DOI: 10.47743/eufire-2024-1-28

TRANSFER PRICING. THE TAXPAYER'S RIGHT TO BE HEARD

NATALIA ȘVIDCHI
West University of Timisoara
Timisoara, Romania
natalia.svidchi@e-uvt.ro

Abstract
Transfer pricing represents a challenge both for the taxpayer and the tax administration. As transfer pricing cases have increased in Romania over the past few years, legal practitioners must face the task of understanding the rationale of the inherent functional and economic analysis, which is far from being exact and straightforward, but rather increasingly interpretative and highly challengeable.
In this paper the author provides a brief presentation of the arm's length principle and of the current legal framework in Romania, followed by a theoretical analysis of the taxpayers right to be heard during transfer pricing tax inspections accompanied by two cases from practice.
The author's conclusion is that, considering the specificity of transfer pricing, the tax inspection has the obligation to inform the taxpayer during the tax inspection whenever it intends to make an adjustment or an estimation of the transfer prices. Moreover, prior to making any adjustments or estimations, the tax administration has the obligation to request from the taxpayer additional explanation and information in writing.
Keywords: *transfer pricing; legal framework; adjustment; estimation; right to be heard.*
JEL Classification: K34, K40.

1. ARM'S LENGTH PRINCIPLE. REGULATION AND PURPOSE

The arm's length principle is an international standard, regulated in Art. 9 of the OECD and UN Model Conventions and taken over in the bilateral double taxation conventions concluded between states according to these two models. To ensure compliance with this principle, the OECD has elaborated the Transfer Pricing Guidelines (OECD, 2022), to which both the relevant provisions of the Tax Code and those of the secondary and tertiary legislation adopted for their application refer.

The arm's-length principle ensures that transfer prices between affiliated entities are comparable to those charged between independent companies in comparable situations and for comparable transactions. The establishment of this principle at the international and, subsequently, at the national levels was necessary to ensure a coherent basis for profit allocation and avoidance of double taxation.

In particular, when a company situated in the territory of one State provides goods or services to non-resident affiliated companies (situated in another State) below their value or free of charge, there is a reduction in the taxable income of the first company and the consequence is that its State of residence loses the right to tax on income that would have been earned if the price charged had been similar to that which would have been agreed at the arm's length (between independent companies).

By providing goods/services below their market value, the tax base of the State where the supplier is located is eroded and the profit is transferred to other states. Sometimes, such practices can be used in tax avoidance structures, i.e. to shift profits to low- or zero-tax countries. At the same time, if the tax authorities find that the arm's length principle is breached and adjust the income (or the expenses) to reflect the market price, to eliminate double taxation, an appropriate adjustment of expenses (or, as the case may be, income) must also be made to the other affiliated party to the transaction.

The risk of base erosion is reduced if the affiliated companies are established within the territory of the same State, as the income does not fall outside the taxing competence of the same tax administration. However, to ensure equal treatment between entities in purely internal situations and those in a transnational situation, and to prevent some optimization arrangements (e.g. transfer of income from one profit-making company to another loss-making company), some states, such as Romania, require compliance with the arm's length principle also for purely internal transactions between affiliated parties.

The conclusion of a transaction between affiliated parties, under different conditions than those which would be agreed between independent entities under similar conditions, should not be followed in all cases by an adjustment by the tax authorities, since, as the CJEU ruled in Hornbach-Baumarkt C-382/16, (CJEU, 2018), see also, SGI, C-311/08 (CJEU, 2010), paras. 71 to 72 and Impresa Pizzarotti, C-558/19 (CJEU, 2020), para. 36, there may be commercial reasons justifying the conclusion of the transaction on terms different from the usual conditions between third parties.

As mentioned, the enforcement of the arm's length principle is made through transfer pricing rules. In the process of applying these rules, to determine whether the prices charged in transactions between related parties are market prices/comparable to those charged between independent entities, a number of methods are used, and the choice of the most appropriate method(s) for this purpose depends on the nature of the transaction analysed, the available information, the circumstances shaping the specificity of the transaction etc (Iovescu, 2024).

Of significant importance in this respect are the OECD Transfer Pricing Guidelines. Although not legally binding, both taxpayers and tax administrations

rely on these Guidelines in the process of determining the transfer prices between affiliated companies.

Thus, both the provisions of Art. 11 para. (2) of the Tax Code 2004 (in force until 31.12.2015), as well as those of Art. 11 para. (4) of the Tax Code 2016 (in force since 01.12.2016), make express reference to the provisions of these Guidelines to determine whether prices charged between affiliated enterprises comply with the arm's length principle.

References to the OECD Guidelines can also be found in the tertiary legislation, respectively in Order no. 222/2008, applicable to transactions made until 31.12.2015, and Order no. 442/2016, in force as of 02.02.2016 (Lupu, 2024).

2. CURRENT LEGAL FRAMEWORK IN ROMANIA

We consider that some clarifications are necessary regarding the current legal framework in Romania, which outlines the obligation of taxpayers to prepare the transfer pricing file.

First, through the transfer pricing file, following the OECD Guidelines, are documented related party transactions and the prices of these transactions to determine whether these prices comply with the arm's length principle, by selecting the most appropriate method for this purpose.

Secondly, only *large* taxpayers have the obligation to prepare the annual transfer pricing file and only if they exceed certain annual thresholds, broken down into three main categories of transactions carried out with affiliated persons (financial transactions, services, sales). *Large* taxpayers, who do not exceed the annual thresholds, but also *medium* and *small* taxpayers, have the obligation to prepare the transfer pricing file only at the request of the tax auditors, during a tax inspection, also only if certain annual thresholds are exceeded (lower than those regulated in the case of large taxpayers required to prepare the file annually) on the three main categories of transactions. If the two sets of annual thresholds are not exceeded, compliance with the arm's length principle will be documented by taxpayers according to the general rules provided by the financial-accounting and tax regulations in force.

Thirdly, according to the tertiary legislation in force, enacted in application of the provisions of Art. 11 of the Tax Code (Order no. 442/2016), the tax inspection is entitled to adjust or estimations of the market price. If the tax inspection makes an adjustment or an estimation according to the provisions of Order no. 442/2016, the market price will be established by reference to the "*value configured by the central trend of the market*". This process – of adjustment/estimation by reference to the value configured by the central market trend/to the median value ("*median value represents that value found in the middle of the comparison range*") – which is not regulated in the OECD Transfer Pricing Guidelines, represents in fact a sanction in cases where:

- the taxpayer did not document that the transfer prices complied with the market value (arm's length) principle (adjustment hypothesis);
- the taxpayer does not submit the requested transfer pricing file or this file is incomplete (estimation hypothesis).

The adjustment or estimation at the median value is a sanction, since, if the tax inspection considers that the transfer pricing file is properly documented, the price related to the transactions made between affiliated companies will be a market price even if it is below the median (central market trend), but within the comparison range. To identify the comparison range, the comparison margin is divided into 4 segments (5 together with the median): *"The high and low segments represent the extreme results. The comparison range represents the range of values of the price or of the margin/result related to comparable transactions carried out between independent comparable companies, after removing from the comparison margin the extreme results*" (Art. 8 of Order no. 442/2016).

3. THE TAXPAYER'S RIGHT TO BE HEARD

In practice, are often encountered situations in which the tax inspection adjusts or estimates the transfer prices, even if taxpayers prepare and present the transfer pricing file, without informing the taxpayer in this regard during the tax inspection, respectively without giving it the opportunity to submit explanations or additional documents to substantiate the analysis in the transfer pricing file. The taxpayer is informed about the adjustment, or the estimation made by the tax inspection only through the draft tax inspection report, the tax inspection considering that by making available this draft, on which the taxpayer can formulate a point of view, its obligation to inform is fulfilled.

Such a view, however, is contradicted by the express provisions of Art. 130 para. (1) of the Fiscal Procedure Code according to which *"The taxpayer/payer must be informed during the tax inspection about the aspects found during the tax inspection action, and at its conclusion, about the findings and their tax consequences".* Therefore, the first thesis of Art. 130 para. (1) of the Fiscal Procedure Code regulates one of the components of the right to be heard, provided for in art. Art. 9 of the Fiscal Procedure Code – during the tax inspection – which is distinct from the one related to the conclusion of the tax inspection (Lazăr and Florea, 2023).

As a rule, the obligation to inform during the tax inspection is oral and contradictory, but, in practice, the tax inspection often requests written explanatory notes from the taxpayer on various issues raised during the tax inspection (Anghel, 2020).

In the special situation of documenting the transfer prices charged between affiliated companies, however, if the tax inspection considers that the transfer pricing file prepared by the taxpayer is incomplete from the perspective of

documenting the compliance with the arm's length principle, it shall request in writing the taxpayer to provide additional information. The written form of the request is required by the provisions of Art. 5 para. (1) of Order no. 442/2016, according to which: *"At the written request of the tax inspection, in order to complete the transfer pricing file, the taxpayer/payer shall provide other additional information, relevant for documenting the compliance with the market value principle".*

The written form of the request for information is also required by Order no. 3710/2015 regulating the model and content of the Tax Inspection Report drawn up for legal entities: "2. Request/Submission of the transfer pricing file. It is specified whether it is necessary to request/submit the transfer pricing file. If it is decided that it is not necessary to request the transfer pricing file, this fact will be justified. If it is decided that it is necessary to submit the transfer pricing file, the number and date of the request for elaboration and presentation of the transfer pricing file, respectively the granted deadline, including references to the taxpayer's request to extend the deadline for its submission, if applicable, shall be recorded. At the same time, information shall be presented on:

a) failure to submit the transfer pricing file on time;
b) incomplete submission of the transfer pricing file, respectively justifications of the missing data necessary to the competent tax body to determine whether the practiced transfer prices comply with the market value principle.

In the situations referred to in letters a) and b), references shall be included regarding the number and date of the address regarding a new request for submission/completion of the transfer pricing file, respectively the new deadline, recording also the situations in which the taxpayer did not respond to this new request of the transfer pricing file, respectively the requested additions, within the established deadlines". Although from the provisions of Art. 5 para. (1) of Order no. 442/2016 results that the tax inspection has the possibility and not the obligation to request additional information, the provisions of Order no. 3710/2015 require the tax inspection to mention the number and date of the address by which is requested the completion of the transfer pricing file.

Also, from the corroborated interpretation of the relevant provisions of Order no. 442/2016 and those of Order no. 3710/2015, it follows that the obligation of the tax inspection to request additional information in writing from the taxpayer refers only to the estimation of the transfer prices hypothesis, respectively when the transfer pricing file is considered incomplete.

However, a thorough analysis of the notions of adjustment and estimation (which is the subject of another paper), apart from the clear situation in which estimation is made due to the failure to submit the transfer pricing file, shows that, theoretically, within the adjustment and estimation procedures, the tax inspection is entitled to undertake the same actions, such as to invalidate the

transfer pricing method, the search strategy, the list of companies in the comparability range etc. The same analysis reveals that both the adjustment and the estimation are based on the taxpayer's lack of documentation that transfer prices comply with the market value principle [see Arts. 7 paras. (1) and (4) of Order no. 442/2016].

From the author's point of view, even if it could be argued that the legal provisions in force allow a clear differentiation between adjustment and estimation, the obligation of the tax inspection to request additional information from the taxpayer during the tax inspection exists both in the estimation and in the adjustment procedures, in the latter case the need for the request being based on the same reasons, i.e. additional information that may justify the analysis contained in the transfer pricing file.

Therefore, the tax inspection has not only the right, but also the obligation to request additional information from the taxpayer if it considers that it is necessary to document the prices charged between affiliated companies, this obligation deriving from the broader obligation regulated by the express provisions of art. 130 para. (1) of the Fiscal Procedure Code. If the tax inspection fails to comply with this obligation, we consider that the taxpayer's right to be heard, as an expression of the constitutional right of defence, which includes, in tax matters, the taxpayer's right to take part in the procedure in which the tax assessment is made and to express itself on all relevant elements of the case, is breached (Costaș, 2016).

Compliance with this right is independent of the outcome of the tax inspection procedure and its breach cannot be corrected neither in the administrative procedure, nor in court. From our point of view, the sanction of non-observance of this fundamental right is the one regulated by the provisions of Art. 49 para. (3) of the Tax Procedure Code, respectively the annulment of the tax decision conditioned by the taxpayer's proof of an injury.

4. PRACTICAL CASES

A prime example illustrating the breach by the tax authority of the right to be heard is of a company providing transport services to affiliated entities established in other EU Member States. During the tax inspection, the tax auditors requested the company the preparation of the transfer pricing file for all transactions carried out by it, directly or indirectly, with affiliated persons, ordering the suspension of the tax inspection for this reason.

Through the transfer pricing file, prepared and presented during the tax inspection, the taxpayer analysed the category of transport services provided to its affiliates by two methods: primarily, prices were justified by applying the price comparison method, and additionally by the net margin method.

The tax inspection removed the price comparison method, accepting the incidence of the net margin method, but based on its own comparability study,

different from the comparability study elaborated by the taxpayer in the transfer pricing file, and estimated the transfer prices for transactions with affiliated companies consisting of transport services.

In fact, almost immediately after the taxpayer submitted the transfer pricing file, the tax inspection requested the Transfer Pricing Department of the tax administration to extract and to communicate a range of comparable companies. The transfer pricing file, with over 200 pages, was submitted by the company on a Friday, and the request to the Transfer Pricing Department was made on Monday of the following week. In the Tax Inspection Report, the tax inspection motivates the request made to the Transfer Pricing Department by the fact that "from the analysis of the transfer pricing file, the tax inspection team found that the company's submission of the functional and comparability analysis does not reflect the central trend of the market according to Annex 3, letter B, item 13, letter f) of OPANAF 442/2016".

However, considering the short period between the date of submission of the transfer pricing file and the date of the request made to the Transfer Pricing Department, but also the fact that the two full days of this period were weekend days, there are serious doubts that the tax inspection has analysed the transfer pricing file, as mentioned in the Tax Inspection Report. In addition, the tax inspection addressed directly to the Transfer Pricing Department without requesting additional information from the taxpayer, as expressly provided for in Art. 5 of Order No. 442/2016.

After a period of approximately two months since the Transfer Pricing Department communicated the range of comparable entities, the tax inspection sent the taxpayer an address requesting the completion of the transfer pricing file, but only from the perspective of the second method used to document transactions consisting of transport services, i.e. the net margin method. This example illustrates the breach by the tax inspection of the taxpayer's right to be heard during the tax inspection and the purely formal character of the request to complete the transfer pricing file, being obvious, from the sequence of events and from the content of the tax inspection documents, that the transfer prices were estimated based on the separate comparability study prepared by the tax inspection before making the request to complete the transfer pricing file.

The second example refers to the same taxpayer, which was subjected to another tax inspection during which the tax inspection also requested the submission of the transfer pricing file. The taxpayer fulfilled this obligation by preparing and submitting the transfer pricing file within the legal deadline, through this file being documented the prices charged by the taxpayer with affiliated companies for several categories of transactions, including transport services. The documentation made through the transfer pricing file showed that the prices charged between the taxpayer and the affiliated companies are market prices.

The file established that the net margin method is the most appropriate to analyse the transactions consisting of transport services between the taxpayer, and the beneficiary related companies, by selecting as profitability indicator *the rate of return on operating expenses* (net operating margin on costs). By comparing the taxpayer's net operating margin on costs for each analysed year with the range (market range) of net operating margins on costs of comparable companies identified because of a comparability study, it resulted that, in one of the analysed years, the net operating margin on costs of the taxpayer does not fall within the market range.

However, in the transfer pricing file, it was considered that this lower net operating margin on costs did not reflect the reality, its low level being the result of objective causes that affected the company's operating income (by decreasing it), but also the operating expenses (by increasing them). For this reason, the net operating margin was theoretically adjusted by increasing the operating income by the amount of unrealised income and by decreasing the operating expenses by additional expenses generated by objective causes affecting the company's activity, and the financial effect of which should not be passed on, through the prices charged, to the beneficiaries of the services.

By increasing operating income and decreasing operating expenses, the taxpayer's net operating margin on costs was adjusted/increased with the result that the net margin/profitability indicator of the taxpayer was within the market range determined by the transfer pricing file. The tax inspection did not contest the analysis made through the transfer pricing file. However, in the Tax Inspection Report, the tax inspection considered exclusively the lower net operating margin on costs, ignoring the theoretically increased one.

In this case, although the tax inspection lasted, not taking into account the suspension periods, 188 days, and for a period of 113 days it was suspended in order to obtain data and information from third parties, the tax inspection never informed the taxpayer about the intention to adjust the income from services provided to affiliates considering the initial (lower) indicator, nor did it request additional information/documents regarding the adjustment/increase of the net margin. This case also illustrates that the tax inspection has not fulfilled its obligation to inform and request additional information in accordance with the legal imperative.

5. CONCLUSIONS

As repeatedly pointed out in the OECD Transfer Pricing Guidelines, transfer pricing is not an exact science, reason why, in the process of their determination, the results may differ depending on the used methodology. The essential aspects of this process are the appropriate documentation and the use of available information. Also, the OECD Transfer Pricing Guidelines recommend tax administrations to analyse transfer pricing files, first, from the perspective of

the information and data presented by the taxpayer therein, which are, as a rule, consistent with factual and commercial reality.

To the extent that the tax authorities totally or partially ignore the analysis and documentation contained in the transfer pricing file, without giving the taxpayer the opportunity to explain or provide additional information, the risk of making mistakes in the tax inspection increases. Therefore, the dialogue between the taxpayer and the tax inspection, on the analysis and documentation of transfer prices, is imperative. The requirement of dialogue is regulated, generally, by the provisions of Art. 130 para. (1) of the Fiscal Procedure Code, but also by the provisions of Art. 5 para. (1) of Order no. 442/2016.

Unfortunately, the absence of such a dialogue is not sanctioned neither in the administrative procedure, nor in the judicial one, being considered a mere formality without legal effects, although precisely this dialogue should substantiate the analysis of the transfer pricing file.

References

1) CJEU (2018). *'Hornbach-Baumarkt' - C-382/16*. [online] Available at: https://curia.europa.eu/juris/document/document.jsf?text=&docid=202410&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=1462414 [Accessed 23.03.2024].
2) CJEU (2020). *'Impresa Pizzarotti' - C-558/19*. [online] Available at: https://curia.europa.eu/juris/document/document.jsf?text=&docid=232156&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=1457780 [Accessed 23.03.2024].
3) CJEU (2010). *'SGI' - C-311/08.* [online] Available at: https://curia.europa.eu/juris/document/document.jsf?text=&docid=74659&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=4215691 [Accessed 23.03.2024].
4) Anghel, T. (2020). *Codul de procedură fiscală. Comentariu pe articole.* București: Hamangiu, p. 414.
5) Costaș, C.F. (2016). Titlul I. Dispoziții generale. In: C.F. Costaș, ed. *Codul de procedură fiscală. Comentariu pe articole.* s.l. Bucuresti: Solomon, pp. 28-33.
6) Iovescu, D. (2024). Criterii de selecţie a celei mai potrivite metode de documentare a preţurilor de transfer. Metode tradiţionale vs. metode tranzacţionale. *Analele Universităţii de Vest din Timişoara. Seria Drept,* Issue 1/2024, pp. 207-214.
7) Lazăr, I. and Florea, B. (2023). *Dreptul Finanțelor Publice. Volumul II. Drept Fiscal și procedură fiscală.* București: C.H. Beck, pp. 569-570.
8) Lupu, M. (2024). Dificultăți și deficiențe în aplicarea prețurilor de transfer în România: o perspectivă empirică. *Analele Univesității de Vest din Timișoara. Seria Drept.,* 1(2024), pp. 191 -206.
9) OECD (2022). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022.* [online] Available at: https://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en [Accessed 23.03.2024].