

THE NEED OF TRANSFER PRICING RULES IN MINIMIZING THE TAX AVOIDANCE PHENOMENON

Marius-Sorin CIUBOTARIU

*Stefan cel Mare University of Suceava, 720229, Romania
marius.ciubotariu@usm.ro*

Corina PETRESCU

*Stefan cel Mare University of Suceava, 720229, Romania
corina_petrescu23@yahoo.com*

Abstract

The transfer pricing mechanism became one of the top international issues in the tax matter, being one of the most used practices for tax avoidance by the multinational companies, raising many debates on the motives that stay behind this practice and on the possibilities of making it an efficient tool for the governmental authorities to limit the results manipulation and the profit shifting phenomenon. Being a matter of huge interest for a vast category of subjects, it became a constant concern in the academic, professional and legislative environment, concerns whose results can be seen today in the existing strategies, methods, procedures and regulation developed for a better management of this domain, aspects that this paper aims to identify and analyze, in order to have a better understanding of the multinational companies behaviour and on their legal obligations and responsibilities related to the transfer pricing matter.

Key words: *transfer pricing; tax avoidance; multinational companies*

JEL classification: *F23, M16*

I. INTRODUCTION

In the current context of globalization and open borders transactions, the multinational companies have a significant role and impact in the international business environment, their activity being in a constant territorial expansion and development, creating this way new value that contributes to the well-being of the entire society, through their implication in the social, environmental and economic matters. The multinational companies can be seen as very important actors in the international market, considering the significant contribution to the world's Gross Domestic Product (GDP), that was estimated to 32% in 2016 (Backer, Miroudot & Rigo, 2019), many of their transactions being registered within the group – over a third of world's trade, that will make around 7-9 trillion dollars in 2018 (Shaxson, 2019). This context facilitates the manifestation of illicit transfer pricing practices, many of the trading subjects within the group being intangible assets (UNCTAD, 2018), difficult to evaluate and quantify, generating the ironic situation mentioned by Bhat (2009), namely that in a free market economy, a significant part of the world's trade is not governed by prices set by the market, but by some individual financial interests to maximize their profits on the one hand and to pay as little tax as possible on the other hand. Therefore, in the context of these conflicting interests, the multinationals intervene to manipulate their results through different methods, but the authorities are not passive in this situation either, coming up with a set of requests and rules that can keep under a better control the multinationals' initiatives and intentions of avoiding taxes through the manipulation of their financial results.

II. MOTIVES BEHIND THE MULTINATIONALS' ILLICIT BEHAVIOR REGARDING TRANSFER PRICES

As we already mentioned before, the multinational companies are interested in maximizing their profits and in the same time in paying as little income tax as possible and that could sound pretty legitimate, but the means and instruments used to achieve this goal are illicit, immoral and unethical, because they exploit the gaps of the existing legal framework, shifting their profits in tax havens characterized by a very low or a non-existent level of taxation (Ciubotariu & Petrescu, 2020). This context encourages the manifestation of tax evasion phenomenon that are defined as deliberately actions to break the law in order to obtain financial benefits that lead to the

deprivation of the general state budget (Timofte, Socoliuc & Grosu, 2019) and therefore of the citizens. There are many voices who call for more transparency and social oriented behavior from multinational companies that risk suffering a reputational damage in the face of an “emerging ethical logic” (Rogers & Oats, 2021) if they don’t move to action. Generally speaking, although maximizing profits and paying little tax is the interest of any other domestic company, the impact of multinationals’ actions in terms of tax avoidance, tax minimization and tax evasion it’s huge compared to the impact of a domestic company that is struggling to face market demands and competitiveness, considering the significant differences regarding the territorial distribution and diversification of their activity, the financial resources invested in research and development (R&D), the knowledge and the abilities of the human capital, the levels of income and expenses and the list can go on. As there is a saying that with great power comes great responsibility, the expectations and the requirements from a multinational company are higher than from a domestic company, because their actions would create a global impact. Of course, none of this should be considered as an excuse for illicit and unethical behavior from domestic companies, but we just wanted to highlight the position of the multinational companies and the importance of their actions.

Therefore, if the multinational companies have so much responsibility on their shoulders, why do they chose to act “irresponsible” in certain circumstances towards the society they live in and towards the rules of ethical conduct? Besides the interest of not paying too much tax, certainly other motives determine multinational companies to use the transfer pricing mechanism in an illicit way for shifting their profits from high tax jurisdictions to low or zero tax jurisdictions, through mispricing of the intra-group transactions: under-invoicing or over-invoicing depending on their interests. In their paper, Lin & Chang (2010) classify these transfer prines motives in two groups, namely internal and external as can be seen in the Figure 1 below.

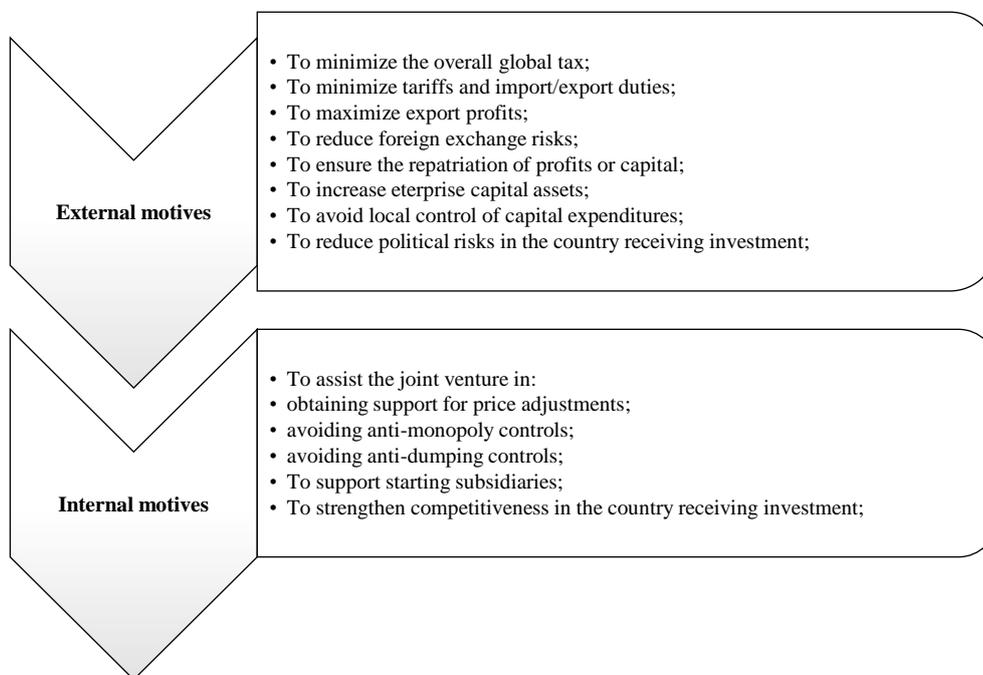


Figure 1 – Motives of practicing transfer pricing manipulation by multinationals

Source: adapted according to Lin & Chang (2010, p.9)

As we can see, there is much planning and strategy behind the mentioned motives, all of them being oriented to the well-being and smooth development of the companies, but almost with complete ignorance of the interests of the other involved parties. Looking at the Sebele-Mpofu, Mashiri & Schwartz (2021) work, we can see that even after eleven years of research, some of the motives still stand at the basis of multinational companies’ actions of results manipulation through unethical transfer pricing, fact that strengthens and highlights their relevance and importance. In the mentioned paper, they also classified these motives in two categories, but differently grouped: the efficiency and the government induced motives and the tax induced motives.

In the first category, regarding the internal efficiency, the following motives can be found: desire to balance incentives, keeping track of the intra-group activities in order to obtain goal congruence, evaluating the performance of profit centers, avoiding or minimizing disputes due to transfers among affiliated companies and achieving a common goal of group profit maximization. Regarding the governmental induced motives, we can find those related to political, exchange, currency and policy risks, as well as those related to regulations regarding the repatriation mechanism, incentives and tax holidays that can be a good motive for transfer pricing manipulation, considering the fact that it means that in a certain period of time, the multinationals would pay tax

only if they reach a certain value threshold of profit. Regarding the second category of motives – tax induced – it is clear that the interests are to avoid or to minimize the tax payments, fact that influences the practiced transfer pricing policies, as we can see in the Table 1 below.

Table 1. Examples of transfer pricing decisions induced by tax motives

Matter	Parent company in low tax jurisdiction	Subsidiary in high tax jurisdiction
Loan/debt financing	provide the debt loan	pay interest for the loan, considering its deductibility at the calculation of profits
Intellectual property right	be the holder of the intellectual property right	pay royalties
Technical knowledge	provide technical expertise	pay technical fees
Management services	provide management services	pay management fees
Brand name	be the owner or holder of the brand name	pay license fees
Cash holding	holding high cash balances	hold low cash balances
Dividends repatriation		retain the profits and use the for refinancing

Source: Sebele-Mpofu, Mashiri & Schwartz (2021, p.8)

As can be seen, many types of activities or services can be subject to transfer pricing procedures and these can be manipulated in such a way that the subsidiary located in a high tax jurisdiction does not record high profits and therefore, does not pay a high amount of taxes, fact that is unjust and unethical towards the society in which it operates.

Analyzing all the mentioned motives that stay behind the transfer pricing manipulation, we can say that the companies are pursuing their interests and objectives, but when these are contradictory to the existing norms and regulations, there must be some legal consequences able of discouraging this type of behavior and of course that the authorities took measures able to tackle this type of situations.

III. TRANSFER PRICING DOCUMENTATION OBLIGATIONS

As we already know, the transfer prices represent a very important mechanism for the transactions between affiliated parties because of their impact on many aspects of a company’s life, such as cash flow, performance indicators results, investment decisions, the amount of paid income tax and the list can go on. Because of their significant importance for a large number of subjects, the authorities issued a number of rules and requirements that could manage this matter. Therefore, in the case that the company is the subject of an audit mission, it has to make available a solid documentation for the auditors’ team that could certify the correctness of the practiced transfer pricing policies or their adherence to the arm’s length principle (ALP) stipulations, in order to avoid a possible adjustment that could mean additional costs and resources.

In order to help the multinational companies to prepare the transfer pricing documentation, an *OECD Transfer Pricing Guidelines* was issued in 1995 for the first time and numerous states adopted its provisions until the present. Over time though, the national systems and requirements regarding the transfer pricing documentation have changed and have multiplied and the compliance to those norms became more difficult for multinationals, this being the reason of various measures taken in order to increase the level of global coordination an uniformity, one of the most important being the *BEPS Action Plan* issued in 2015 (OECD, 2015).

The BEPS Action 13 Report identifies three main objectives of the transfer pricing documentation requirements that should stay at the basis of the domestic regulation design (OECD, 2015):

- to give the assurance that the contributors give an appropriate consideration to the requirements regarding the transfer pricing, the other trading conditions between affiliated parties and also to the reporting of the resulted income from these transactions;
- to provide the tax administrations the required information for a just and evaluation of the transfer pricing risks;
- to provide the tax administrations with the necessary information in order for them to proceed in conducting an appropriate audit of the transfer pricing practices.

From the above-mentioned information, we can appreciate that the main role of the transfer pricing documentation is to give appropriate and reliable information to every interested user, especially to the tax authorities, because on their basis, they can conclude whether the legal requirements have been met. In addition, the Organisation for Economic Co-operation and Development (OECD) identified a standardized three-tiered approach of the transfer pricing documentation as can be seen in the Figure 2 below:

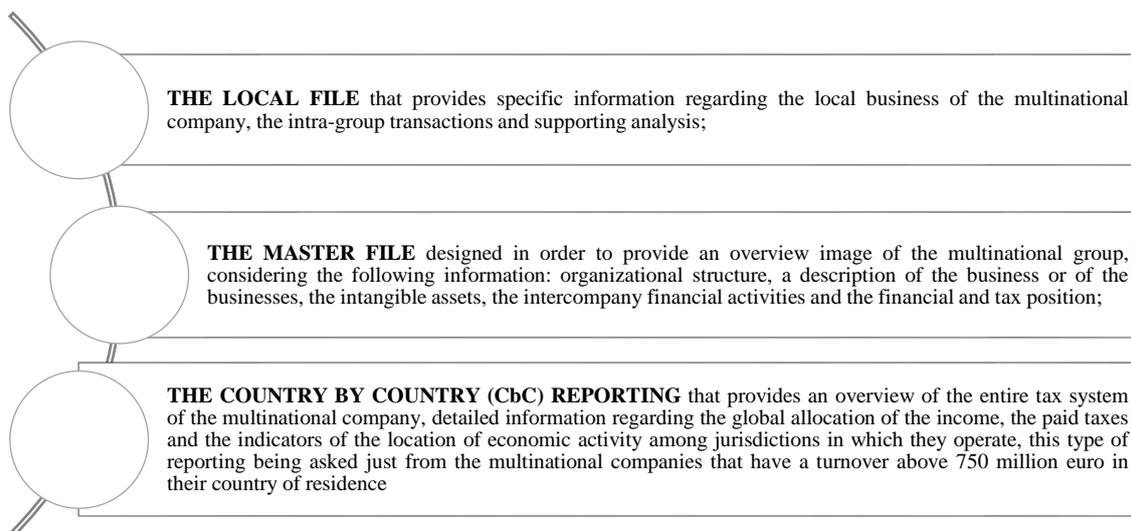


Figure 2 – The three-tiered approach of the transfer pricing documentation

Source: https://www.aldersound.fi/wp-content/uploads/oecd_g20_documentationmemorandum_oct2015.pdf

The local and master file is normally submitted or kept by local taxpayers to their domestic administration and the CbC report is filed by the parent company in its country of residence (Cooper, Fox, Loeprick & Mohindra, 2016). All of these reports, regulated in the national legal framework of many countries that wish to fight against profit shifting and results' manipulation phenomenon, have a significant role in helping the tax authorities to identify and to manage the illicit activities of multinationals regarding tax evasion, tax minimization or tax avoidance, which means that there are important steps made ahead towards a more equitable society.

In Beebeejaun's (2019) paper, there are listed some benefits of a proper transfer pricing regime as it follows:

- helps the global fight against tax evasion;
- curbs illicit flows of capital, considering that there is a greater scrutiny and monitoring of international transactions that can help in the detection and prevention of money laundering activities;
- increases certainty of investors regarding the treatment of related parties transactions, thereby it reduces their financial risks;
- fair competition through the arm's length principle that ensures equitable treatment of domestic and foreign investors;
- protects local enterprises from unjustified transfer pricing adjustments by other countries.

We can see that there are benefits for many parties that are involved in the economic life of the society such as investors, domestic companies, international companies, tax authorities and implicitly the citizens who will benefit of public goods and services that would be available only because of a productive investment of the collected income from taxes. Therefore, we can appreciate that the transfer pricing rules are effective and helpful in creating a more safe, fair and ethic business environment for all. In a previous work of his, Beebeejaun (2018) highlights the results of a study conducted in 2013 by Lohse & Riedel (2013) on the transfer pricing regulations of 26 European countries and on the existing evidence of profit shifting in that countries, results that support those benefits mentioned above, these being the main conclusions of the study:

- transfer pricing legislations reduce profit or income shifting;
- the implementation of transfer pricing documentation is found to reduce profit shifting behavior by around 50% on average;
- transfer pricing penalties are likely to exert a limiting effect on shifting behaviors.

Considering that these results were obtained in 2013, then even more now - when the regulations, standards and legislation have been improved and updated to the current needs of our society – the existing transfer pricing norms and requirements should have a huge impact on the illicit behavior of multinationals in the sense of decreasing it, which means that we are slowly learning how to better manage this conflict of interests situation: the multinationals wanting to pay as little tax as possible and the tax authorities wanting to collect the fair amount of tax from the contributors.

Even though the preparation of the transfer pricing documentation is costly for companies - their prices could reach some thousands of euro for relatively small companies that have little interaction with affiliated parties, or several tens of thousands of euro for the companies with really complex and diverse business relations with affiliated parties (Transfer Pricing Services, 2020) – it is a legal obligation and ignoring it will bring the appropriate sanctions. However, the companies should not consider this request as a burden, but they should be aware that through this documentation, their own business and activity would be more organized and operational and the

internal communication process would be simplified, decreasing this way other costs. Therefore, the transfer pricing documentation does not benefit only the tax authorities or the governments, but those who prepare them too, giving them a better insight on their business that will help them in the decision-making and planning process.

There are voices that say that the fight against results manipulation, tax evasion and tax avoidance would be more efficient and productive if the ALP - the basic principle of the regulated transfer pricing mechanism that provides that the headquarters and the affiliates of a multinational company have to be treated as separate entities rather than as inseparable parts of a single unified business, where the internal transfer prices have to consider the market price that would have been obtained in an independent comparable transaction (Choi, Furusawa & Ishikawa, 2020) – would no longer be applied. Instead of considering the same group companies as separate entities for tax purposes, there should be adopted a unitary taxation system for the whole group and the resulting taxes should be distributed across countries on the basis of a “formulary apportionment” which would distribute the taxes according to some indicators, such as total sales, employment or physical assets (UNCTAD, 2020). This would mean that the multinationals would not be interested anymore in shifting their income or profit from a jurisdiction to another, because their tax obligations will be allocated according to the real economic performance of every subsidiary and its indicators would be more difficult to manipulate. Because intra-group transactions would not affect the measure of domestic profits, there would be no need for transfer-pricing rules for intra-group transactions, which would remove a major source of dispute between corporations and tax authorities (Tax Policy Center, 2020). Of course there are many other advantages and disadvantages of this initiative, but this would mean a huge revolution of the global tax system, because this would need the implication and the effort of every country in creating and applying a unitary tax mechanism for multinationals, because an unilateral initiative would not be able work, but to create more difficulties in the international tax matter cooperation.

IV. CONCLUSION

After going through all the information presented in this paper work, I think we can appreciate that on the one hand, we have a better understanding on the multinational companies' behavior, on their motives, objectives and strategies regarding the tax evasion, tax avoidance or tax minimization. On the other hand, we have seen how the authorities took action and didn't put this huge problem aside, but worked to find solutions, methods, procedures and requirements that were efficient and able to reduce in a pretty significant measure the monetary losses generated by the illicit activities of the multinationals who do nothing but taking advantage of the existing loopholes and misinterpretations of the guidelines or legal framework. The growing interest of the tax authorities regarding the transfer prices matter is confirmed by the multitude of resources dedicated to this domain and through the numerous public debates regarding the tax structures of the multinational companies (Ciubotariu & Petrescu, 2020). Therefore, we can say that our objective is achieved, considering the extra knowledge that was offered to every reader, through a detailed approach of the established research topics.

There is a long and difficult journey ahead that needs more and more implication on international level of every country and every tax authority in order to create and obtain a maximum minimization of the profit shifting and results manipulation phenomenon, as well as of any fraudulent activity in tax matter, fact that is quite difficult considering that besides the international agenda on diminishing tax fraud - that everyone approves - every country has its national interests, strategies and policies that are difficult to be left behind for the sake of the global community. Looking in the future, we can be certain that there will be found better solutions and answers for today's problems and questions, but we must not forget that every one of us is responsible for the day of tomorrow.

REFERENCES

1. Backer, K., Miroudot, S. & Rigo, D. (2019). Multinational enterprises in the global economy: heavily discussed, hardly measured, VOX. Retrieved December 2, 2020 from <https://voxeu.org/article/multinational-enterprises-global-economy>
2. Beebejaun, A. (2018). The efficiency of transfer pricing rules as a corrective mechanism of income tax avoidance. *Journal of Civil and Legal Sciences*, 7(237), 2169-0170. doi: 10.4172/2169-0170.1000237
3. Beebejaun, A., (2019). The fight against the international transfer pricing abuses: a recommendation for Mauritius, *International Journal of Law and Management*, 61(1), 205-231. <https://doi.org/10.1108/IJLMA-05-2018-0083>
4. Bhat, G. (2009). Transfer pricing, tax havens and global governance, German Development Institute. Retrieved December 2, 2020 from https://www.die-gdi.de/uploads/media/DP_7.2009_01.pdf
5. Choi, J. P., Furusawa, T., & Ishikawa, J. (2020). Transfer pricing regulation and tax competition. *Journal of International Economics*, 127, 103367. doi: 10.1016/j.jinteco.2020.103367
6. Ciubotariu, M.S. & Petrescu, C. (2020). Base erosion and profit shifting – an overview, *European Journal of Accounting, Finance & Business*, 13(23). Retrieved December 2, 2020 from <http://www.accounting-management.ro/index.php?pag=showcontent&issue=23&year=2020>
7. Ciubotariu, M.S. & Petrescu, C. (2020). The influence of BEPS Actions on the legal framework and practices regarding the transfer prices in Romania, dissertation, Ștefan cel Mare University of Suceava, Romania.

8. Cooper, J., Fox, R., Loeprick, J. & Mohindra, K. (2016). Transfer pricing and developing economies. A handbook for policy makers and practitioners, World Bank Group, Washington. doi: 10.1596/978-1-4648-0969-9
9. Lin, C., W. & Chang, H.C., (2010). Motives of transfer pricing strategies: systemic analysis, *Industrial Management and Data Systems*, 110(8), 1215-1233. <https://doi.org/10.1108/02635571011077843>
10. Lohse, T. & Riedel, N. (2013). Do transfer pricing laws limit international income shifting? Evidence from European multinationals, CESifo Working Papers. Retrieved December 21, 2020 from <https://www.econstor.eu/handle/10419/84180>
11. OECD (2015). Practical toolkit to support the successful implementation by developing countries of effective transfer pricing documentation requirements. Retrieved December 20, 2020 from https://www.imf.org/external/np/EXR/key/pdf/EN_draft-toolkit-transfer-pricing-documentation-platform-for-collaboration-on-tax.pdf
12. OECD, (2015). Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report. Retrieved December 12, 2020 from https://read.oecd-ilibrary.org/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en#page14
13. OECD/G20 Base Erosion and Profit Shifting (2015). Three-tiered approach to transfer pricing documentation. Retrieved December 2, 2020 from https://www.aldersound.fi/wp-content/uploads/oecd_g20_documentationmemorandum_oct2015.pdf
14. Rogers, H. & Oats, L. (2021). Transfer pricing: changing views in changing times, *Accounting Forum*, 1926778. Retrieved November 20, 2020 from <https://www.tandfonline.com/doi/full/10.1080/01559982.2021.1926778>
15. Sebele-Mpofu, F., Mashiri, E. & Schwartz, S.C. (2021). An exposition of transfer pricing motives, strategies and their implementation in tax avoidance by MNEs in developing countries, *Cogent Business & Management*, 8, 1944007. doi: 10.1080/23311975.2021.1944007
16. Shaxson, N. (2019). Over a third of world trade happens inside multinational corporations, Tax Justice Network. Retrieved 6 November, 2020 from <https://taxjustice.net/2019/04/09/over-a-third-or-more-of-world-trade-happens-inside-multinational-corporations/>
17. Tax Policy Center (2020). Briefing Book. A citizen’s guide to the fascinating (though often complex) elements of the US tax system. How would formulary apportionment work? Retrieved 6 November, 2020 from <https://www.taxpolicycenter.org/briefing-book/how-would-formulary-apportionment-work>;
18. Timofte, C., Socoliuc, M. & Grosu, V. (2019). Measuring tax evasion. Conceptual approaches. *The USV Annals of Economics and Public Administration*, 19, 1(29). Retrieved 16 November, 2020 from <http://www.annals.seap.usv.ro/index.php/annals/article/view/1149/959>
19. Transfer Pricing Services (2020). Cost of making transfer pricing file. Retrieved 16 November, 2020 from <https://www.transferpricing.ro/en/i-need-the-transfer-pricing-file/cost-of-making-a-transfer-pricing-file>
20. UNCTAD (2018). Trade and Development Report 2018. Power, platforms and the free trade delusion, United Nations Publications. Retrieved 16 November, 2020 from https://unctad.org/system/files/official-document/tdr2018_en.pdf
21. UNCTAD (2020). Trade and Development Report 2020. From global pandemic to prosperity for all: avoiding another lost decade, Retrieved 16 November, 2020 from https://unctad.org/system/files/official-document/tdr2020_en.pdf