THE TRANSACTIONS BETWEN AFFILIATED COMPANIES AND THE FISCAL CONSEQUENCES WHEN THEY ARE NOT „AT AN ARM'S LENGHT"

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Abstract: *The role of multinational companies in the international commerce has grown considerably in the last 20 years. This reflects the growth of national economies and the technological progress, especially in the communications field. The development of multinational companies implies very complex fiscal aspects for the companies and for the fiscal administration agencies, because national fiscal regulations can't be seen in an isolated manner, but in a vastly international context.*

In the case of fiscal administrations there are specific problems at a policies level, but also at the practical level. At the level of the fiscal policies the states must reconcile their legitimate right to tax the profits of a tax payer on the basis of the income and of the expenses that can be reasonably considered as being generated inside their territory, with the necessity to avoid imposing an income element more than once by a single fiscal organism.

The Fiscal Business Committee, which is the main fiscal organism of OECD[1], has published a number of reports regarding the application of the articles over MNEs[2] and over the others. The committee encouraged the accepting of joint interpretations of these articles and reduced the risk of an inadequate imposement and offered satisfactory ways to solve the problems generated by the interactions of the legislations and practices of different countries.

When applying the directory principles in taxing MNEs, one of the most difficult problems is establishing the most fair transfer prices. *The transfer prices* are the prices at which a company transfers goods and intangible proprieties or offers services to affiliated companies.

Two companies are affiliated if one of them participates directly or indirectly in the management, control or capital of the other, or if "the same persons participate directly or indirectly in the management, control or capital" of both companies (i.e. if both companies are under a joint control).

The OECD members continue to sustain the "arm's length" principle as it was included in the Fiscal Convention Sample of the OECD (and in bilateral conventions that commits legally the signers of the treaty) and in the 1979 Report. These Instructions focus on implementing the arm's length principle in order to estimate the transfers of the affiliated companies through prices. The intend of the Instructions is to help the fiscal administrations (the ones of the OECD members, and the ones of the non-member countries) and MNEs by indicating ways to find mutually satisfactory solutions for transferring prices, thus minimizing the conflict between fiscal administrations and between fiscal administrations and MNEs and avoiding expensive trials. The instructions analyze ways to evaluate if commercial and financial relations inside a MNE comply with the arm's length principle and try to think of ways to implement these methods.

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[1] OECD – Organisation for Economic Co-operation and Development
[2] MNE – Multinational Enterprise

When the transfer price doesn't reflect the market forces and the arm's length principle, the tax liabilities of the affiliated companies and the inland revenue of the host countries could be disorientated. That's why the OECD members decided that, for fiscal purposes, the profits of the affiliated companies can be adjusted as necessary in order to correct this kind of distortions and to ensure the implementation of the arm's length principle. The OECD members consider that an appropriate adjustment can be obtained by setting conditions for the commercial and financial relations they anticipate they will identify among the independent companies in similar companies and in similar circumstances.

It was noticed that the arm's length principle works efficiently in most cases. For example, there are many cases which involve buying and selling merchandise and money loaning and in which a price at an arm's length can be found in the independent companies' transactions in comparable circumstances.

Both the fiscal administrations and the tax payers often have difficulties in obtaining enough information for implementing the arm's length principle. Further more, it may not be possible to obtain information from the independent companies for motives of confidentiality. In other cases the information about the independent companies that can be reveled may just not exist. At this time I must mention that transfer prices are not an exact science, but it requires a thinking exercise from both the fiscal administration and the tax payer.

Although they acknowledge the arguments mentioned above, the point of view of the OECD members continues to be that the arm's length principle must govern the evaluation of the transfer prices between affiliated companies. The arm's length principle is a solid theoretic principle because it ensures the safest approximation of the open stock market when merchandise and services are transferred between affiliated companies. Although it may not be always easy to put in practice, it generally leads to the adequate levels of income among the members of a MNE group and acceptable for the fiscal administrations. This principle reflects the economic realities of the facts and of the special circumstances of the controlled tax payers and adopts it as a reference for the normal market operations.

The implementation of the arm's length principle is based on the comparison of the controlled transactions' conditions with the conditions of the transactions that take place between independent companies. The relevant economic characteristics of the compared situations must be sufficiently comparable, for such a comparison to be useful.

All the methods that use the arm's length principle can be tied to the concept that independent companies take into consideration the options they can use in comparing one option to another. They take into consideration all the differences between these options that might significantly alter their value.

In order to gain a complete understanding of the facts and circumstances surrounding a controlled transaction it can be useful to examine the data of the year on course and the data of the previous years. Analyzing this information can uncover facts that might have influenced (or should have influenced) the settling of the price transfer. For example, using the data from the previous years will show if the lost afferent to a transaction reported by a tax payer is a part a historic series of loses in similar transactions, if it is the result of the economic conditions specific to the previous year that lead to the rising of the costs in the following year, or if it is a reflection of the fact that the product is at the end of its life cycle. This kind of analysis can be useful especially when a method of the transactional profit is applied as a last alternative.

The data from more years are also useful in supplying information about the life cycles of businesses and their respective products. The differences in the life cycles of the businesses or the products can have a substantial effect on the transfer price's conditions, effect that must be established when the comparability is determined. The data from the previous years can show if a independent company engaged in a comparable transaction has been affected by the comparable economic conditions in a comparable manner, or if the different conditions from a previous year have substantially affected its price or its profit as so it can't be used as a comparable.

The data from the following year after the transaction can be relevant in the analysis of the transfer prices, but the fiscal administration should be careful avoiding using the retrospective angle. For example, the data of the following year can be useful in comparing the life cycles of the control or uncontrolled transactions' products. The purpose is to establish if the uncontrolled transaction is a proper comparable in the use of a certain method. The subsequent behavior of the parts will also be relevant in setting the real terms and conditions the act among the parts.

When an affiliated company consistently registers losses, while the MNE group is profitable, the data can attract a special analysis of the transfer price's elements. Of course, the affiliated companies and the independent companies too can stand real losses because of the massive starting costs, the unfavorable economic conditions, or because of other legitimate economic reasons. Still, an independent company won't be ready to bear indefinite term losses. An independent company which registers repeated losses will eventually stop to continue the activities in the same terms. In contrast, an affiliated company that registers losses can continue to do business if the respective business is beneficial for the MNE group as a whole.

The fact that there is a company that registers losses and closes transactions with profitable members of the MNE group can suggest to the tax payers or the fiscal administrations that they should check the transfer prices. A member of the group can have consistent losses because it produces all the products that generate loss, while other members produce products that generate profit. An independent company would offer these services only if it would be recompensated with an adequate price. Consequently, a way to approach these transfer prices problems is to consider that the company which generates loss receives the same price per service that an independent company would receive as the arm's length principle states.

An intended compensation is the compensation that an affiliated company includes deliberately in the controlled transaction's terms. It appears when an affiliated company offers an advantage to another affiliated company inside the group, which is equilibrated by the different received benefits from the respective company.

The acknowledgement of the intended compensations doesn't change the fundamental criteria that the controlled transactions' transfer prices must comply to the arm's length principle.

The arm's length principle doesn't condition the use of more methods, and actually the excessive dependence for such an approach would create a considerable burden for the tax payer. Thus, this Report doesn't condition the fiscal inspector or the tax payer to make analysis by using more than one method. Although in some cases choosing a method can be difficult and initially more methods could be taken into consideration, generally it is possible to select one method that is suitable to deliver the best estimation for a price at an arm's length. Still, in difficult cases when a single approach is not conclusive, a flexible approach will allow the combined use of the evidences supplied by different methods. In this type of cases it is best to try to reach a conclusion that is in accordance with the arm's length principle and that is satisfactory from a practical point of view for everybody involved. This conclusion can be reached by taking into consideration the data and the circumstances surrounding the case, the combination of the existent proof and the relative safety of the different analyzed methods.

One of the administrative ways to exercise and to resolve the disputes regarding the transfer prices is to verify simultaneously the affiliated companies.

The simultaneous fiscal verifications can be a useful instrument in determining the correct tax liabilities of the affiliated companies when the costs are splinted or invoiced and the profits are allotted between tax payers from different fiscal jurisdictions or when there are problems with the transfer prices. The simultaneous fiscal verifications can facilitate a information trade about the practices of the multinational companies, about complex transactions, about the arrangements of the contributions to costs and the methods to allot profits in special fields like global commerce and innovating financial transactions. As a result, the fiscal administrations can gain a better understanding and a whole perspective over the MNE's activities and can obtain extended possibilities to compare and verify the international transactions. The simultaneous fiscal verifications can sustain the information trade that aims at developing a good knowledge of the tax payers' behavior and the practices and trends inside the branch and other information that can be valid beyond the specific verified cases.

An objective of the simultaneous fiscal verifications is to promote the concordance with the regulations regarding the transfer prices. Obtain the necessary information and setting the facts and circumstances tied to aspects like the transfer prices' conditions in controlled transactions between the affiliated companies from two or more fiscal jurisdictions can be difficult for a fiscal administration, especially in the cases when the tax payer doesn't cooperate or doesn't offer the necessary information in useful time. The simultaneous fiscal verification process can help fiscal administrations to establish these facts sooner, more efficient and cheaper.

With the continuous growth of the globalization of commerce and trades and the growth of the complexity of the MNE's companies' transactions, the transfer prices problems have become more and more important. The simultaneous fiscal verifications can reduce the difficulties met by the tax payers and the fiscal administrations regarding the setting of the MNE's transfer prices. Is recommended the more ample use of the simultaneous fiscal verifications when checking cases of transfer prices and to facilitate information trade and friendly procedures. In a simultaneous fiscal verification when we are dealing with a recalculation, the two countries involved must try to reach a result that will avoid the dual taxation for the MNE group.

Glossary

Plus cost addition

An addition measured by comparing the margins calculated after the covering of the direct and indirect costs by the goods and services supplier in a transaction

Costs contributions arrangements ("CCA")

A CCA is an agreement between companies in order to split the costs and the risks of development, production or acquiring goods, services or rights, and to establish the nature and weight of the interests of each participant in the results of the development, production or acquirement goods, services or rights.

Independent companies

Two companies are independent from each other if they are not affiliated to each other.

Deliberate adjustment

An advantage offered by an affiliated company to another affiliated company inside the group, which is compensated to a certain extend by different advantages received in return from the respective company.

Multinational Enterprise group (MNE group)

A group of affiliated companies that have subsidiaries in two or more countries.

The arm's length field

A field of numbers is allowed to establish if in the case of a controlled transaction the conditions are at an arm's length. The numbers are derived from the use of the same transfer prices' method for multiple comparable data, or from the use of different transfer prices' methods.

The distribution method based on a global formula

A method to allocate the global profits of a multinational enterprises group on a consolidated base, among the affiliated companies in different countries, by using a pre-established formula.

The plus cost method

A method of transfer prices that uses the costs covered by the goods supplier (or services supplier) in a controlled transaction. At these costs we add the corresponding plus cost addition so that a corresponding profit will produce (the used assets and the risks are also taken into consideration). The result reached after the plus cost addition to the costs mentioned above can be seen as the at an arm's length price of the original controlled transaction.

The direct invoicing method

A direct invoicing method for specific intra-group services on well defined bases.

The indirect invoicing method

A invoicing method of the intra-group services depending on the allotting of the costs and of the distribution methods.

The dividing of the profit method

A method of the transactional profit that identifies the combined profit that must be divided among the affiliated companies in a controlled transaction (or controlled transactions that can be combined in accordance with the principles in Chapter I of the OECD Guide). This profit is divided among the affiliated companies after an economic base that approximates the division of the profits after an arms' length arrangement.

The net transactional margin method

Is a transactional profit method that examines the net profit's margin from a corresponding base (for example: costs, sales figures, assets) achieved by the tax payer in a controlled transaction (or transactions that can be combined in accordance to the principles in Chapter I).

The comparable uncontrolled price method (CUP method)

Is a method of transfer prices that compares the price of the transferred goods and services in a controlled transaction to the price for the goods and the services transferred in an uncontrolled comparable transaction, in comparable circumstances.

The re-sailing price method

Is a method of transfer prices that is based on the price of a re- sailed product of an affiliated company to an independent company. The re-sealing price is diminished with the margin of the re-sailing price. The remaining price can be seen as an arm's length price after all the adjustments with other costs associated with the purchasing of the product (for example: customs charge).

The transactional profit method

Is a method of transfer prices that examines the profits which result from certain controlled transactions of one or more affiliated companies that participate in these transactions

The arm's length principle

Is an international standard that the OECD members agreed to use in order to determine the transfer prices from a fiscal point of view. This principle is presented in Article 9 of the Fiscal Convention Sample of the OECD as follows: when the created or imposed conditions among the affiliated companies in their commercial or financial relations are different than the ones between independent companies, the profits accumulated by a company during the lack of these conditions can be included in the profits of that respective company and can be taxed accordingly.

Controlled transactions - the transactions between two companies that are affiliated to each other.

Uncontrolled transactions - the transactions between companies that are independent form each other**.**

The simultaneous fiscal verifications

A simultaneous fiscal verifications, as it is defined in Part A of the OECD Convention on the simultaneous fiscal verifications, is „an agreement between two or more sides to simultaneously and independently verify on their own territory the fiscal situation of the tax payers in which they have a common interest, in order to exchange relevant information they can obtain this way .

Bibliography:

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