independent entities, thus conducting to a non-justifiable allocation of profits between the entities involved (in case of MNEs, between various tax jurisdictions).

Transfer pricing is a matter that concerns both entities residing in the same tax jurisdiction as well as taxpayers from different tax jurisdiction. In the first case, tax authorities may consider appropriate to limit any abuse of shifting profits/losses between domestic taxpayers (it is acknowledged that potential tax advantages may be obtained by domestic groups e.g. by shifting the group’s profits towards the losses carrying entities). In case of transactions between related parties operating in different tax jurisdictions, even more complex tax implications may arise since

MNEs e.g. may be tempted to repatriate profits by means of transfer pricing (to be explained more in detail in the following sections of this paper).

Transfer pricing refers to the price setting between related parties, analysis of the prices applied, documentation of the prices applied and potential adjustment of charges made between related parties for physical goods or intangible property.

A significant number of governments[1] have adopted transfer pricing regulations in their domestic tax legislation. In most countries, transfer pricing regulations adopted adhere to the arm's length principle – according to which related parties transactions should be established by reference to prices applied in case of comparable transactions between two or more unrelated parties dealing at arm's length. OECD has published guidelines on applying the arm's length principle[2], which are followed, in whole or in part, by many tax jurisdictions (not only by those of the OECD members). The United States and Canadian transfer pricing rules are similar in many respects to the OECD guidelines, with certain points of material difference. There are however certain countries (e.g. Brazil and Kazakhstan) which implemented rules that are materially different overall.

Transfer pricing regulations are not meant in principle at imposing at what prices should transactions be carried out by taxpayers. However, such rules offer the tax authorities the instruments necessary in order to adjust (only for tax purposes, at least as regards Romania) the profits taxable in Romania so to be in line with the arm's length principle. Moreover, from the perspective of the taxpayer, transfer pricing aims at determining what constitutes arm's length prices and how to set intra-group transfer pricing policies so that the prices applied fall within the arm's length range. A complex analysis should normally be performed by taxpayers with the view of comparing prices actually charged between related parties with prices or relevant profitability derived by independent entities from similar/comparable transactions. The rules generally require that functions, risks, tangible and intangible assets and terms of conducting unrelated party transactions or activities be reasonably comparable to such items with respect to the related party transactions or profitability being tested.

In order to test intra-group transfer pricing applied, one of the following methods, where appropriate and supported by reliable data, may be applied: the comparable uncontrolled price method, the cost-plus method, the resale price method and profitability based methods (profit split and transactional net margin method). Different methods may be imposed by domestic legislations when testing goods by difference to those applied for services or use of property due to inherent differences in business aspects of such broad types of transactions. Specific

[1] According to http://www.tpanalytics.com, about 60 countries worldwide have adopted transfer pricing regulations

[2] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

mechanisms for sharing or allocation of costs may also be particularly imposed when performed between related parties in order to reduce tax controversy.

As regards the relationship between different tax jurisdictions, the treaties for the avoidance of double taxation normally provide for specific provisions regarding the cooperation of tax authorities in the tax field as well as on mechanisms for avoidance of double taxation in case of taxpayers. Also, advance pricing agreements between the taxpayer and the tax authority in its jurisdiction as well as between the taxpayer and tax authorities in various tax jurisdictions may be obtained in order to secure the transfer pricing policy applied.

Transfer pricing documentations sustaining the application of the arm's length principle in case of intra-group transactions may be required to be prepared either in advance, together with the submission of annual tax returns or upon tax authorities' specific request. Administrative fines may be applied for non-compliance, in addition to assessment of supplementary profits tax and late payment charges. As an alternative to the arm's length principle, the global formulary apportionment, in substance accounting profit allocation method between the sub-national jurisdictions of the United States and Canada, may be used for the assessments of profits taxable between different tax jurisdictions. Advocates of such system sustain that under the formulary apportionment firms would no longer have an artificial tax incentive to shift income to low-tax locations.

Overview of the Romanian Transfer Pricing Regulations

Transfer pricing regulations were introduced in the Romanian Fiscal Code[1] starting 2005, however the focus of law makers and tax authorities on transfer pricing matters increased only starting 2008.

According to the Romanian rules, in principle, in case of transactions between a Romanian taxpayer and related parties, the Romanian tax authorities may adjust the amount of income or expenses as necessary, in order to reflect the market value of the goods or services provided in the transactions and the arm's length profits taxable in Romania. Subsequent law amendments were meant at clarifying that the transfer pricing regulations apply also in case of intra-group transactions carried out between domestic taxpayers.

According to the Romanian Fiscal Code, an affiliation relationship is defined by at least one of the following cases:

- two individuals qualify as related parties if such persons are spouses or relatives up to the third degree, inclusive;

[1] Law 571/2003 regarding the Fiscal Code

- an individual is related with a legal entity if the individual owns, directly or indirectly, including holdings of related parties, a minimum of 25%, by value or by number, of the shares/units or voting rights in the legal entity, or effectively controls the legal entity;
- two legal entities are related if at least:

  (i) the first legal entity holds, directly or indirectly, including holdings of related parties, a minimum of 25% of the value/number of shares/units or voting rights in the other legal entity or controls the legal entity;

  (ii) the second legal entity holds, directly or indirectly, including holdings of related parties, a minimum of 25% of the value/number of shares/units or voting rights in the first legal entity;

  (iii) a third party legal entity holds, directly or indirectly, including holdings of related parties, a minimum of 25% of the value/number of shares/units or voting rights both in the first and in the second legal entity.

Romanian taxpayers are required to prepare a transfer pricing documentation to demonstrate that intra-group pricing complies with the arm's length principle. The Romanian transfer pricing provisions have become effectively applicable by both tax authorities and taxpayers as of 2008 when Order 222/2008 on the content of the transfer pricing documentation file was adopted.

The transfer pricing documentation file should comprise information regarding the taxpayer, the group and the related party transactions (including an analysis of functions performed and risks assumed by the related parties), as well as information on the transfer pricing method used for determining the value of related party transactions and a set of relevant statistical comparables (benchmarking analysis).

The five transfer pricing methods specified in the OECD Guidelines are also accepted for Romanian transfer pricing purposes. The choice of the most appropriate transfer pricing method should be performed on a case-by-case basis, depending on inter-alia the nature of the controlled transaction analyzed, as established further to a functional analysis, the availability of reliable information on comparable uncontrolled transactions and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may need to be performed. Subject to the availability of reliable comparable data, traditional transaction methods are preferred in practice to profit-based methods. Local comparables are preferred, but Pan-European comparable sets are accepted in lack of domestic comparables.

Romanian entities performing transactions with related parties should make available upon request of tax authorities and within a required term, a file comprising the transfer pricing documentation for such transactions. The deadline for the submission of the transfer pricing documentation file to the tax authorities cannot exceed three months. Upon taxpayer's written request, this deadline may be extended only once for a period equal to the one initially established.

Non-submission or submission of an incomplete transfer pricing documentation file within the set deadline further to two consecutive requests from the tax authorities triggers the estimation by authorities of the transfer prices for the related party transactions (this is beside a fine for non-compliance of up to RON 14,000). The corresponding adjustments made after the estimation of the prices by the tax authorities may result in additional profits taxable at a rate of 16% and late payment charges/penalties. According to Government Decision no. 529/2007 regarding the approval of advance pricing agreements and advance tax ruling, taxpayers engaged in transactions with affiliates can request the issuance of a unilateral, bilateral or multilateral advance pricing agreement ("APA"), subject to fees of either EUR 10,000 or EUR 20,000, depending on the type of APA requested. In a similar manner, the official term for issuing an APA is either of 12 or 18 months, the longer period being provided in case of bilateral and multilateral agreements. APAs are mandatory against tax authorities only if their terms and conditions have been observed by the taxpayer.

Taxpayers that entered into APAs for related party transactions are not required to prepare and submit a transfer pricing documentation file for the periods and transactions covered by such agreements. The statute of limitation period on assessment of transfer pricing adjustments is currently five years, excerpt for tax evasion or fraud, cases in which the statute of limitation period extends to 10 years. The Romanian Fiscal Code stipulates that the tax authority should consider the OECD Guidelines when analyzing the prices applied in related-party transactions. In addition, the legislation on transfer pricing documentation requirements is aligned to the EU Code of Conduct on transfer pricing documentation.

Practical Considerations

As a general remark, Romanian tax authorities are currently little sophisticated as regards transfer pricing matters. However, an increased focus on transfer pricing audits may be observed and would likely continue in the future given the increased complexity and spread of operations carried out by MNEs. One practical point of discussion concerns the current definition of related parties according to the Romanian transfer pricing regulations, which is not fully aligned to the OECD recommendations, law interpretation difficulties arising as regards the assessment of affiliation relationships between legal entities by means of common control held by a natural person. Although tax authorities frequently adopt an aggressive approach during tax audits, the definition itself as currently included in the law apparently establishes an affiliation relationship between legal related parties only in case of holding/control exercised by a legal entity (thus excluding the case of common control by an individual). The Ministry of Finance, the public authority competent with tax law adoption and interpretation does not provide a clear interpretation of such matter, even if, any potential law interpretation issued would still remain unbinding towards the National Agency for Tax Administration, the public institution having the competency to perform transfer pricing audits.

Separately from the above, the duly application of transfer pricing provisions by taxpayers recording losses may be scrutinized by tax authorities during tax audits since a history of losses may be a sign of inadequate allocation of profits e.g. between the non-resident mother company and the domestic subsidiary/branch. On a related note, during tax reimbursement audits, transfer pricing documentation requirements may be invoked by the tax authorities solely with the intention of delaying tax reimbursements.

On the other hand, the Romanian subsidiaries of non-resident MNEs perform various inter-company transactions with their mother companies, the pricing applied in such cases being frequently not at all transparent or obviously arm's length compliant. The nature of such transactions is not always easy to connect with the nature of the core business activities performed, especially when they involve numerous services renderings or interest/royalties payments. The concern in this respect is whether such payments for services rendered or intangible property is not in substance a way of low-tax profits repatriation, under the relevant international treaties for the avoidance of double taxation.

3. Foreign Direct Investment

Literature usually provides for an analysis of FDI from a win-win perspective for all stakeholders involved in the investing process. However, a correct evaluation of the social and economic efficiency of FDI should scrutinize the benefits, gains and costs generated by FDI for each participant on various time frames (meaning, on the short, medium and long run).

In the following, the paper presents situations when the win-win hypothesis is no longer applicable in case of FDI participants as a consequence of misuse of transfer pricing practices.

Profit Repatriation

The profitability and the revenues derived by MNEs further to FDI carried out in Romania are matters of interest not only to the MNE itself, seeking for new marketplaces or cheap but instructed labour force, but also for the host economy, hoping for positive spillover effects generated by the FDI.

Certain particularities should be observed as regards the business behaviour of Romanian subsidiaries of foreign MNEs. As such, even if in theory the legal and tax regulations should not imply discrimination between local and foreign companies (even if at least the tax practice has proved the contrary in several cases), we may note certain differences as regards the level of profitability and the utilization of profits derived, i.e. either by reinvestment in the host-country or by repatriation to the home country.

As a non-deniable rule, the level of the profits repatriated by MNEs are exceeding the level of profits reinvested in the host country at least on a medium and long run, which, even if may trigger the conclusion that the foreign investors derive higher benefits further to running FDI, the facts are supported by the inner motivation of foreign investors, respectively of deriving profits (developing a business in a foreign country would likely qualify as circumstantial facts).

There are certain facts supported with empirical evidence that should be mentioned. Thus, it is obvious for example that the host country may not influence in any way the level of the reinvested/repatriated profits by foreign MNEs. It cannot be denied that certain incentives may be granted as regards reinvested profits (e.g. as applicable up to 31 December 2010, Romanian tax law provided for tax exemption of profits reinvested in acquisition of new equipments) as an attempt for limiting profits repatriation, however, on the long run, the foreign investors seek for full recovery of their investment (including any reinvested profits).

Table 1. The reinvested and repatriated profits in/from Romania by FDI entities during 2007 – 2011

Formula	FDI indicator	2007	2008	2009	2010	2011
(a)	Net FDI profits		6.412	4.496	4.222	4.710
(b)	Net FDI losses		4.108	4.277	4.495	5.132
(c) = (a) – (b)	Net share capital participation	4.084	2.304	219	- 273	-422
(d)	Net interest income	266	634	475	764	833
(e) = (c)+(d)	Net income of foreign investors	4.350	2.938	694	491	411

(f)	Distributed dividends	2.757	2.696	1.608	1.970	2.075
(g)=(c)-(f)	Reinvested profits	1.327	-392	-1.389	-2.243	-2.497
(h)=(d)+(g)	Repatriated profits	3.023	2.546	2.083	2.734	2.908

Source: BNR (www.bnr.ro)

Based on the figures presented in the above table, certain conclusions can be easily drawn. First of all, under normal business conditions (i.e. 2007, before the economic crisis), the level of repatriated profits was up to three times higher than the level of reinvested profits. During the period 2008 – 2011, we can observe a significant drop of the net income derived by foreign investors from FDI run in Romania, in line with the global economy collapse, however, in 2011 repatriated profits slowly redressed up to the level recorded in 2007 (based on massive domestic disinvestments and increase of interest income from intra-group financing).

Based on the above figures, the behaviour of foreign investors regarding Romanian FDI can be characterized by the following:

- significantly higher levels of repatriated profits (up to three times) in comparison to reinvested profits;
- a continuous drop of net share capital participation as a result of scarce financial liquidities;
- an increased level of net interest income paid by Romanian FDI to foreign investors as a result of disinvestment and inter-company funding;
- a decreasing net income of foreign investors from Romanian FDI given the two components mentioned above;
- levels of distributed dividends and repatriated profits tending to equalize after the crisis overcome;
- an accelerated disinvestment process proven by the negative levels of reinvested profits starting 2008.

The empirical data presented above sustains the ideas presented earlier according to which the various stakeholders obtain disproportionate advantages further to FDI performance, especially since FDI is fully controlled by foreign investors, acting solely with the view of deriving satisfactory profits from host countries to be subsequently repatriated.

Transfer Pricing and FDI

The figures presented in the above table represent in principle the accounting figures (profits) declared by Romanian FDI entities under statistical analysis by the National Bank of Romania and the National Statistics Institute. However, the accounting figures of host country FDI entities may sometimes reflect the result of controlled transactions. Irrespective of the key drivers based on which MNEs chose Romania as a location for implementing FDI, the group's activities are often structured so that almost all transactions involving the domestic company be carried out with related parties (e.g. in case of manufacturing activities, acquisition of raw materials and sale of finished products, as core transactions, are carried out with group companies). Under such conditions, it may not be the MNEs interest to allocate a significant/justifiable portion of profits to the Romanian partner since such profits would normally be taxable herein both at company as well as shareholders' level. As such, domestic FDI entities may find themselves acquiring e.g. raw materials at significantly higher prices and selling finished products under market price to group companies (we have seen in practice situations when raw materials price before processing by the Romanian FDI entity was higher than the actual product sale price).

Such behavior of MNEs may be convenient since, in the end, the intention, as already proved, would be to repatriate profits (under such example Romanian taxes being evaded). Similar examples may be given as regards services renderings by mother companies to Romanian FDI entities (in particular management, consultancy but also administrative services) and royalties payments in relation to brand, know-how, intangibles in general at prices higher than the actual market price. There could be cases where the services would not actually be rendered by the mother company or the services would not have been acquired under normal business conditions by the Romanian FDI entity. The above would likely generate non-justifiable expenses at the level of the Romanian FDI entity with a direct impact on the accounting and tax profit. In the light of the above, the transfer pricing regulations should give the Romanian tax authorities the means and the powers to adjust the tax position of the Romanian FDI entity so that, at least, the right amount of profits be taxed in Romania.

The Romanian tax authorities are yet little sophisticated on transfer pricing matters while intra-group transactions are increasingly complex. There is currently an increased interest on transfer pricing matters given the estimated tax collection involved. The control of the tax authorities on non-observance of transfer pricing principles should nonetheless have no accounting impact at the level of the Romanian FDI entity and on the level of the profits repatriated.

4. Conclusion

Empirical evidence proves that under normal business operations, MNEs repatriate a large amount of profits derived from host countries. Under the same pattern, MNEs involve in significant disinvestment in case of economy collapse and scarce financial liquidities, however the repatriated profits remain positive (mostly as a consequence of the interest income derived from intra-group financing). What statistical data available showed may not be the actual level of profits repatriated by MNEs.

A category of intra-group transactions carried out by MNEs in host countries may only aim at affecting the accounting and tax position of the local FDI entity (profits are repatriated if such transactions are carried out other than at arm's length). Services renderings (especially management, consultancy, administration), royalty payments, but also transactions involving tangible goods are carried out at financial and commercial conditions imposed by MNEs. Transfer pricing regulations do not have nor intend to have the power to constraint the MNEs on how to use their profits (reinvestment versus repatriation), however, such rules try to assure that the appropriate amount of tax is collected in Romania in relation to MNEs host country operations.

Romanian tax authorities increased focus on transfer pricing matters has conducted to transfer pricing adjustments in 2010 of EUR 8.5m, while the single highest adjustment performed by the tax authorities in 2011 amounted to as much as EUR 30m. The collected tax further to transfer pricing audits is likely to further increase in the future. Transfer pricing regulations are one of host countries means of reducing the apparent disproportionate advantages derived by MNEs further to carrying out FDI.

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