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Transfer Pricing – between Optimization and International Tax Evasion

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Abstract

Each enterprise in the private sector aims to increase financial return, which is achieved by obtaining a higher net profit by increasing revenue and reducing expenditure. In this endeavor, compliance with tax obligations occupy a very important role because handling taxes may lead to an increase in revenue and / or a reduction of spending, and this action is called tax optimization. In the case of multinational companies, the main tool that can be used to lower the tax burden and increasing, sometimes in sizeable benefits in net, is the transfer prices or the prices they registered entities in the group transactions between them, along with another instrument with great impact, ie tax havens. Tax evasion, designating evading payment obligations of a company according to the national tax system, may be legal in the sense that tax optimization does not violate the rules, but exploiting loopholes that are in them. But when legal tax rules are violated, we deal with tax fraud, which will be subject to punitive measures by public authorities as it affects the whole population.

Keywords: transfer pricing, tax haven, multinational society, globalization, tax evasion and fraud.

1. Introduction

The process of economic and financial globalization is mainly driven by the creation and functioning of multinational corporations, which comprise corporate entities with diverse activity profiles located in different

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countries. Multiple trade and financial relationships are commonly established between these entities, generically referred as transfer pricing. By manipulating these prices, a multinational company can improve its profitability by diminishing tax liabilities - an operation known as tax optimization - but more often by resorting to mechanisms that allow the international tax evasion. The impact of international tax evasion on public finances in the countries where these companies are located is particularly negative, affecting the funding of national public services.

The paper "Transfer pricing - between optimization and international tax evasion" describes the transfer pricing mechanism, the ways in which it can be used for fiscal optimization, and how to achieve international tax evasion, giving as a significant example the scheme of international evasion applied by a large and well-known multinational society, Ikea.

In the paper's conclusions, there are proposed measures to combat international tax evasion through transfer pricing.

2. Theoretical Background

The importance of the transfer pricing in the world economy as well as in each of the countries is now very high, being an effective tool for increasing the profitability of multinationals. Thus, transfer pricing allows tax optimization through the artificial calculation of taxable profits by corporate entities, as well as the transfer of profits across borders, including their placement in a tax haven.

The role of the transfer pricing is even greater as much as the share of multinational companies in world trade and, implicitly, in the value added has steadily increased in recent years, reaching over 60% of the total [2], which makes their impact on the national public finances to be very large.

Theoretical literature in the field addressing the issue of international financial flows, transfer pricing by multinationals, legal tax evasion that these companies take over the countries where they are located is rich and includes both theoretical and methodological papers as well as extensive analyses of the statistical databases collected by recognized international institutions such as OECD, UNCTAD, IMF, OXFAM, etc. In this respect, among the items made in the bibliographical references of the paper there are mentioned: the impact of the migration of financial flows and the existence of tax havens [2]; management of group companies using transfer pricing as the main tool for increasing their global profit [3]; case study on a legal tax evasion scheme applied by a large multinational company, IKEA [4]; the need to adopt global regulatory arrangements between countries to
diminish international tax evasion [1]; legal regulations adopted by Romanian tax authorities to monitor transfer pricing by multinationals located in our country [5]; forecasts on the evolution of international financial flows and their consequences for global and national macroeconomic developments [6].

3. Argument of the paper

The issue of transfer pricing has become acute nowadays, when globalization is expanding more and more, favored by the accentuated tendency of deregulation, which the vast majority of states have accepted. On the other hand, the tax optimization policy by legal tax evasion practiced by most multinational companies is evident [3], [4]), with a significant negative impact on public finances and, implicitly, on the financing of services managed by the public sector, mainly social services [2].

The paper states that each state is a fiscal sovereign and can adopt and enforce legal rules appropriate to its own policies, but it must at the same time to respect international legal commitments which it had concluded with third countries. The paper highlights that monitoring the transfer pricing will help to maintain a competitive economic environment so that the chances of profitability of small and medium-sized firms are not significantly affected by the dominant position of group firms.

4. Arguments to support the thesis

International tax evasion has been impressive - an OECD analysis [6] claims that less than 10% of capital companies account for about 80% of global profit - and this polarization is possible through the use of various mechanisms, including transfer pricing applied for aggressive tax optimization is the first. Financial theorists and analysts around the world have supported and continue to support the need to find common solutions to the problems that are also common to all countries. In this respect, international specialized institutions [7] have proposed transfer pricing models - including commercial, financial, patrimonial transactions, etc. - by which to protect national interests, without prejudice to free competition.

5. Arguments to argue the thesis

The rules on transfer pricing take into account the economic and fiscal environment of the partner countries, but the tax system and tax policy
varies from country to country and adapts to the country's short-term requirements. In order to attract as much foreign direct investment as possible, national public authorities are tempted to implement reforms to attract large firms by introducing incentives, primarily fiscal. In this way, the productive activity increases, implicitly the added value and the number of jobs.

5.1. Structure

General framework

Accelerating globalization process stimulates the creation of multinational companies which, through the activity of the national entities associated exert their influence on production costs. Adapting the structure of corporate obligations imposed by the laws governing the competitive market liberalized from the constraints of national boundaries deemed necessary to protect national economies allow mergers, absorptions by creating subsidiaries and hence the holding. Currently, companies categorized as multinationals in our country, whether they exclusively European, the most numerous, or even international exert their influence on the profitability of commercial, economic and, consequently, financial, of the whole of the companies corporate operating on the territory declares national and resident legal entities.

Although regarded with reluctance, growth and financial multinationals growth raises increasingly controversial problems to the national tax administrations, and even these entities themselves, as development and implicit taxation results they obtain can not be considered separately, according exclusive of declared central headquarters, which can be placed, for reasons of tax optimization in a tax haven.

In the process of globalization, trade transfers, and in return, the financial ones, is dealing with constraints generated by fiscal sovereignty of national jurisdictions. Since national tax policies pursuing clearly defined objectives, rules imposed economic resident agents are different from state to state. Tax harmonization, even within the European Union is limited to a few areas well defined by EU legislation.

In this context of economic globalization, transfer pricing has become a strategic tool by which multinational companies analyze and influence, sometimes decisively, their products and assets which are subject to transactions with third parties and, obvious, which make financial gain.

The term transfer pricing denotes relationships between institutional entities that are part of a group and are located in different states, regarding the prices and terms of trade of goods, services or assets. Normally, such
transactions are made between independent enterprises on the principle of full competition, but between entities that are part of a group, transfer pricing will be determined according to the interests of multinational society.

Every society seeks tax optimization, which means to pay tax, respecting the law in force, but a tax as small as possible and in this respect, transfer pricing is an ideal tool. Diminishing tax burden is, however, a threat to the public finances of the countries where are located the companies of the group and that has been stipulated in the model tax convention drawn up by the OECD that the benefits created by transfer pricing to be added to the benefits of the group and taxed accordingly.

In the multinational companies, institutionalized entities located in different countries exercising their fiscal sovereign authority, exchanges of goods and services whose prices are known as transfer pricing or internal transfer prices that do not always respect the law of competition in the free market.

Transferred prices are important for international corporate group profitability because by manipulating their tax base and/or tax levy mandatory under the tax jurisdictions where the companies are located components they can be achieved more targets considered tax optimization:

- transfer pricing is a real tool for financial management company that uses as assessing performance management firm profitability by influencing major commercial, economic and financial return;

- in the European Union, transfer pricing may allow cross-border transfer of the benefits obtained both due to the real economic performance, as the economic policy conditions imposed in the globalization process and regional interests debated and accepted by Member States.

General concepts on transfer pricing

Although businesses that make up a multinational company are connected through several functions, they must behave in terms of tax as if they were independent companies that must comply with the arm's length principle. This means that the prices they will use in transactions between them or transfer prices will be determined according to special methods explained and recommended by OECD and accepted by the countries involved in international trade.

Foreign trade is an important part of the economy of all countries and hence of the world economy. In this respect, it is pointed exports of goods, which in the year 2014 amounted, according to statistical information disseminated by the World Trade Organization (WTO), to 18,001 billion $EU and the exports of services to 4870 billion $EU.

Of all the huge volume of trade, the OECD estimated that intra-group transactions represented approximately 60%, which means that more than 13,700 billion $EU transfers are the result of the multinationals. Given
the impressive size of these transactions, it is necessary to analyze their progress in accordance with the principles of OECD and accepted by the national tax jurisdictions and, consequently, pursuing the correct transfer pricing.

Transfer pricing is an important source of multinational power because they have information about international transactions in various fields, which other economic actors do not know. This asymmetry of information can be used by multinationals as a tool for financial and tax optimization and why tax administrations and international institutions must, together, to introduce regulations on intra-group transfers and financial flows to monitor compliance therewith.

Although implementation of the principle of full competition it relatively easy, to identify economic characteristics of such competition is an enterprise which proves often difficult. The difficulty arises from the fact that if a multinational group members are considered independent entities, to determine the correct transfer pricing must take into account synergies, economies of scale and unique transactions that are generated as a result of the existence of the group.

Consequently, OECD, including tax jurisdictions collaborating in this field, have developed and proposed several methods for determining transfer prices so as to approach as much as the principle of free competition.

Also it should be noted that pricing policies for transfer have no influence on the financial statements of multinational companies, as the effects of transactions between member companies of the same group are canceled on consolidation.

On the other hand, however, although the prices of transfer does not affect the consolidated financial statements of a group, individual accounts of companies will be affected. In these accounts are recorded inflows and outflows according to actual exchanges and their recovery using transfer pricing, which will be reflected in the financial statements of the individual companies.

Tax optimization using transfer pricing

Transfer prices are practiced in transactions between companies (entities) that make up a multinational company. These prices may be legally determined so to transfer the benefits recorded by a group in its subsidiaries implanted in different countries, whose tax regimes are more permissive.

The use of transfer prices lower than market prices is not, generally speaking, illegal [2]. Thus, national and international regulations, mainly those issued by OECD, does not oblige companies to use market prices competitive balance. Businesses can justify a price reduced or increased, as
appropriate, in the transactions with other companies of the same group, citing in the unit cost differences in quality, patent or invention exhibit weighting applied in the production etc.

Tax administrations accuses of organizational entities of the multinationals of transfer pricing abuse because they handle trim the tax and thus diminishes the obligation to pay tax on. In addition, the large multinational companies manipulate transfer prices by resorting to so-called tax havens, where gross benefit will be taxed at a very low or even zero.

All these opportunities for legal tax evasion led economic and tax international organizations, such as OECD, World Bank, European Commission, to develop, implement and, if possible, even impose a series of measures were part of a program called BEPS\(^3\) to limit the possibilities of tax evasion of multinationals and lead to achieve a profound reform of the international tax system.

In any country, but especially in developing economies, a key issue is the choice of the tax system to satisfy the requirements of economic efficiency and those of ensuring social equity. These targets relate to multiple aspects and has many features but can be grouped in terms of the impact that may have on the community where these mechanisms are implemented in two main categories:

- one refers to the economic efficiency, respectively achieving growth targets proposed under the tire classification of material, human and financial resources originally specified;
- the other one, which considers social equity, the envisaged measures following the correction of inequalities that can arise with the entry into force the new regulations.

In this regard, subsequent tax procedures, requiring for a depth knowledge of specific sampling activities to direct and indirect taxes will apply appropriate methods and techniques to stimulate voluntary compliance of taxpayers.

Globalization, which resulted in liberalization of financial flows of investment and trade in the world, produced profound changes in the functioning of enterprises. In case of multinational companies, the borders of states where there are located the firms components is no longer a barrier to trade, but tax liabilities are subject to further national regulations in countries where these entities are declared resident, according to the principle of fiscal sovereignty in the field of direct taxation of each state.

\(^3\) The term BEPS is the acronym in English, the erosion of the tax base and transfer of profits (Base Erosion and Profit Shifting), which may arise due to shortcomings in the national tax legislation and the lack of correlation between different tax systems of the countries that are localized various institutional entities of a multinational.
Tax optimization, designating a management aimed at reducing tax liabilities in the form of taxes and fiscal charges, often materializes by aggressive planning, using methods and techniques within the law, including legal tax evasion.

Tax jurisdictions is characterized by national economic policy and, consequently, by their own tax regimes, often are competing with other foreign states or countries that are in the same union of states, such as the European Union. In an attempt to attract an increasing amount of direct foreign investments, some countries have adopted a more relaxed tax regime, reducing both tax system rates and accepting significant trim deductions.

After economic consolidation that followed the Second World War, the developed capitalist countries have seen a strong growth and continuing financial results trend and in recent decades the multinational companies, thanks to the expansion of the globalization process, have registered huge profits. Unlike the growing profits, tax contribution of the groups show a downward trend, considered as a percentage of total taxes paid by all their entities. Thus, a study conducted in 2014 [1] estimates that multinationals pay 5% corporate tax, compared with at least 30% small and medium enterprises.

This situation is explained by several mechanisms, among which the most important concerns:

- schemes increasingly more sophisticated, involving cross-border financial transfers, which are used by the group companies shirking tax obligations imposed by national tax regimes of the states where the components entities are localized;
- tax benefits which multinational companies negotiates and derive from developing countries to achieve the promise of direct foreign investment in their territory. These advantages translate into lower taxes for certain activities - which impede free competition - the low fees or exemption from taxation of capital gains.

Transfer prices are also used to improve the financial picture of an entity component when it wishes to obtain a bank loan. Rules bank lending institutions require analysis of the risks the firms demanding credits, analysis that follows several installments of financial management, such as the amount of net financial debt (medium and long) relative to equity; net financial debt relative to the operation result; cost of borrowed capital relative to the operation result; self financing capacity (net profit plus depreciation combined) reported in net financial liabilities etc.

When these rates which which shows the quality of financial management highlight a less efficient financial management, intra-group
transfer pricing can be used to manipulate the size of financial ratios, through the schemes such as the one below [3]:

![Diagram of transfer pricing](image)

**Figure 1** - The role of transfer pricing in international tax evasion and fraud

Although many states accusing multinational companies that do not pay taxes to their real benefits they derive from the activity on their territory, the extent of financial losses of those states is hardly dimensioned and the estimates amounted to, overall, a few hundred billion dollars or euro.

Many companies thrive internationally renowned recently arrived in the center of media attention because they were accused of tax evasion, among the most popular being Apple, Amazon, Google, Vodafone, Ikea and Starbucks.

A classic example is Ikea, multinational company of Swedish origin that produces goods and services related to some of them: furniture, household textiles home utility, food etc. Today [4], IKEA owns: about 300 stores worldwide, two secret foundations, one in the Netherlands and the second in Liechtenstein; four subsidiaries in the tax havens from Netherlands, Liechtenstein, Belgium and Luxembourg; a special tax agreement concluded with the Netherlands; a business agreement with Luxembourg in order to reduce taxes.

Ikea scheme that makes tax evasion presents several steps:

1. Branches and other franchises of Ikea Group declared lower profits by paying a fee of 3% to the Netherlands, the gain from those payments are not taxed elsewhere. This makes the tax to be reduced from...
35% in Belgium up to 64% in France. The report observes that in the period 2012-2014, Ikea Group has transferred the amounts in the form of royalties by about 3.1 billion euros to Inter Ikea Systems BV in the Netherlands;

2. In the same period, Inter Ikea Group paid 587 million euros to unspecified recipients. In the Netherlands there is no levy tax at source on royalties and interest, even if they have not been taxed in other countries, so these amounts are not taxed in the Netherlands;

3. Because Inter Ikea does not report its accounts, the report could not identify recipients which were directed by the amounts referred as other expenses;

4. Since 2012, the Dutch branch of Ikea Group transferred the sum of EUR 972 million to its subsidiary Interogo Finance SA in Luxembourg as debt repayment contacted to purchase brand Ikea. In the Netherlands it is not taken any tax at source and does not retain any royalty. Luxembourg Branch transferred dividends amounting to 807.8 million euros to Interogo Foundation & InterogoTresury subsidiary in Liechtenstein AG, 2012-2014;

5. Due to agreements between the Ikea company and the tax authorities in Luxembourg, Ikea subsidiary resident here pays a tax corporatist tiny, with a share of 0.06%;

6. In Liechtenstein, which is a tax haven, dividends received from foreign subsidiaries are not taxed and the money from the Luxembourg subsidiary enters into secret accounts foundation.

The report by Marc Auerbach for the European Parliament on tax evasion schemes that Ikea multinational société place through its subsidiaries estimates that fiscal damage for all European countries where the Ikea’s subsidiaries are located arose in the two years (2012-2014) to over a billion euro.

6. Dismantling the arguments against

Excessive regulation of multinational companies' activities may discourage them, with the effect of diminishing globalization, which produces a slowdown in trade and financial activity, the immediate consequence being the slowdown in global macroeconomic growth.

On the other hand, if no common measures are taken for all states to overcome international legal tax evasion, the polarization of the population in terms of income per capita will increase, meaning that the group of rich, very few people, will enrich even more, while the rest of the population, the majority of people, will be poorer. The income imbalance will be reflected in lowering the standard of living and will create increasing tensions in all the plans: economic, social and political.
In conclusion, the adoption of transfer pricing regulations as well as other mechanisms specific to globalization is necessary but carried out following an in-depth analysis of cross-border financial flows and a responsible assessment of the effects these regulations will have on the collectivities.

7. Conclusions

According to Keynes’s interventionist theory, many developing countries, and some developed ones apply growth models based primarily on lowering the tax oppression, watching as multiplication phenomenon due to the value added in the economy to increase. In this way, the tax authorities of these countries want to stimulate economic residents’ activity, but also to attract foreign direct investment. For the latter, the national tax authorities accept the trim exemptions and reduced or even zero tax rates, opaque financial arrangements, etc., in a bid to attract foreign capital and implementation of subsidiaries of multinationals on their territory.

Most often, the low level of taxation and financial schemes benefiting multinationals rather than the national economy, which is due to these tax policy measures, no significant amounts that should feed public finances and thereby to finance social public services, education, health etc.

Multinational companies that adopt aggressive tax planning strategies exploit inconsistencies and gaps in the tax rules which there are in the different tax jurisdictions. They minimize their tax contribution making no longer be taxed the benefits by transferring them by little or no taxed activities. Also multinational companies can artificially assign ownership of the assets or financial transactions to some subsidiaries that exists only on paper, located in secrecy jurisdictions, applying zero or nominal tax rates very low, ie tax havens.

To this is added the fact that multinational companies often enter into agreements with the tax authorities, because the promise to invest in those countries, get a number of advantages on reducing the tax burden, royalties or the taxation of dividends, which constitute a breach of the principle of full competition.

Other type strategies of fiscal abuse include manipulating of transfer pricing. This practice involves a deliberate increase in import prices and / or a drop in prices of exports of goods and services between subsidiaries of the same company. While, in theory, the deliberate manipulation of transfer prices is considered tax fraud, in practice tax rules today enable companies to establish multiple prices for goods and services own more or less
which makes these practices hardly be criminalized by the tax authorities in developing countries. Financial flows arising from intra-group loans and grants that each component entities and debt service - repayment plus debt costs – related to these can use also the transfer prices to make tax evasion. Thus, interest charged can be declared higher when it is deductible and the net benefit, resulting to be transferred to a tax haven will be diminished.

Due to the growing negative aspects on the functioning of multinational companies, OECD formulated the principles which should have applied transfer pricing and treating tax provisions in connection therewith, which were later improved and supplemented by control methods of trading and financial transnational transactions, being, however, specified the penalties to be applied for failure to comply with these rules.

To enforce those principles, OECD [7] has compiled an exhaustive list containing the information necessary for the tax administrations that they can track the prices charged on transfers they perform and entities, including their location. To this end, the informations relate to:

- taxpayer, ie the company involved in a transfer price. The informations relate to the sector, the role that this company has in the economic and social environment, the economic environment characteristics, the risks they may face the taxpayer etc.;

- associated companies, on which will be specified the type of business, organizational structure, relationships and their share in the structure and levels of income of the multinational in recent years.

- transactions with independent firms that perform similar operations;

- operation aimed at establishing the price: the strategy adopted, the calculation method.

The type and characteristics of the information proposed by the OECD [6] to monitor transfer pricing can be found generally in the information that taxpayers must provide national tax administrations, which means that closer cooperation between them can support both avoid international double taxation and tax evasion and fraud products of international transactions.

In a multinational company, between companies that compose the group there are many transactions and property, economic and financial relations: the sale or purchase of goods, services, disposal or concession of licenses, patents or trademarks, loans ...

Obviously prices of these operations do not necessarily reflect the free play of market forces, being dictated mainly by the group's policy, thereby possibly differ greatly from the prices used in transactions with
similar products / services between independent enterprises, on the open market or prices designated under the appellation of "arm's length".

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4 The basic principle in the theory of transfer pricing enshrined in directives OECD is known as the "arm’s length: for business to be fair, between two partners must establish relations as between two people who do not know, they are independent, ie between them to stay away an arm’s length. Source: http://www.transferpricing.ro/am-nevoie-de-transfer-pricing-services/tps-o-oferta-flexibila#tpdoc