

Optimization of Transfer Pricing in a Recession with Reflection on Croatian Situation

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Abstract—Countries in recession, among them Croatia, have lower tax revenues as a result of unfavorable economic situation, which is decrease of the economic activities and unemployment. The global tax base has decreased. In order to create larger state revenues, states use the institute of tax authorities. By controlling transfer pricing in the international companies and using certain techniques, tax authorities can create greater tax obligations for the companies in a short period of time.

Keywords—Documentation, Methods, Tax Optimization, Transfer Pricing

I. INTRODUCTION

TRANSFER pricing issue is very important for all OECD countries, as well as for many other ones, among them also for Croatia, especially when realizing that there are 350 leading US, European and Asian multinational companies across 34 industry sectors in Croatia.

Global recession's consequences are reduced liquidity, downward pressure on the stock markets, inflationary pressure in commodities, rising unemployment, reduced investment, consumer demand and production. With rising unemployment comes reduced personal income taxes, and with reduced corporate profits come reduced corporate revenue. Globally, tax authorities will increase their efforts to collect taxes needed to fuel their governments' spending. A substantial increase in tax audits, especially those focused on transfer prices, is expected. In addition to the increased number of audits expected globally, the difficulty and complexity of such audits are expected to increase as tax authorities continue to become more sophisticated and open to sharing taxpayer information. Issues that may have been overlooked before will be reconsidered. Settlement positions arrived at in the past may no longer be accepted [1].

As a result of the intensely challenging economic circumstances, many tax jurisdictions around the world are redirecting their attention to transfer pricing issues.

In addition to ensuring they have adequately documented their transfer pricing to defend historical positions, companies also must consider ways to optimize current and future transfer pricing positions. This includes evaluating current transfer prices under current structures as well as opportunities to modify current organizational and tax structures [1].

The role of the international companies in the world trade dramatically increased in the last twenty years. This increase

causes the increase of the complexity of tax issues for tax authorities and international companies, due to the fact that the rules of the individual states for the taxation of the international companies can not be addressed individually and isolated, but in the broader international concept. Member States of the OECD choose individual approach to the companies as the most suitable way to achieve righteous results and minimize risk of the unpublished double taxation. Using this principle, each individual member of the group is subject to income taxation that is created in that company, according to the taxation principle based on the residence and on source. In order to ensure the correct application of the individual approach, states members of the OECD accepted the independence principle, according to which special influences on income have to be eliminated [2].

In the light of these efforts, documentation of transfer pricing is, amongst other elements, a crucial enabler of passing tax audits or even having the cost of certain intra-Group services left non tax deductible. It is therefore the intention of Group Tax offices of many international companies to prepare a Group wide Transfer Pricing documentation, Master - file on Group level, in the area of regularly invoiced Group Charges.

II. TRANSFER PRICE REGULATIONS AND POLICY OBJECTIVES

In the recession, tax authorities have tendencies to focus their inspections on transfer pricing activities due to the fact that these activities in most cases are substantial in value. Tax inspections refer mostly to international transactions, although it is possible to inspect transactions among national associated companies (enterprises), as well. Tax inspection of the transactions within the same country, (same jurisdiction), are focused on associated companies that use tax benefits (for example: beneficial income tax, lower for particular parts of the country, or possibility to carry over the generated loss in the next years and use it for diminishing the next year's tax base).

International regulations that rule transfer pricing issues are:

- OECD Articles of the Model Convention with Respect to Taxes on Income and on Capital, and
- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Two enterprises are associated if one of the enterprises fall under conditions defined by article 9 item 1a) or 1b) of the OECD Model Convention with Respect to Taxes on Income

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and on Capital [2]. Associated enterprises are defined as follows [3]:

a. Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b. The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other contracting State.

The above definition is often incorporated into local laws and regulations. Respectively, associated enterprises, according to the Croatian Corporate Income Tax Act, are enterprises where an enterprise of a Contracting Party participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting Party, or the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting Party.

The transfer pricing rules in Croatia are stipulated by the Corporate Income Tax Act (the CIT Act) and the Corporate Income Tax Bylaw (CIT Bylaw). In basic terms, these rules focus on the general requirement that transactions between related parties should be performed at arm's length.

Formation of transfer pricing is done for the purpose of realization of specific objectives. Transfer price policy objectives are: [4]

- Consolidated profit maximization,
- Minimization of tax liabilities,
- Increase in market share,
- Reduction of the impact of economic constraints.

Transfer pricing functioning within the group at the international level has the following features [4]:

- Companies within the Group operate in different tax systems,
- Use of tax benefits and deficiencies of the individual countries' tax systems,
- Operating profit redistribution into the companies that operate under more favorable tax terms,
- Consolidated profit maximization,
- Minimization of tax liabilities on the group level.
- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations represents international generally accepted standard for determination and control of transfer prices. It defines the following:
 - Applying the principles of independence (independent market principle, the principle of impartial transaction),
 - Principle of the taxation of individual companies,
 - Transfer pricing methodology,
 - Transfer pricing documentation structure.

III. TRANSFER PRICING DOCUMENTATION

There is a problem of conducting control of intercompany transactions and transfer prices. International companies and tax authorities are getting education in terms of creating the

documentation on transfer pricing, or their control.

Individual countries have OECD transfer price provisions incorporated in their legislation. Local legislations, such as Croatian, often regulate the relationship among associated companies through transfer pricing rules. Thus, the Croatian legislation regulates that the business transactions among related parties will be recognized as tax deductible only if the taxpayer at the request of the Tax Administration provides data and information on related parties and business transactions among them, transfer price methods used to determine the comparable market price and the reasons for selecting specific methods [5]. Documentation structure, according to the OECD Transfer Price Guidelines, is divided on general and specific part of the documentation. The content of general and specific part of the documentation is as follows [4]:

A. General part of the documentation is usually generated by the parent company. It can be unique for the whole Group. It contains:

- Description of the taxpayer,
- The organizational structure at the international level,
- The type of intercompany relations,
- Description of the transfer price determination system,
- General description of operations and business strategies,
- Economic and other factors,
- Description of the competitive environment.

B. Special part of the documentation is to be prepared by each related party in the Group. It contains:

- Information on transactions with related parties,
- Analysis of the comparability of transactions,
- Data on the characteristics of assets and services,
- Functional analysis,
- Contract conditions,
- Economic and other conditions that affect the transactions,
- Business strategies,
- Application of transfer pricing methods and their compliance with the comparable market prices,
- Other documentation.

Draft regulations on transfer pricing in the Republic of Croatia define the following content of the transfer pricing documentation [6]:

1. Description of business attributes of the taxpayer,
2. The structure of organizations with related parties (schematic display),
3. Description of business characteristics of the related parties,
4. Description of transactions with related parties for the past three years,
5. Grouping of transactions in accordance with the nature of business relations,
6. Description of contract, contractual conditions and transfer pricing with related parties, which in particular should include the following:

- a. Historical analysis of operations and transfer pricing with related parties,
 - b. Description of planned development of business relations and of transfer pricing with related parties,
 - c. Overview of the accompanying documentation of transactions and transfer pricing with related parties.
7. Functional analysis, especially:
 - a. All related parties that have business relations with the tax payer, and / or
 - b. Analysis based on goods / services,
 8. Comparative analysis, and
 9. Data of the chosen methods of forming the transfer prices.

Correct determination of transactions, functions and risk is crucial for the proper selection of methods for transfer prices formation. In determining the transaction it is important to:

- Identify what is happening in a particular transaction,
- Create cash flow analysis for transactions among related companies,
- Analyze functions, risks and assets that the company has / bears in a particular transaction.

The starting point in determining the comparability of transactions is the functional analysis. The purpose of functional analysis is to determine the role of each party in the transaction. In transactions between unrelated parties the fee will reflect the functions performed by each company, taking into consideration used property and assumed risks.

A. Functional Analysis

Functional analysis is based on the assessment of:

- Functions (activities) that each related party performs in the transaction,
- Tangible and intangible assets used in carrying out the activities, and
- Business risks arising from transactions [6].

Functions to be compared and identified are business functions of procurement, production, sales, marketing, research and development, finance and accounting and other business functions. Activities in business functions are performed with certain assets, whose analysis is also needed, in order to make comparison and determine transfer price. The more assets are engaged, considering the value of these assets, the higher transfer price can be expected. A company that performs the low-risk functions should expect lower level of profitability compared to the company that performs high-risk functions.

In the following example functions, assets and risks resulting from transactions between manufacturer and associated distributor (representing related parties) will be compared to functions, assets and risks resulting from transactions between manufacturer and non-associated customer (representing non-related parties).

Applied transfer prices should reflect the result of the given analysis.

TABLE I
ANALYSIS OF FUNCTIONS

Functions	Transaction 1: Manufacturer (M) - Associated Distributor (D)		Transaction 2: Manufacturer (M)- Non- associated customer (K)	
	M	D	M	K
<i>Raw material</i>	Yes		Yes	
<i>Production equipment</i>	Yes		Yes	
<i>Production know-how</i>	Yes		Yes	
<i>Warehouse</i>	Yes		Yes	
<i>Transportation</i>		No	Yes	
<i>Warehouse for goods for sale</i>		No	Yes	
<i>Sales representative</i>		No	Yes	
<i>Marketing and know-how</i>		No	Yes	
<i>Advertising and promotion</i>		No	Yes	
<i>Brand</i>		No	Yes	

TABLE II
ANALYSIS OF ASSETS

Assets	Transaction 1: Manufacturer (M) - Associated Distributor (D)		Transaction 2: Manufacturer (M)- Non- associated customer (K)	
	M	D	M	K
<i>Production process organization</i>	Yes		Yes	
<i>Production</i>	Yes		Yes	
<i>Quality control</i>	Yes		Yes	
<i>Raw material and final products</i>	Yes		Yes	
<i>Transport</i>		No	Yes	
<i>Search for non-associated customers</i>		No	Yes	
<i>Marketing and advertising</i>		No	Yes	
<i>Service</i>		No	Yes	

TABLE III
ANALYSIS OF RISKS

Assets	Transaction 1: Manufacturer (M) - Associated Distributor (D)		Transaction 2: Manufacturer (M)- Non- associated customer (K)	
	M	D	M	K
<i>Production process organization</i>	Yes		Yes	
<i>Production</i>	Yes		Yes	
<i>Quality control</i>	Yes		Yes	
<i>Raw material and final products</i>	Yes		Yes	
<i>Transport</i>		No	Yes	
<i>Search for non-associated customers</i>		No	Yes	
<i>Marketing and advertising</i>		No	Yes	
<i>Service</i>		No	Yes	

Table 1: The role of functional analysis in correct determination of transfer prices [6]

The more functions that determine the profit in the production and distribution chain of a certain company, as well as the more assets the company uses and the more risk it bears, the higher level of company profitability is expected.

B. Comparative analysis

Comparative analysis is important when comparable uncontrolled price method is applied, because this method focuses directly on the market price of goods or services, while other methods focus more on the comparative analysis of the distribution of certain business functions among the participants in the transaction.

Comparative analysis:

1. Analyses (estimates) if the negotiated price among related parties corresponds to a price that is negotiated among unrelated parties,
2. Includes:
 - One or more uncontrolled transactions of chosen unrelated party, as basis for comparative analysis,
 - Uncontrolled transaction is comparable with controlled transaction if one of the two conditions is met:
 - None of the differences between controlled and uncontrolled transactions can significantly affect the price in a free market, or
 - Reasonable and sufficiently precise adjustments can be made in order to eliminate the important effects of these differences.

All differences must be quantified, and for the cumulative effects the price agreed among unrelated parties has to be corrected, in order to determine the price among related parties, that is consistent with the principle of independence.

Market price determination depends upon the applied method.

- Comparable uncontrolled price method compares the selling prices of products or services,
- Cost plus method compares the margins,
- Net profit method compares net operating profit.

It is necessary to find a "benchmark". Prices among related companies have to be as close to the benchmark as possible. Identification necessary for benchmarking is done through a database. Tax administrations and international companies use the Amadeus database, created by the company Bureau van Dijk, for benchmarking.

AMADEUS is a comprehensive European database containing financial information on public and private companies. Amadeus data base provides financial and business information on detailed current and historical information on over 9,000,000 European companies. Data includes standardized annual accounts (consolidated and unconsolidated), financial ratios, activities and ownership for companies throughout Europe - east and west. It contains descriptive information, company financials, news, market research, ratings and country reports, scanned reports, ownership and M&A data [7].

Transfer prices are not exact science. The application of relevant method can suggest the range of relatively equally reliable values instead of one exact value (price or margin).

What is also very important is that, using this range, the

company – taxpayer can optimize transfer prices and its tax status.

If the important conditions of the controlled transactions (for example price or margin) exceed the range of values acceptable for determining the independence of controlled transactions determined by tax authorities the tax payer has to get a chance to present the arguments according to which transfer pricing conditions satisfy the principle of independence.

C. Transfer price methods

Transactional methods used in application of principle of independence can be divided into traditional and other methods.

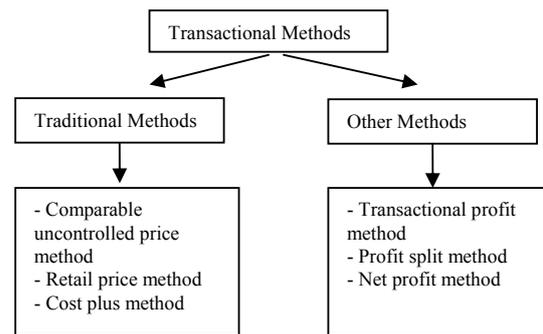


Fig. 1: Transactional methods [2]

Description of methods is as follows [2]:

For comparable uncontrolled price method, prices of goods or services among related parties are compared to the prices for similar goods or services that are applied among unrelated parties. It is necessary to make comparative analysis. Transaction among related parties is comparable if it is done under the same or similar conditions as transaction among unrelated persons. Sometimes it is necessary to make adjustments, according to the functional analysis. Internal comparable prices can reduce the costs of study preparation.

Retail price method tests the market character of the transaction by comparing the trade margin with the margin realized in comparable uncontrolled transactions - the analysis of margin comparability is to be done. This method is applicable in cases when the goods are bought from the related party and resold to unrelated party (for example distributors). It is usually applied in situations where the seller does not add significant value to the goods by partially changing them or by using valuable intangible assets in order to improve them. Requirements for comparability according to the retail price method are less strict and more dependent upon functions and risks taken, rather than upon the similarity of goods traded.

Cost plus method adds gross margin to the costs incurred at the suppliers of goods or services' level, with the aim of making profit. The market principle of "margin" added to the costs incurred in the comparable uncontrolled transactions is tested. Comparability depends primarily upon the similarity of

functions performed and risks taken, and not upon the similarity of the respective material goods.

Profit split method compares the distribution of profit in transactions among associated parties with the distribution of profit that would unrelated parties expect when participating in one or more transactions. The contribution to the transaction of each party, based upon functional analysis, is evaluated. It is used in situations where it is difficult to identify each transaction.

Net profit method compares the net profit in relation to a certain base (total cost, sales revenue, assets or equity) that the company achieved in controlled transactions (in relation with related parties), with the net profit achieved by the non-related party in transactions with other non-related parties. This method is similar to the cost plus method or retail price method. It is used in situations where it is difficult to identify each transaction.

In addition to the transfer pricing study, it is also very important to have other documentation that can be used for proving the transactions among related parties, such as contracts, emails and other correspondence, review of hours spent, reports, etc. The documentation has to be sorted in a logical and functional order.

IV. INFLUENCE OF RECESSION ON TRANSFER PRICING

The OECD has not explicitly addressed transfer pricing during recessions. However, the OECD Transfer Pricing Guidelines contain a number of statements implying that changes in economic conditions or business strategies may render transfer pricing arrangements obsolete that previously were at arm's length.

One of the most important principles of OECD Guidelines-based transfer pricing is that profits of affiliated companies should reflect functions, risks and economic circumstances. Once a transfer pricing method has been found that adequately reflects these three items, the transfer pricing system is supposed to remain stable over time. Economic recessions represent extraordinary times in the sense that economic circumstances are unstable and may have implications on the international allocation of functions and risks in a multinational group.

Survival in recessions often necessitates a change of business strategy. For instance, companies in trouble may need to reconsider their product portfolio, pricing strategy and cost structure, the location of their subsidiaries, etc. Changes in business strategies may also imply the need for changes in the transfer pricing policy. Although the transfer pricing was at arm's length under the old business strategy, it is possible that this is no longer the case under the new business strategy.

Planning studies conducted today to determine transfer prices for the coming fiscal years are likely to draw on data between 2005 and 2007 or in some cases also 2008. As these years were growth years for many companies, they are unlikely to provide financial data or market prices that reliably indicate profitability for 2009, which is expected to be a recessionary year. In fact benchmarking the boom years to set transfer prices during recessions most likely creates an upward

bias for routine profits. To remove this bias, it is necessary to adjust financial data from the good years to account for the likely economic circumstances of the bad years.

Accounting in benchmarking studies for recessions has been largely untested territory. Practitioner approaches could include conducting data searches not in the most recent years, but in recession years, for instance 2000-2001 in the European Union. A modification in this approach would focus on the relative difference between margins earned in recessions and boom years [8].

In such uncertain economic times, multinational companies should approach defending past transfer pricing policies including those established under advance pricing agreements during robust economic times in a very complex and careful way. In this economy, taxpayers might consider a variety of ways to modify their transfer prices. Modification of profit splits, number of years analyzed, and even targeting a different position in the range may be beneficial. In addition, companies may use the economy as a reason to consider modifications in cost sharing, intangibles migration or other transfer pricing formation.

Regardless of the choices made, care should be taken to ensure the transfer pricing is supported by the facts and that any modifications have been made in an arm's length manner. In these uncertain times, with less money in the tax system, it is expected that tax authorities will focus on reviewing all transfer pricing policies carefully, especially if modifications have been made. Proper defense of these situations will be critical in the months and years ahead [1].

V. CONCLUSION

Monitoring and control of transfer pricing is necessary for maintaining objectivity in the taxation of individual companies within the group. Elimination of the transfer pricing effects would be achieved by harmonization of tax systems. OECD guidelines on transfer pricing represent international standard for the treatment of transfer pricing at the international level. RH implemented OECD guidelines in its tax legislation.

OECD Transfer Price Guidelines defines transfer pricing documentation structure, used to justify and defend intercompany transactions. The most important parts of transfer pricing documentation are functional analysis, comparative analysis and transfer price methods. Functional analysis identifies and compares business functions, assets used in transactions and risks taken. Comparative analysis estimates the correspondence of a negotiated price among related parties to negotiated price among unrelated parties. In practice it is often done using Amadeus database. Tax authorities often have the access to this database and they use it when controlling the taxpayer's transfer pricing, but the taxpayer itself can also benefit from this database in the process of transfer pricing preparation and set-up. Usually the taxpayer itself does not have the access to the database (because it is quite costly), but can order this service from big audit companies that buy the access and provide services to their clients.

Completed benchmarking within the transfer pricing

documentation can demonstrate the existence of room for increasing the transfer price. Benchmarking data is used to defend, document, and optimize intercompany transactions. Many multinational companies are experiencing significant operating losses as a result of the global economic crisis. Transfer pricing can be optimized in sense of increasing operating profit on the companies' consolidation level. Well prepared documentation with market benchmarking is the base for making decisions in transfer price optimizing.

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