PROBLEMS ARISING FROM TRANSFER PRICING

[*]Mensur Nuredin, [**]Nazife Yakupova, page 31-42

March, 2017; 2 (1)

ABSTRACT

We live in a time of fast technical-technological development and application of automatic data processing. The technological development of people offers a variety of opportunities for development and innovation. More precisely, we can say that we live in an era of information characterized by mass communication between people, states and companies. This development, especially with the emergence of e-commerce, has contributed to a large number of multinational companies that have the flexibility to market their businesses and activities anywhere in the world.

Today, much of the global trade consists of international transfers of goods, services, capital and intangible assets (intellectual property) that take place within a multinational company group. Just when these intra-company transactions or transfers take place, occurs the phenomenon of transfer pricing.

The "transfer pricing" in the literature is presented as a technique for the most favorable distribution of revenues and expenditures between subsidiaries, branches and joint ventures within a group of interconnected entities. The subsidiaries and branches of multinationals have the ability to manipulate their intra-company transaction accounts. That is, they can perform these transactions for a higher or lower price than the determined market price. Therefore, this study analyzes the basic problems that arise due to transfer pricing and after the problem is identified, the proposed and used solutions will be considered.

Keywords: Transfer pricing, Tax evasion, Arm's Length Principle

[*]Assoc. Prof. Mensur Nuredin, PhD
International Vision University, Faculty of Law, Republic of Macedonia,
e-mail:
mensur@viziyon.edu.mk
[**]Nazife Yakupova, LL.B
International Vision University, Faculty of Law, Republic of Macedonia,
e-mail:
nazife.yakup@viziyon.edu.mk

Article type:
1.02 General scientific articles

UDK: 336.221:338516.46

Date of received:
Novembar 22, 2016

Date of acceptance:
February 12, 2017

Declaration of interest:
M.N., N.Y., the authors reported no conflict of interest related to this article.

1. INTRODUCTION

The rapid advancement of technology, transport and communication has contributed to a multitude of multinational companies that have the flexibility to market their businesses and activities anywhere in the world. This has increased significantly with the emergence of the e-commerce phenomenon. Namely, electronic commerce can be said to be a process of exchanging goods and services using the Internet or another computer network. This trade follows the basic rules and principles of traditional trade, connects sellers and customers through the exchange of goods and services for money, the only difference is that business is managed through networked computers.

Nowadays, a significant part of the global trade consists of international transfers of goods and services, capital (such as money) and intangible assets (for example, intellectual property) that take place within a multinational company group. Namely, such transfers are called "intra-group" transactions. These transactions within the intra guppy tend to grow steadily, and cover almost 30% of all international transactions (UN, 2013: 1).

When transferring the above transactions, occurs the transfer pricing. Namely, a transfer price is the price that is formed in connection with transactions in assets or in connection with liabilities between related parties. (Pendovska, Maksimovska-Veljanovski, 2010: 318).

Generally, when mentioning the term transfer pricing, it does not immediately associate on the negative side of the term. This is so because of the companies they are used more and more in a negative sense. And thus the tax administration faces a series of problems in determining the tax base ie the tax. In this regard, we will try to analyze in detail the concept of transfer prices and to present the basic problems that arise with its use.

2. CONCEPTUALLY AND METHODOLOGICAL DETERMINATION

Several research methods will be used in the research. The process of collecting, systematizing, analyzing and presenting the collected information will be realized using a rounded and scientifically-funded approach. The method of analysis as one of the basic ones will be applied to determine the basic characteristics and features of the phenomena that will be subject to research. Then the descriptor method will be used in the explanation or description of the subject of research. Namely, during the entire research process, unavoidable methods of synthesis, induction, deduction and comparison will be used.

3. THE CONCEPT OF TRANSFER PRICING

The "transfer pricing" in the literature is presented as a technique for the most favorable distribution of revenues and expenditures between subsidiaries, branches and joint ventures within a group of interconnected entities. They are of considerable importance to companies in the globalized economy, since their operations extend to countries with different legislative regulations and tax regime.

The pursuit of profit, cash flows, marketing goals, economies of scale, and competitive advantages through joint ventures cause subsidiaries and affiliates to have cost estimates to calculate efficiency and taxable profits (Horngren et al., 2002). In such an environment, corporations must develop processes for allocating overall business costs and create strategies for estimating transfer pricing for goods and services.

Given that the largely distributed overall business costs are subjective, companies enjoy discretion in their distribution in individual products, services and geographical areas. Such discretion can allow them to cut taxes and thereby increase profits by ensuring that (wherever possible) most of the profits are located in countries with low risks and taxes.

Experts confirm that transfer pricing allows multinational companies to avoid double taxation, but it is also open to abuse.

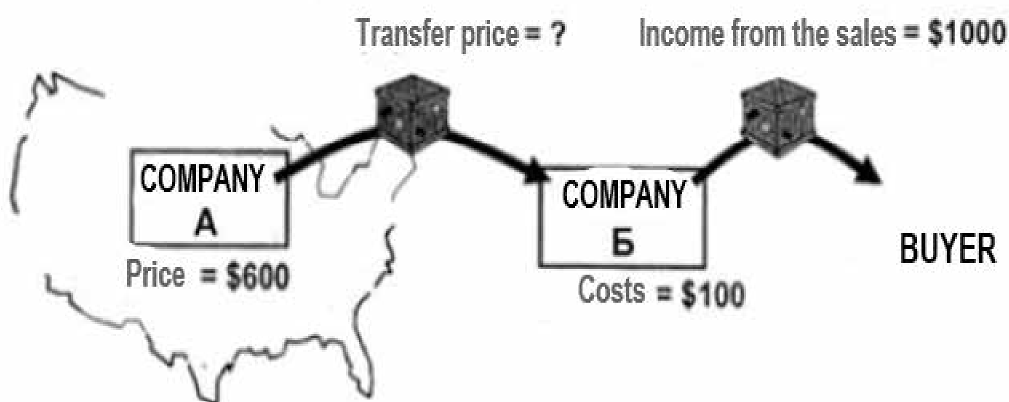
Generally speaking, transfer pricing refers to pricing between two affiliated companies in intra-company transactions or intra-company trading. The latter may involve the purchase and sale of goods, patents or services between a parent company and its subsidiaries or between two subsidiaries controlled by a joint parent company etc. (Smitha Francis, 2012: 1).

In fact, the transfer pricing mechanism is used by multinationals in order to hide the real income from international transactions thanks to differences existing in tax systems.

4. PROBLEMS GENERATED BY TRANSFER PRICING

Theoretically, multinational companies must charge their intra-company transactions at market value. But it is clear that subsidiaries and branches of multinational companies can manipulate their intra-company transaction accounts, such as selling goods, patents (industrial property rights), or services to each other for a higher or lower price than the fixed market price, and Such a profit from a company in one state can be transferred to a company located in another country that has a lower tax rate for taxation or in countries called tax havens (PricewaterhouseCoopers, 2009: 1-24).

This allows multinational companies to minimize their net tax profits in countries with higher taxation rates. It also has a significant impact on state revenues, which means that the countries are reducing their incomes. This fact can be illustrated by the following example:



Example 1 (Schadewald, Misey, 2013:1202):

Company A, as a domestic company, manufactures small machines for sale in the United States and abroad. Sales abroad are carried out through Company B, which is wholly owned by the foreign company.

In Company A machines are produced for $ 600 and plus the cost of marketing in the market are $ 100, and sold abroad for $ 1,000. Regardless of the transfer price used for selling from Company A to Company B, the total sales earnings are $ 300 o'clock ($ 1,000 ultimate selling price - $ 600 for production - $ 100 for sales costs). However, transfer prices affect The distribution of total profits between Company A and Company B.

To the extreme, a transfer price of $ 600 will fully allocate the total $ 300 profit to Company B, as shown in Table 1.1.

Table 1.1

Transaction	Influence on Company A	Influence on Company B
Production of the machine	Cost of production: 600$	/
Controlled sales	Sales income : 600$	Price of the sale: 600$
Foreign sales activities		Cost of the sales = 100$
Sale of the foreign buyers		Income form the sales = 1000$
	Net profit: $ 0	Net profit: 300$

At the other extreme, The transfer price of $ 900 will fully allocate the total $ 300 profit to Company A, as shown in Table 1.2.

Table 1.2

Transaction	Influence on Company A	Influence on Company B
Production of the machine	Price of the production: 600$	/
Controlled sales	Revenue from sales: 900$	Price t of sales: 900$
Foreign sales activities		Cost of sales = 100$
Sale of foreign buyers		Income from sales =1000$
	Net profit: 300$	Net profit: 0$

Business advisors argue that “transfer prices continue to be, and will remain, the most important international tax issue that multinational companies face” (Ernst & Young, 2006: 1). This is completely plausible as transfer pricing allows companies to reduce their tax costs by allowing capital to be exported to more favorable locations.

According to a study by US companies, “transfer prices play the most important role in the total amount of national accounting, potentially reducing declared value of exports and current account (and thus of GDP) (Bernard, Jensen and Schott; 2006: 19-20).

4.1 Abuse or misuse of transfer pricing

The exchange between the intra-companies of multinationals has allowed them to switch costs (price) and profits internally and across boundaries from one country to another. This can be said that it encourages the most common method of tax evasion, as the company can change the price (costs) and profits in a way that is most favorable to it in general. The basic mechanism for this is simple: the cost is transferred to companies in high-tax countries and the profit is transferred to companies in countries with a low –tax.

The effect of this is that in high-tax countries, the cost will be deducted from profits, and thus a small tax will be paid or no tax will be paid at all. However, for profits in countries with low taxes or in non-state countries, a small tax will be paid or the tax will not be paid at all. As a result, multinational companies in general can save very large amounts of taxes.

It is reasonable that if multinational companies are allowed to structure their own internal flows in the best possible legal way, it is also clear how massive the loss of tax revenues will be if transfer pricing is independently determined by multinational companies. This means that worthless goods can be sold for millions. But there is also the possibility of false transfers. From a historical point of view, the problem of transfer pricing primarily concerned physical goods, as they represented the most important part of international trade. However, this principle is applicable to all types of goods, for example, to intangible assets, such as intellectual property rights (licenses, patents, etc.) that are more and more important to international businesses, and their Role in the wrong assessment of prices (Karkinsky and Riedel, 2012). To illustrate: a multinational company can form a company in a state tax haven, in which it does not have to pay a fee for licensing fee (costs). That company will thus own the rights of the brands of a multinational company. But any of its affiliates worldwide will have to pay a license fee for the company (Dharmapala and Riedel, 2012).

It is difficult to say how much of the tax revenue the state loses due to the transfer prices, but various calculations confirm that this is a serious problem.

5. THE RULE OF TRANSFER PRICING: ARM'S LENGTH PRINCIPLE

The problem that underlies any tax evasion associated with multinationals usually refers to the fact that the relationship that should normally occur between two independent, separate entities of different owners begins to occur more often and more often between the subjects of one and the same Owner (subsidiaries, affiliates). A solution to this problem has now been found by comparing intra-company transactions with comparable transactions between independent, unrelated entities

or companies, and then requiring that the internal exchange be the same as the external one. This approach became known as the "*Arm's Length Principle*".

Although this solution sounds logical and simple at first glance, the problem can not be easily identified: it takes a lot of work to determine if the company follows the arm's length principle for all its transactions. In addition, the exact comparative price is not easy to find, because most of the transactions are unique. To circumvent this problem, there are various methods that try to improve the assessment of comparative prices; They include, for example, the "cost plus (price plus)" method, where the production price of goods is calculated and a reasonable profit margin is added to it.

However, there are many goods that are hardly comparable, no matter which method is applied. This applies in particular to non-material goods such as intellectual property rights. Patents or licenses by definition are unique, so it is extremely difficult, if not impossible, to find comparable prices for these goods.

The application of any rule on transfer pricing and any other tax rule is linked to the requirement that there is real economic activity among independent entities. According to this definition and control of this condition is of great importance for the fight against tax evasion.

The difference, le the gap between micro / small companies and large companies is immeasurable. However, there are indications that, although most states do not approve micro / small companies, the reality is different. In the Netherlands, for example (Henn, 2013: 4), in order to accept the company as a legal (existing), it is sufficient to register and have an address. Even if it is not so simple, it is possible that it is included in large sales, and similarly with very few employees (staff).

In the world, Switzerland with tax privileges for holding companies has attracted the branches of all major multinationals, and now it is the largest location for the exchange of goods in the world, although it has almost no own goods. In this way, a large amount of money goes to Switzerland and they are no longer taxable in the countries producing goods; Which elucidates the problem, that despite the fact that there is

a real economic activity in Switzerland, it does not essentially depict the economic activity in the countries concerned. If the main business is still going on in the state producers, it is appropriate that Switzerland gets a lot of the profits.

Given such problems of the adequacy of the activity of companies compared to the tax revenue, the setting of excessive criteria for what constitutes economic activity can be a partial solution to the problem.

6. CONCLUSION

The rapid technical-technological development, the emergence of the Internet and e-commerce has caused a large number of multinational companies that have the flexibility to market their businesses and activities anywhere in the world. Much of the international trade consists of international transfers of goods, services, capital and intangible assets (intellectual property) that take place within a multinational company group. When these transactions or transfers are processed appears the phenomenon transfer price. Namely, a transfer price is the price that is formed in relation to asset transactions or in relation to liabilities between affiliates. In the literature it is defined as a technique for the most favorable distribution of revenues and expenditures between subsidiaries, branches and joint ventures within a group From interconnected subjects. Multinational companies and their subsidiaries and affiliates are able to manipulate these intra-company transactions. That is, they can perform these transactions for a higher or lower price than the determined market price. And since these transactions are often carried out internationally, that is, with related companies from different countries, a series of problems arise in the state taxation of taxation. With this abuse, transfer pricing arises the problem of tax evasion, which states are trying to resolve with the "Arm's Length Principle".

A tax evasion method appears as the company can change the price (costs) and profits in the way that is most favorable for its entirety. Simply

illustrated, the cost (prices) can be transferred to companies in countries with high tax rates, and profits to transfer to companies in low-tax countries (states tax payers). The effect is that in high-tax countries, the cost will be deducted from profits, and thus a small tax will be paid or no tax will be paid at all. However, for profits in countries with low taxes or in non-state countries, a small tax will be paid or the tax will not be paid at all. As a result, multinational companies in general can save very large amounts of taxes. But if seen by the states, they will have huge losses in their income. We know that in all countries in the world tax is the basic, most important and oldest source of income. Not long ago in the 3rd century Ulpianus noted the significance of this institute and said that “taxes are the nerves of the state”. Therefore, each state will have an interest in pursuing policies that will not have losses in its revenues and will require the most appropriate solution. But it is very difficult to determine how much of the tax revenue the state loses due to transfer prices, but varied calculations confirm that this is a serious problem.

As a solution to the problem of tax evasion, which appears with the abuse of the transfer price appears the The Arm’s Length Principle. In fact, it is a method of comparing intra-company transactions with comparable transactions between independent, unrelated entities or companies, and then requiring that the internal exchange be the same as the external one. While this solution sounds logical and simple, the problem can not be easily identified, because it is difficult to determine if companies follow the arm’s length principle for all their transactions and it’s not easy to find a comparable price because most of the transactions are the unique.

From all this we conclude that the abuse or misuse of transfer pricing by multinational companies arises a number of problems in the sphere of taxation. And with the emergence of tax evasion, states lose their income. To some extent the states are trying to solve this problem with the arm’s length principle, but a complete solution is not found and it continues to exist.

7. BIBLIOGRAPHY:

1. Smitha Francis, "Transfer Pricing and Tax Evasion: Beyond the trans Atlantic furore", 2012.(http://www.networkideas.org/news/jan2013/pdf/Tax_Evasion.pdf)

2. Markus Henn, "Tax Havens and Taxation of Transnational Corporations", International Policy Analysis: Friedrich – Ebert - Stiftung, June 2013. (http://library.fes.de/pdf-files/iez/global/10082.pdf)

3. Tom Karkinsky and Nadine Riedel,"Corporate Taxation and the Choice of Patent Location within Multinational Firms", 2012.

4. Dhammika Dharmapala and Nadine Riedel,"Earnings Shocks and Tax-Motivated Income-Shifting: Evidence from European Multinationals", Journal of Public Economics, 2012. (http://gabriel-zucman.eu/files/teaching/DharmapalaRiedel13.pdf)

5. Ernst & Young, "Global Fraud Survey", 2006.

6. Andrew B. Bernard, J. Bradford Jensen and Peter K. Schott, "Firms in International Trade", 2006.

7. Charles T. Horngren et al., "Introduction To Financial Accounting", 2002.

8. PricewaterhouseCoopers, "Global Economic Crime Survey Economic Crime In A Downturn", 2009 (https://www.pwc.com/gx/en/economic-crime-survey/pdf/global-economic-crime-survey-2009.pdf)

9. Michael S. Schadewald, Robert J.Misey, U.S. Taxation of International Transacations, "Chapter 12 Transfer Pricing", 2013.

10. Prem Sikka, Hugh Willmott , "The Dark Side of Transfer Pricing: Its Role in Tax Avoidance and Wealth Retentiveness", Essex Business School, 2010.

11. Hüseyin Işık, "Çok Uluslu Şirketlerde Örtülü Kazanç Ve Örtülü Sermaye - Uluslararası Düzenlemeler ve Uygulamalar ile Türk Vergi Sisteminin Karşılaştırılması ve Öneriler", Ankara, 2005.

12. PwC, "International transfer pricing 2013/14 - Transfer pricing at your fingertips", 2014.

13. Пендовска, Весна; Максимовска- Велјановски, Александра; Мангова- Поњавиќ, Кики: „Финансово право",- Куманово „Македонска ризница" 2010.