

The Role of Transfer Pricing in Economic Globalization

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Abstract

Globalization is one of the most controversial topics in the economic literature. Transactions are not just licit, the increasingly organized nature of operations and the ingenuity of organizational and manifestation forms of offshore entities have led to a continuous amplification of the globalization phenomenon. This phenomenon can be assimilated with the transfer pricing existing reason. These transfers pricing have appeared in a context where groups of companies present in several countries carry out economic activities in those countries. Equally, these prices are thought to be the key element that underlies fiscal system exploitation.

Keywords: economic globalization, transfer pricing, tax optimization, offshore companies, the principle arm's length

1. Introduction

Globalization has emerged since the beginning of the 21st century and is characterized by emphasizing the reduction and elimination trend of the barriers between international economies. At the moment, globalization is one of the most controversial topics in the economic literature. While the global integration of the world economy is progressing, more and more transnational companies are planning new foreign direct investments (FDI) and establishing new subsidiaries abroad. Given the current conditions of economic activities internationalization in all its aspects, tax optimization methods are correlated with transfer pricing regime.

This expansion requires the transfer of tangible and intangible assets (including services) between the holding company and their foreign subsidiaries. Thus, the most common problem in this context is the pricing of these cross-border transfers. As a result of the means of production modernization and technologies, social division of labor, market expansion, transaction of goods, money transaction beyond state borders, diversification of short-term trade relations, leads to the following situation: the same taxpayer develops economic, political or social relations with several countries. Thus, the business globalization phenomenon implies a divergence between the multinational corporations and the national governments that aim to meet their citizens interest. One acceptable meaning of globalization implies the existence of a single global economy and represents the triggering factor of transfer pricing as it dominates the global financial system and capital markets.

2. Economic globalization: influence factor on transfer pricing existence

Economic globalization led to the expansion of production and sales markets, causing various useful effects, both on the level of production costs optimization and on the differences between incomes and current payments. In the same time, the migration of capital and human resources and the differences of the legislative system between the states have generated some costs of the economic globalization. Repeatedly, these expenses have generated the apparition of economic crime internationalization phenomenon. For that taxable base transfer technique to be considered legal, it has been created a similarity with the tax optimization concept. As a result of the economic and financial global crisis, transfer pricing gain new development opportunities and so appeared the need of capitalization. This phenomenon can be assimilated with the reason of existence of transfer pricing (Patroi et al., 2013).

The issue of transfer pricing is an extremely complex one, because in the opinion of many economic analysts, these represent the main vector for the extension of economic crime phenomenon. In some cases, there is an illegal transfer of capital, although in an apparent form of legality, across national borders. Transfer pricing are also a commercial reality and represent the prices at which goods or services are bought/ sold, noting that both the seller and the buyer, are controlled by the same entity or common entities. Establishing the transfer pricing is another issue for the global operations that involve enforcement actions with customers (including marketing, establishing the price, the risk etc.) related to a certain financial product or a line of financial products in several tax jurisdictions and/or via multiple participants.

As any good is sold/ bought at a certain price established between the buyer and the seller, in the same way is needed to establish a price, even when the two are affiliated. These transfers pricing have appeared in the context where groups of companies present in several countries, carry out economic activities in these countries. As a result of the lasting economic and financial crisis, which is characterized by diminishing the amounts owed to the state budget, the interest of many countries to legalize and have control upon transfer pricing is increasing, in order to efficiently manage financial and tax risks, which are involved.

Lately, there is a growing interest upon the transfer pricing phenomenon, both from transnational companies pursuing fiscal optimization and an optimal working capital, and the international tax authorities pursuing tax flow optimization. The tax optimization methods used by multinational companies in the states where they operate, are mostly between the borders of legal and illegal, because they try to exploit certain weaknesses of the tax system. From a conceptual point of view, globalization refers to outsourcing the tax base, to reduce tax burden of a certain company and to move the taxing right towards a country with less restrictive tax policy.

The economic globalization and the desire of the most contributors to reduce tax burdens, made many countries to adopt several methods in order to protect the tax revenue, especially measures to avoid outsourcing of the tax base towards affiliates, in order to obtain a more favorable tax regime. It must be specified that transfer pricing topic is a quite controversial and has both supporters and critics, but all depends on their skills of using them in order to reduce tax burden, thus taking advantage of the opportunities that are offered. At the same time with economic globalization occurs the amplification of interstate financial flows generated by transfer pricing and so economic crime internationalization gets new valence. Therefore, many people believe that transfer pricing represent a real technique of raising money, acquired through tax avoidance methods, more or less legal. In the same time, transfer pricing represent the link between tax regulations of certain countries, and a group of affiliated companies that use tax havens can make possible to pay higher transfer pricing to its subsidiary located in a country with normal tax system (Bremont, Geledan 1993).

Transfer pricing is the "endpoint" of ingenuity in what concerns the exploitation of tax legislation (Patroi et al.,2013). These prices can be at the same time both an opportunity and a threat, their influence upon affiliated persons' transactions being very significant. If there is a transaction that involves companies from several countries that use transfer pricing which are not based on the principle of market value, it can lead to a double taxation or adjustments of the tax base.

3. The involvement of offshore companies in transfer pricing

In the current international context, the ascension of offshore industry is favored by the trend of investment planning, specific to multinationals, which prefer to enter on a new market via these companies, in order to minimize the risks, regardless of their nature. By using tax havens, multinational companies also secures its possibility of applying a beneficial tax management in what concerns the currency repatriation of dividends and the transfer regarding the confidentiality of the shareholding, the management and the preformed operations.

Lately, the existence of a growing number of offshore operations, have led to a so-called industry, an industry whose basic feature is confidentiality. Often, these transactions either don't have an economic nature, or they have only a writable component, being actually fictive. All these things, the not very licit transactions whose basic feature is half-light, the increasingly organized nature of the operation or the increasing ingenuity of the organization forms and manifestation of offshore entities, have led to a continuous amplification of globalization. It should be said that the main effect in using tax havens is the reduction of tax obligations, but we can also talk about destabilization of the competitive environment, depending on the magnitude of the phenomenon. This "host" companies obtain via more or less legal practices, additional income which helps in achieve certain position in the market where they carry out their activity.

As an example of what has been mentioned above, these transactions represent a branch of a tolerated legislative tax evasion, because the incomes collected by multinational companies are not properly registered exactly where they were achieved. More frequently, these offshore companies show up in the trade field, through exports and imports. In exports, we usually meet a "price rising", and the companies' products are re-exported to another destination, not to an offshore company. Therefore, the profit is transferred to companies' form tax havens with tax policies reduced or even zero taxes. In the case of imports, things are very different, because offshore companies are based on a resizing of the importers expenses, these achieve oversized costs with raw materials or materials, which leads to a decrease of the profits taxable base and the profit tax related. Here the report is reversed, because at the offshore companies the profit increases with the growth of the expenses, not by reducing the incomes.

Lately, the notion of "tax haven" has become "*offshore financial center*". The ascension of offshore industry is due to the fact that these offshore companies wish to minimize their risks, regardless of their nature. The term "offshore" refers to jurisdictions that offer various tax advantages to the companies registered in these jurisdictions (UNCTAD – World Investment report, 2001, Promoting Linkages). „Offshore companies are entities that reduce the risk, because rather than to respond with all the parent companies patrimony, they better not respond at all" (K.L. Gyorgy 2005). It has to be noted that the companies motivations in what concerns the use of tax havens are not just of fiscal nature, but the companies try to minimize the political and military risk in the countries where they develop their activity.

A common feature of the implementation of transfer pricing refers to the difference between the taxation level of the profit produced in the residence country of the parent company and the other tax rates from the countries where other companies belonging to the group are registered, the earnings being stored in the countries with the lowest taxation level. When offshore companies and transfer pricing are combined, the benefits increase impressively. Preventing all the problems occurred due to the combination of the two phenomena, arise a bigger problem: the cooperation between the source country and the countries of residence. Practically there are various transfer techniques of the profits, using both transfer pricing and tax havens. So we can conclude that: „the favor that these companies have by using tax havens does not come only from the absence of taxation or low taxation, the other non-tax havens are just as significant" (Craiu 2004).

4. Arm's length principle: the basis of transfer pricing given the globalization conditions

The arm's length principle or market value principle, as it is known in Romania, has been introduced in the intern tax law in 1994 and represents the international standard of transfer pricing, being regulated in the Organization for Economic Cooperation and Development (O.E.C.D.) documents - Reports 1976, 1984 and the editions of the Guide in 1995 and 2010- (Patroi et al.,2013) and applies to all types of related-party transactions.

Since 2010, in Romania, the related party transactions between two Romanian legal entities also falls under the scope of investigations in order to establish transfer pricing, while only previously non-resident related-party transactions have been investigated by the tax authority. The 19th article of the Romanian Tax Law (Law no. 571/2003, as amended) established the general rule that transactions between persons or affiliated entities must be evaluated at a normal market value, the one that would have been agreed by independent parties. Transfer pricing Romanian Law follows the guidelines of the O.E.C.D. and requires that the transactions between affiliated parties to conclude a transaction at the right market value. If transfer pricing is not set at the arm's length principle, Romanian tax authorities have the right to adjust the contributors' incomes and expenses, in order to reflect the market value. The Tax Law defines¹, the notion of market price as: „the amount that would be paid by an independent client to an independent vendor, at the same time and in the same place for the same good or service or a similar one, in conditions of fair competition”.

The tendency of evolution in what concerns the transfer pricing in Romania, reveals that there is a growing interest of the Romanian tax authorities towards transfer pricing, which is one of the main areas of tax investigation.

1 Art. 7, paragraph (1) pct.26 ,Tax Code

Under these circumstances, multinational companies should pay attention to the arm's length principle, their transactions with affiliate parties and their documentations, as to be prepared for any conflicts with tax authorities regarding transfer pricing. This principle of market value applies to all the transactions with affiliated parties, including transactions between a foreign legal entity and its permanent Romanian headquarter.

O.E.C.D. Guide makes a reference to this principle, because it represents the International Price Standardization agreed by O.E.C.D. member states, in order to be used by multinational companies and tax administrations, in fiscal matters. Transactions between affiliated parties must respect this arm's length principle (named in the specialized doctrine „the arm's length principle- ALP”) and to be held, without being affected by the affiliation relationship between them. At international level, this principle regulates the method of establishing and testing transfer pricing, specifically regarding the associated enterprises for tax purposes.

Most of the countries have adopted this principle for the following reasons²:

- wide acceptance of the arm's length principle as the best option for establishing and testing transfer pricing;
- the conventions of avoiding double taxation signed by the majority of the countries have been influenced either by the O.E.C.D Model Convention, or the UN Model Convention and therefore they accepted this principle in the agreements concluded between them;
- the international benefits of accession to the same evaluation standard of transfer pricing by avoiding double taxation.

The developing globalization, the sophisticated communications and informational system and the technology, allows an international company to have control upon the operations of its various subsidiaries form around the world. Commercial trade between associated companies is often an intangible element, such as services and software systems. The developed countries have undergone some structural changes and are witnessing an extraordinary growth of the services sectors. The nature of the things on which international tax principles are based, have significantly changed. All this changes bring challenges in applying the arm's length principle on globalized and integrated operations of the international companies. In general, it is clear that in the 21st century, the market value principle shows real challenges in international companies revenue allocations. Moreover, it is accepted that transfer pricing is not a precise science and that the application of those transfer pricing techniques involves the application of information, validated and judged by the taxpayers and the tax authorities. Taking into consideration the qualification and informational “gaps” and the limited resources from many developing countries, establishing transfer pricing can be very difficult. This is why it takes the best officers that could lead to the organizations skills development, given their special abilities.

Therefore, the main benefit brought by accepting this principle is the higher degree of certainty about its acceptance, its equitability both in the relationship between two opponent tax authorities and in the relationship between taxpayers and the tax administrations, as well as its practical applicability (J. Rhee 2010).

5. Conclusions

Globalization is a wide phenomenon, and is characterized by externalizing the tax base, reducing the companies tax burden and the “transfer” of the taxable base towards a country with less restrictive tax system. Economic globalization has led countries to adopt measures to protect the tax revenue, and especially measures to avoid the outsourcing of the taxable contribution towards affiliated entities, in order to obtain a more favorable tax system. Given the expansion of economic globalization, interstate financial flows amplification generated by transfer pricing occur, and by default, the internationalization of economic crime gets new valence. Therefore, many believe that transfer pricing are real methods of acquiring money, by making more or less legal activities allowing the avoidance of the tax. Transfer pricing domain is the link between tax regulations on different national market, and a group of affiliated companies that use tax havens, implicitly offshore companies can make it possible to pay high transfer pricing to its subsidiary located in a country with normal taxation, increasing their profits in the tax havens and decreasing them in countries with normal taxation.

2 According to paragraph. 3.1.2, United Nations Practical Transfer Pricing Manual for Developing Countries, 2012.

Establishing transfer pricing is one of the most important international tax issues. But a practical approach will help to focus on the solutions of these problems, solutions that will help the developing countries to tackle problems of transfer pricing evaluation issues, in a way that is robust and equitable to all the parties involved. The world economy is characterized by a continuous expansion of transfers between countries; multilateral cooperation's and causes the apparition of risks resulting from foreign trade.

All international trade relations, in the globalization context are influenced by numerous financial, political factor, currency and their dynamic emphasize or dissipate risk in foreign trade and financial relations.

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