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Management Decisions in Transfer Pricing

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Abstract
The article is aimed at highlighting the importance of management decisions on valuing transactions between related parties and the effect of such transactions on an entity's profit. The article will primarily focus on transactions carried out between members of multinational companies, with an emphasis on Societas Europea, as well as within a company – e.g. the establishment and the founder, as well as between partners, shareholders and the company itself.
Transactions carried out between related parties may be different, e.g. the purchase and sale of goods, services or financial transactions. Individual transactions must be valued in accordance with the legislation of each country of the European Union, following the principle of an independent relation. In the pricing of transactions between related parties, there may be downward pressure on prices and thus, the correct profit from a transaction may be unrecognized. The subject of the article will be the just complexity of setting transfer prices, the risk of deviations in the valuation of transactions between related parties from the aspect of requirements of the legislation.

Keywords
Transfer pricing, management decisions, arm´s length principle, the European Company.

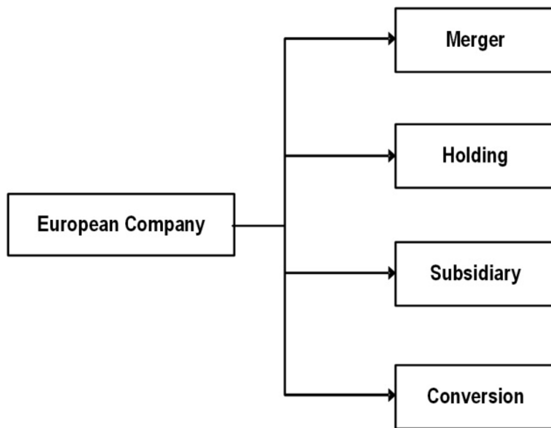
Introduction

The sale of goods, providing services and various financial transactions are carried out at present, not only between firms within the same state, but also between those in different countries. Carrying out transactions with business companies outside one country, doing business with a view to improving and extending the scope and positions in individual markets, increases a company's performance and leads to a better recognition of a profit. Since there are different groupings of companies, multinational companies and companies also establish their operations in other countries. Transactions carried out within these groupings, multinational companies as well as between a company and its establishment should correspond to the arm's-length principle even if such transactions are impacted by various non-market factors. Due to a broad range of dependents, the contribution will focus on transactions carried out between members of multinational companies, in particular on relations within the European Company and the pricing of these transactions subject to compliance with the arm's-length principle.

1. The European Company

The European Company represents a capital company or a firm that may carry out business in the European Community. It represents a certain period of a joint-stock company, whose share capital totals 120,000.- € (Máziková, 2010). The company is registered in the Commercial Register of the State where it has its registered office and, at the same time, must also be registered in the Official Journal of the European Union. Any European company has a specific possibility of changing its registered office within the European Union, where the company does not terminate its activities, but rather continues its activities in another country. The European Company can be established in four different ways, namely it can be:

- a merger,
- a holding,
- a subsidiary,
- a conversion.



Schema 1 Ways to found the European Company
Source: Own processing

A **merger** of joint-stock companies in European society is regarded as the setting up of a European company, where two or more joint-stock companies from different Member States of the European Union merge, make a fusion. The successor company is the European Company. There is a condition: at least two founding companies must be governed by different laws.

A common **holding** company in the form of a European company is regarded as the formation of a European company with at least two limited liability companies governed by the law of another Member State of the European Union, resp. if one company has a subsidiary company governed by the law of another Member State. Shareholders of two or more joint-stock companies or limited liability companies holding at least 50% of the voting rights in these companies place their shares in the new European Company in exchange for its shares. The European Company will become the founding companies of the parent company.

When creating a **subsidiary** of the European Company, the European Company with several subsidiary entities or a single European Company is established. A European subsidiary may be established by other legal entities as the capital of the company, i.e. a European subsidiary may be established by all types of companies, cooperatives and other legal entities, either public or private ones, except non-profit organizations (companies) (Parajka, 2007).

When **converting** an existing joint-stock company formally and materially established within the European Community into the European Company, it is conditional that it should only apply to joint-stock companies and that, for at least two years, it should have had the status of a subsidiary company governed by the law of another Member State.

2. Valuing a transaction between related parties

The establishment of the European Company is always based on a relationship between two or more interconnected companies, no matter if they are interrelated as the parent and the subsidiary, the creation of a holding of, a merger or a fusion between two or more companies that are located in different states of the European Union. All transactions carried out between such companies represent foreign related parties' transactions. It may be a different type of transaction purchase and sale of goods, providing services or financial transactions that need to be properly valued. The valuation of individual transactions between related parties must be carried out in such a way as to adhere to the arm's-length principle, which also properly recognizes both a profit and a loss company, as well as subsequently the tax base and income tax (Pakšiová & Janhuba, 2012).

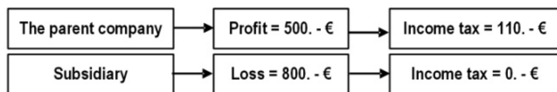
The arm's-length principle is based on comparing the terms of the contract price of individual transactions made between related parties and independent persons. The arm's-length principle ensures the equality of related parties and independent persons in order to achieve balanced taxation, thus preventing the creation of tax benefits for related parties, due to the fact that it gives the related parties and independent persons to the same level.

Transfer pricing is essentially aimed at creating prices so that the profit of the whole group and individual operations is optimized, without having made a reduction in the tax burden and prevention of tax evasion.

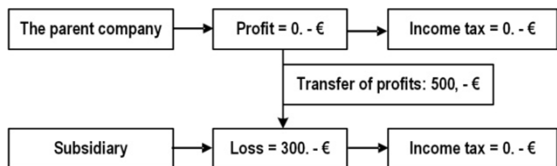
Example 1:

The parent company made a profit of EUR 500.- € and should pay the income tax of 22%, which means 110.- €. Its subsidiary generated a loss of EUR 800.- €. Carrying out fictitious transactions and transfers of profits from the parent company to the subsidiary, the parent company shows a zero profit and the loss of the subsidiary recognized in the amount of 300.- €, with the tax

burden on groups of addicts reduced from 110.- € to 0.- €.



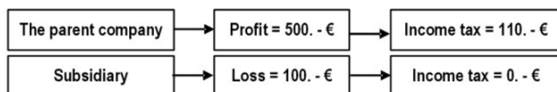
Schema 2 The profit or loss and the tax burden of the related parties before the transaction
Source: Own processing



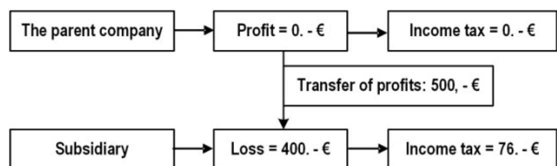
Schema 3 The profit or loss and the tax burden of the related parties after the transaction
Source: Own processing

Example 2:

The parent company made a profit of EUR 500.- € and should pay the income tax of 22%, which means 110.- €. Its subsidiary generated a loss of € 100.- € and income tax in that country is 19%. Carrying out fictitious transactions and transfers of profits from the parent company to the subsidiary, the parent company shows a zero profit and the subsidiary recognizes a profit of 400.- € and the tax of 76.- €, with the tax burden on groups of related parties reduced from 110.- € to 76.- €.



Schema 2 The profit or loss and the tax burden of the related parties before the transaction
Source: Own processing



Schema 3 The profit or loss and the tax burden of the related parties after the transaction
Source: Own processing

When applying the arm's-length principle, managers may use any of the transactional methods in order to value the transaction correctly and without a benefit (Kubaščíková & Stanley, 2013). A distinction is made between direct and indirect methods of transfer pricing. Under **the direct method**, the price of a controlled transaction and an uncontrolled transaction price are compared. In **the indirect transfer**, **the pricing method** is modified in that transaction prices are subject to an indirect control through a variety of indicators such as the net profit margin.

There are two subdivisions of transfer pricing method, namely the unilateral and the bilateral methods. The unilateral method only examines one of the parties to a transaction. On average, it examines the party carrying out less complex functions and bearing a smaller risk. For the purpose of an examination, either a domestic or a foreign entity plugged into a transaction can be chosen. The bilateral method examines both parties to a transaction and their contribution to the expected profit earned. Consequently, profits are split between such related parties in accordance with the arm's-length principle.

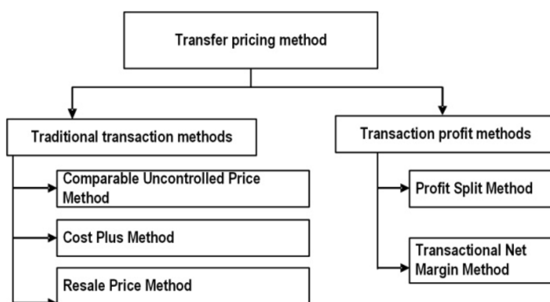
When choosing a transfer pricing method, it is necessary that the most suitable method for a particular transaction should be selected, taking into account the specifics of each transaction. The basic breakdown of transaction valuation methods is based on methods of their allocation, which are based on the comparison of prices – the so-called traditional transaction methods, and those based on the comparison of the profit – the so-called transaction profit methods.

The traditional transaction methods are:

- Comparable Uncontrolled Price Method (CUP),
- Cost Plus Method (CPLM),
- Resale Price Method (RPM).

The transaction profit methods are:

- Profit Split Method (PSM),
- Transactional Net Margin Method (TNMM).



Schema 4 The transfer pricing method
Source: own processing

Comparable Uncontrolled Price Method

The Comparable Uncontrolled Price Method is based on the comparison of prices for individual transactions between related parties in trade relations with the price used for transactions between independent parties in comparable conditions. This is a direct and unilateral transfer pricing method.

This method is applied when a company trades the same goods to the same markets with independent parties or when there is a similar company making the same product in the same market at the same level of the market and the company applies similar prices.

The method is unsuitable to use when goods are sold resp. providing specific services and are only sold within a group of related parties. There is no possibility of making a comparison between sold goods or provided service. The sale of goods is carried out at different levels of the market (retail, wholesale) or in other quantities.

Cost Plus Method

The Cost Plus Method is based on adding a price premium to actual direct and indirect costs of the production of a good product that is the subject of transactions between related parties. The applied premium price must be the one that would apply in a transaction with independent parties in a comparable store under comparable conditions. It is the case of the indirect and the unilateral transfer pricing methods.

This method is most commonly used in manufacturing companies, especially in construction contracts or the provision of the basic administrative services, such as financial advice, legal advice, IT.

Resale Price Method

The subsequent Resale Price Method is calculated as a transfer of assets purchased by the foreign related party converted to an independent market price. The calculations are based on the price at which the foreign related person sells an asset to an independent person, with a subsequent price reduction on the normal amount of the trading range, i.e. margins. It is the case of the indirect unilateral transfer pricing method.

This transfer pricing method is particularly suitable to use in the case of distributors who do not contribute to the assessment of products sold and when sales are made by related parties and independent parties (Mateášová & Meluchová, 2013).

The Profit Split Method

The method of dividing profits is based on dividing expected profits from controlled transactions between related parties, expecting independents in joint ventures and respecting the arm's-length principle. Profit sharing is then carried out either on either planned or actual earnings. It is the bilateral method.

This method is especially suitable to use in cases of transactions where both companies are an important intangible asset and individual transactions are so interconnected that they cannot be assessed separately.

Transactional Net Margin Method

The Net Margin Method determines the amount of the profit margin of the business or financial relationship between related parties in relation to the fixed base, for example costs and revenues, and compares it with the profit mark-up used in relation to unrelated third parties. It is the unilateral transfer pricing method.

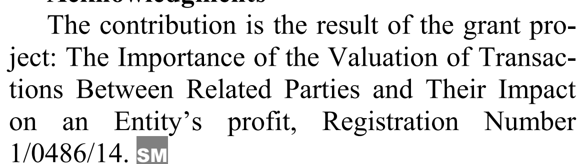
Those methods can only be applied to individual transactions or for more of the same transactions. If several different types of transactions are made, it is then necessary that each transaction should be examined on an individual basis. It is the most widely used method of determining transfer prices.

Conclusion

Every transaction carried out between foreign related parties is specific and needs to be assessed individually with respect to its compliance with the arm's-length principle. In valuing the type of transactions of buying and selling goods or providing services or financial transactions, valuation must be such that it properly reports a profit or a loss company, and subsequently the tax base and income tax as well. It is important to avoid transfer of profits to companies operating at a loss and thereby minimize income tax or a transfer of profits to companies in countries with a lower tax burden.

When fixing prices for individual transactions carried out between related parties, managers can make a choice between different methods of transfer pricing. Each of these methods is specific and appropriate for a different type of a transaction. The correct method of the valuation of transactions between related parties can be chosen depending on the type of transaction, its characteristic and the possibility of having it compared with other transactions that the given trading company

has carried out with independent parties under comparable conditions, and in compliance with the arm's-length principle. When using the single transfer pricing method, special rules are applicable to each case. Choosing a specific transfer pricing method is necessary for a company to justify and demonstrate, through appropriate transfer pricing documentation.



Acknowledgments

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