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THE CONCEPT OF TRANSFER PRICING IN THE CURRENT ECONOMIC CONDITIONS

Background discussion of the transfer pricing concept, which is the international transfer pricing standard that Organization for Economic Cooperation and Development (OECD) member countries have agreed should be used for tax purposes by Multinational Enterprises (MNEs) groups and tax administrations.

The concept of transfer pricing, accepted both internationally and within the European Union, is the universal method of determining the right pricing to be used among related parties and, therefore, is used by the OECD and by the United Nations Tax Committee (UN) and also in the tax treaties concluded by the governments [1, 2].

In applying the foregoing principles to the taxation of MNEs, one of the most difficult issues that have arisen is the establishment for tax purposes of appropriate transfer prices. Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. For purposes of these Guidelines, an **associated enterprise** is an enterprise that satisfies the conditions [art. 9, 3]:

- two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other;
- if the same persons participate directly or indirectly in the management; control, or capital of both enterprises (*i.e.* if both enterprises are under common control);

Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. Transfer pricing issues originally arose in transactions between associated enterprises operating within the same tax jurisdiction. The domestic issues are not considered in these OECD Guidelines, which focus on the international aspects of transfer pricing. These international aspects are more difficult to deal with because they involve more than one tax jurisdiction and therefore any adjustment to the transfer price in one jurisdiction implies that a corresponding change in another jurisdiction is appropriate. However, if the other jurisdiction does not agree to make a corresponding adjustment the MNE group will be taxed twice on this part of its profits. In order to minimize the risk of such double taxation, an international consensus is required on how to establish for tax purposes transfer prices on cross-border transactions.

The structure of transactions within an MNE group with its component parts such as companies, also called associated enterprises is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independence entities. Thus, a large and growing number of international transactions are no longer governed entirely by market forces, but by forces which are driven by the common interests of the entities of a group. In such a situation, it becomes important to establish the right price, called the "transfer price" for intra-group, cross-border transfer of goods, intangibles and services [4, p. 56].

Transfer pricing refers to the general term for the pricing of cross-border, intra-firm transactions between related parties. These transactions are also referred to as controlled transactions, as distinct from uncontrolled transactions between companies that are not associated and can be assumed to operate independently in reaching terms for such transactions.

Transfer pricing- the pricing policies and practices that are established when physical goods as well as services and intangible property are charged among associated business entities [5] – is traditionally used in international tax law as the principal method for allocating income between jurisdictions. Since they determine the income of both parties involved in the cross-border transaction, the transfer price tends to shape the tax base of the countries involved in cross-border transaction.

As afore described, MNEs represent a substantial fraction of the global trade and industry. Therefore, a challenge that they have to face is the articulation decision process among their several subsidiaries, located in different countries. Consequently, some can argue that transfer prices are frequently deployed in order to separate complex decisions among different decision makers, by delegating responsibilities among different agents.

In addition to this coordination function, transfer pricing is also used for tax purposes, namely as a device of international tax planning. In fact, taxable group profits are allocated among the participating companies by adjusting transfer prices. Therefore, MNEs frequently shift their profits to low tax legislations in order to reduce the group's overall tax burden. In other words, it can be said that the transfer pricing mechanism is a tool often used by corporations to avoid high taxation in certain countries [6, p. 63].

Transfer pricing is based on the closely related fundamental principles [7]:

1) companies with permanent establishments or affiliated companies in other countries have to compute the profits of the different units on the basis of separate accounts (separate entity approach);

2) for goods and services exchanged by them, prices have to be charged as if they were among independent persons (arm's length principle);

In relation to the first condition, it is important to notice that there are certain differences between the treatment of permanent establishments and subsidiaries but, notwithstanding this fact, the functionally separate entity approach adopted by the OECD further gives an equivalent treatment to permanent establishments and to subsidiaries. In fact a concern for the tax authorities has been to maintain a level playing field with respect to the use of a branch or a subsidiary to carry on business in a given jurisdiction. It only makes sense to apply the same principle in both situations, and the arm's length principle was selected.

The main reason why companies started to use transfer pricing is to help identifying which parts of the enterprise are not performing well, to escape double taxation when repatriating profits and, ultimately, to reduce tax. Despite the recognition that intra-group companies frequently try to minimize their costs through the manipulation of transfer prices, the fact is that this is not always like this, since the leads to those companies may also have reasons to carry on their management in normal market conditions and mimic their intra-group relations, the open market schemes.

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