AN APPROACH ON LINKS BETWEEN TRANSFER PRICING AND TAX HAVENS

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ABSTRACT: Transfer pricing are the prices at which a company transfers physical goods and intangible property or provides services to affiliated companies. Transfer pricing mechanism is the most frequently used instrument for the transfer of the tax base from countries with high tax to low tax countries. In the context of transfer pricing, all transactions should be made only respecting the principle of market value (Arm’s length principle). Under current conditions, we can say that globalization influences the transfer pricing, because it makes possible to transfer profits from one country to another, by removing state barriers. The expression “transfer pricing” is used as shorthand for multinational corporations to store profits in tax havens and to avoid tax evasion in developed countries. These two terms (transfer pricing and tax havens) combined, make the benefits of affiliated groups to grow impressively.

KEY WORDS: Transfer pricing, “arm’s length” principle, transfer pricing file, economic globalization, tax haven, “offshore”.


1. INTRODUCTION

The transfer pricing issue is extremely complex. These appeared in a context where groups of companies present in several countries (multinational companies) preform economic activities in those countries. We can say that in current context of business internationalization and globalization, the transfer pricing raise the fiscal authorities’ interest and represent the main area investigated by them within fiscal control.

The main purpose of this article is to briefly introduce the most important aspects of transfer pricing and to answer the following questions: what transfer pricing is and that is their connection with tax havens?

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2. TRANSFER PRICING AND ECONOMIC GLOBALIZATION

Transfer pricing is a commercial reality and represents the prices at which goods or services are sold or bought, noting that both the seller and buyer are controlled by the same entity or by shared entities.

The main inter-companies transaction types involve: goods sale, services provision (for example, a central IT group provides support services worldwide), transfer or sale of tangible or intangible assets (for example, selling or licensing technology) and intercompany finance (e.g. a loan among companies, guarantee fees, factoring).

Establishing transfer pricing is also a problem for global operations that involve running some actions with costumers (including marketing, price setting and risk management activities) related to a particular financial product or a financial product line, in several tax jurisdiction and/or via several participants.

Most of the countries, ask multinational enterprises to demonstrate that their inter-companies transactions are in accordance with the market value principle or respect the “arm’s length principle”. Their primary concern is whether, taxable persons that operate in a certain country achieve a fair income.

Transfer pricing is an international fiscal problem, so that OECD directives (Organization Guidelines for Economic Cooperation and Development) have established “arm’s leg” as the basic principle of transfer pricing. This principle implies the following situation: when two close people (affiliates) meet, there is the natural tendency for them to hug each other. The theory requires that the relationship between these people be the same as between two strangers (independents) that shake hands. When they conclude a transaction, and so they remain at an arm’s length (Arm’s Length Principle – ALP Eng).

In order to explain better this principle, we are given the following example: If two companies, who have had commercial links, conclude a transaction, it will generally have as result a market price. This is known as “arm’s length” transaction, because it represents the real negotiation product in a market. The arm’s length price is usually considered to be acceptable for tax purposes. But, when two companies have commercial links, they may wish to artificially distort the real price at which the transaction is registered, in order to minimize the total tax bill. This could, for example, to help registering the profit in a tax haven with low or zero tax.

Preparing the transfer pricing documentation should no longer be considered just as a compliance exercise, but should become an inherent part of the fiscal risk management strategy of the group. The transfer pricing file represents a requirement of documentation imposed on entities, individual or legal entity, that come into commercial and financial links with other individuals or affiliated legal entities. A good file should contain the information required by legislation in force, included in the ANAF ORDER 222/2008 (Official Monitor, no. 129/2008). It is important mentioning that transfer pricing legislation in Romania is heavily influenced by the regulations issued by two extremely important organizations: OECD and the European Commission via the Joint Transfer Pricing Forum of the European Union (EU Joint Transfer Pricing Forum). Thus, the national legislation on transfer pricing

In Romania, the law penalizes the circumstances when files are not presented or are incomplete. Each taxpayer is required to do a pricing file, because via these regulations, tax legislation ensures that:

a) receives the information they need to run a proper risk assessment on transfer pricing, respectively a tax audit on transfer pricing.

b) the tax payer has given adequate attention on regulation concerning the transfer pricing determination method and has reported revenues from transitions with affiliated party.

If the taxpayer refuses to provide the transfer pricing file or gives incomplete information, the taxpayer bears a fine imposed for file failure. The transfer pricing file audit can be initiated by selecting taxpayers by various criteria such as: significant transaction with affiliates; significant, recurrent loss; nonpayment or incomplete payment of tax liabilities; taxpayer behavior: appropriate or inappropriate. The document is also a way of fiscal protection. Each company knows the assumed risks and the assets used within the group, so that can argue that affiliates have sense and economical content and were conducted at the market price. This is the taxpayer defend for the tax inspector, and for the pricing adjustments and it should be updated whenever changes occur.

The methods used to determine the pricing transfer establish whether the conditions required in commercial or financial links between affiliated companies are in accordance with the principle of market value. CTN has the freedom to choose their own method that will not be contested by fiscal authorities. We could say that choosing a method could be hard, and initially various methods should be considered, in order to fulfill the condition that the best estimate of a price at the market value of the asset is provided.

“When establishing the method for right transfer pricing, one should consider several factors which include the individual circumstances of the case, transaction type, contractual terms, the market and industry conditions in which the company operates, the precision degree of making adjustments in order to obtain the best comparability, and last but not least, the analysis of functional profile and risk analysis of the companies involved in the analyzed transaction” (Adrian Rus, Department Manager of Tax Assistance of Ernst & Young, available at http://www.startups.ro/analize/ce-sunt-si-cum-utilizezi-preturile-de-transfer).

The transfer pricing problem is complex both for fiscal authorities and multinational companies, being the most important fiscal problem at present for them.

Because of the economy globalization and the desire of most taxpayers to reduce the tax burdens, states now take measures to protect the tax collections and especially measures to avoid outsourcing tax base of contributions to affiliate entities to obtain a more favorable tax regime.

The current economic globalization has brought not only benefits, but some side effects, less auspicious, such as, for example the phenomenon of internalization of
economic crimes. Practically, “globalization can be assimilated as the transfer pricing reason of existing” (Pătroi, et al., 2013, pp.5-7).

As a summary, we can say that “transfer pricing are important, because if there is a change of them, this will have effects both on the allocation of profits in a multinational company, and on the evolution of other taxes in the residence country. The tax authorities pay more attention in what concerns the transfer prices, because their trading is an important part of the tax basis for companies” (Press Release: OECD Publication - Ghidul preturilor de transfer, Camelia Dobre [online]- available at - http://www.startups.ro/analize/ce-sunt-si-cum-utilizezi-preturile-de-transfer).

3. HOW TO USE TAX HAVENS, BASED ON PRACTICING TRANSFER PRICING

Transfer pricing is one of the most important issues of national and international taxation. In Romania, the concept of transfer pricing was first mention in the Tax Code of 1994. But not until 2000 was developed the necessary legislation to ensure the application of the arm’s length standards in transactions between affiliated parts (Pricewaterhouse Coopers, 2005), and the Law no. 571/2003 regarding the Fiscal code defines related parties.

In what concerns the “tax haven” term, it refers to those jurisdictions where tax burden is very low or nonexistent. In the same time, both in the scientific literature and in practice, the tax havens are also called “tax shelters” because of the advantages they offer. Their attractiveness lies not only on the fiscal reasons, but is optimized by the secrecy and confidentiality of the operations developed, the existing infrastructure or the political and social stability.

According to a statement released on 11 December 2012 by the European Commission, “almost 1 trillion euros is annually lost due to tax evasion in the European Union”, says Algirdas Šemeta, European Commissioner for taxes. Lee Sheppard said that “transfer pricing is the edge for the irregularities in the international tax system” (Lee Sheppard, 2012). Starting with the definition given by Lee Sheppard, this article shows how transfer pricing can be used by multinational companies to maximize their profits via tax evasion in order to obtain tax cuts. Considering these details, I want to emphasize the connection between transfer pricing and tax havens because I believe that these transfer pricing are used as “a smokescreen” that allows developed countries to avoid fiscal evasion.

Some experts consider that the association of tax havens and tax fraud is a bit forced, as long as the utilization of the advantages given by tax havens is not properly sanctioned. These tax havens “attract like a magnet” the financial resources of affiliate groups, leading to economic crime internationalization, acting with an apparent tempt of legality. This “form of legality” started to come out lately, as a result of investigations initiated by special committees.

Transfer pricing represent the prices at which transactions occur between companies of the same group and are frequently used by large companies for “fiscal optimization”, favoring certain subsidiaries, namely those from countries with softer tax regime. It is also known that transfer prices are seen as a legitimate business
opportunity for transnational corporations, and are often used for financial distort and to avoid taxation. More than ever, all over the globe, companies seek to proactively attenuate the associated risks with the transfer prices- reducing the risk of a faulty audit or preventing a double or triple taxation, the result of implementing a wrong strategy.

Transfer prices intervene whenever two companies belonging to the same multinational group makes transactions: for example, when an American subsidiary of Coca-Cola buys something from a French subsidiary, associated with Coca-Cola, parties establish a price for the transactions- this is the way of establish transfer pricing.

Establishing transfer pricing is not in itself illegal or abusive. The mispricing of the transfer value, also known as transfer pricing manipulation or abusive transfer pricing, is illegal or abusive. Transfer pricing are usually investigated as part of the ordinary tax audit. It is also well known that multinational companies can work against national interest and the damage resulting from the prevailing approach of the arm’s length principle was and still is, substantial. Governments around the world are systematically impeded in their ability to collect incomes from corporate tax systems.

If comparability differences are found, the taxpayer cannot adequately explain such differences, and is concluded that transfer prices are not established at arm’s length, and the tax authority is entitled to adjust the amount of incomes and expenses, so the market value to be revealed. Currently that provision is applied both to internal transactions and cross-border ones (ANAF, 2014).

Newspapers use the term “transfer pricing” as a shorthand for multinational corporations that store their profits in „tax havens” to avoid tax evasion in developed countries. Specialists in taxation fields are bothered by this characterization, arguing that transfer prices are a neutral expression to describe the process by which profits are distributed between different jurisdictions.

The financial accounting ignores affiliates and treats the corporatist group as a single entity. Multinationals report big profits registered in tax havens such as the Cayman Islands, Luxembourg, Switzerland and Ireland. However some incomes are not taxed anywhere. Americans call this “incomes from nowhere”, while Europeans call it “white income”.

In order to combat tax evasion, the authorities propose several measures (Pătroi, et al., 2013, pp. 119-122):

1. removing the interpretable tax practices – this measure determined the representatives of major economies to put pressure on the OECD to emit a report outlining the cause and nature of the tax base erosion, which has happened with the publication of the erosion of the tax base report and profit move on 12 February 2013 (OECD, 2013);
2. strengthening rules for foreign companies controlled by residents- analysis and development of current rules on the control of affiliates is recommended;
3. combating damaging fiscal practices by enhancing transparency and the economic substance- it reiterates the conclusions of the OCED report in 1998, on the preferential regimes in that lox taxing in certain jurisdictions will not help long term any estate, because in the end, the other jurisdictions will reduce charges and all estates will lose;
4. abuse prevention by conventions of avoiding double taxation - is necessary the development of the current legislative framework, so that is takes into account the situations where member countries are interposed between bilateral relations regulated by convention of double taxation avoidance;

5. transfer pricing analysis regarding intangible assets, capital risks and other transactions with risks, measure that takes into account the value creation chain, within groups of companies, which are proposed to implement rules that prevent unjustified fiscal optimization by transferring them in low tax jurisdictions;

6. review the transfer pricing documentation – the lack of multinational companies’ transparency makes it difficult for tax authorities to check the transfer pricing policies. These companies will have the obligation to transmit to all tax authorities’ information about global allocation of the income, economical developed activities and the international paid taxes.

Fiscal motivations are a determined factor in the use of tax havens (Pătroi, 2007, pp. 152-153), and they vary from perfectly legal to the fraudulent ones, considered real financial engineering, among these are:

- “tax planning” transactions, preformed in compliance with legal fiscal stipulations, specific for transport and naval industry and for the sales through subsidiaries in tax havens that do not affect related parties.
- “tax avoidance” transactions, which are situated at the edge of legality and skillfully exploits, with maximum effectiveness, some legislative gaps and administrative inconsistencies. In this type of transactions an aggressive mechanism of transfer pricing is performed. They can be found under the form of using investment companies in construction field and services field.
- “double trusts” transactions that involve tax fraud and are performed without respecting the law, there’s no doubt about this. In this category is included the covering of some strategies to avoid paying taxes and masking suspect commercial transactions, in order to hide that transactions about which are claimed to cause losses, in fact never actually occurred. The fraudulent use of tax havens by these type of transactions is done by creating some sales companies, which are structured to look like they have connections only with separated parts, although in reality is exactly the opposite, those being managed and led by the same group of interests.

Factors influencing the decision of establishment in a certain tax haven fall into three broad categories:

- general factors which generally refer to the legal protection offered by tax haven, the existing consensus and political stability, the social situations and the lack of social convulsions etc.
- particular factors, which take into account the residence of individuals and legal entities, the tax havens accessibility from a geographical point of view and the links with the external, the living costs and establishing operations.
- specific factors, with a very large margin of variability, depending on the purpose of the future user of the tax haven.
It should be noted that there isn’t a system of quantitative and qualitative ranking of tax havens, universally valid. A certain tax haven becomes “optimal” in relation with the quality and the purpose that the user pursues.

But lately, the term “tax haven” turned more into the pretentious “financial offshore center”. The rise of the offshore industry is due to the offshore companies that want to minimize their risks, regardless of their nature. The term “offshore” refers to jurisdictions that offer many tax advantages to companies registered into those jurisdictions (UNCTAD, 2001).

Thus, we could define the “financial offshore center” as representing “states where most of financial transactions conducted by institutions located in their territory are managed for benefits on clients’ residents in other states” (Bișa, p. 35). A common feature of practicing tax havens cases refers to the difference between tax rate of the profit obtained in the residence country of the parent company and the existing tax levels in the countries where the other members of the group are registered, the profits migrating to countries where the least taxed are. Since transfer pricing and tax havens are combined, the resulting benefit increases impressively.

Tackling the problems created by corroborating transfer pricing with tax havens raises a greater obstacle: the cooperation between the source- country and the residence country. In practice there have been highlighted several methods to transfer the profits using both tax havens and transfer pricing.

Methods of the profits’ transfer: the mechanism of converting debts into shares; rate interest mechanism; service delivery mechanism; dividends mechanism and the royalty mechanism.

As a summary, we can say that “pricing is the point terminus of ingenuity in matters of exploitation of tax legislation” (Cuciureanu, et al., 2013, p. 5), because is the link between the existing tax regulations of different national markets, and “a group that uses tax havens can make its subsidiary to be paid high transfer prices, which is situated in a country with normal tax system, increasing its profits in tax havens and decreasing them in countries with normal tax system” (Brémont & Gélédan, 1993, p.277).

4. CONCLUSION

The issue of transfer pricing is complex both for tax authorities and for multinational companies, being the most important fiscal problem they face at present. These are carefully monitored, because their trading is an important part of tax base for companies. Transfer pricing are seen as shorthand for multinational corporations store the profits in tax havens to avoid tax evasion in developed countries.

In the current context of economic and financial global crisis, were the capitalization need grows, the process of “delocalization” of cash resource, generated precisely by transfer pricing mechanism, gets new valence.

The link between transfer pricing and tax havens consists in determining if the price is somehow too small or too big, so to be moved to a “more friendly” jurisdiction.

As a consequence of the above mentioned information, we can conclude that the favors enjoyed by tax havens are not only the result of a tax absence or a poor tax, the
non-tax advantages are equally significant, and the combination of tax havens with transfer pricing makes their users benefits to grow impressively.

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