

VOLUNTARY COMPLIANCE IN THE AREA OF TRANSFER PRICING FOR DIFFERENT TYPES OF TAXPAYERS

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Abstract

Voluntary compliance in the area of transfer pricing has to be encouraged by the tax administrations all over the world. The widespread of a multinationals structure challenges the tax systems incorporated worldwide as intercompany transactions may involve many different tax jurisdictions, each of them with its own set of rules.

The goal of the research is to investigate whether and to what extent taxpayers, part of multinationals or groups, respect the arm's length principle and are voluntary compliant with regard to transfer pricing by verifying if the profit margin obtained in the period analyzed is similar to other independent companies. The companies analyzed were selected from the middle taxpayers in the Bucharest region and from the large taxpayer category.

The research observes the number of taxpayers that are voluntary compliant and records a profit indicator within the range of the independent companies thus respecting the arm's length principle.

The conclusions of the research will include what category of taxpayers is more voluntary compliant than the other within the area of transfer pricing.

Keywords

voluntary compliance, transfer pricing, taxpayers, interquartile range, arm's length principle

JEL Classification

E64, M42, M48

Introduction

What does voluntary compliance really represents and how can compliance be voluntary if the law compels compliance? According to Jack Manhire, former Chief of Legal Analysis for the IRS Office, voluntary compliance is the IRS's dependence on taxpayers to assess the correct amount of tax on their returns, file those returns properly and timely pay the tax due. (Manhire, 2015)

Transfer pricing compliance is among the largest tax risks that tax administrations are managing but rates of tax recovery resulting from audits and enquiries vary significantly. A more voluntary compliance approach is an essential step in the process both for MNEs and for the fiscal administration to increase transparency and develop strong relations based on mutual respect.

The research aims is to identify whether and to what extent taxpayers, which activate on the market of manufacture of electrical/ electronic equipment, other parts and accessories for

motor vehicles, respect the arm's length principle and are voluntary compliant with regard to transfer pricing by verifying if the profit margin obtained in the period analyzed is similar to other independent companies. The taxpayers taken into consideration are part of MNE groups or were owned for more than 25% by legal entities, making them affiliated entities according to the national law.

The analysis will cover the period of 2011-2015 and will research the behavior of companies with regard to tax compliance versus tax planning.

1. Literature review

Tax administrations are required to help minimize the tax risks that affect the reduction on tax revenues. On the other hand, any tax administration should seek to encourage taxpayers' voluntary compliance. This reciprocity requires a series of measures prescribed, in most cases, by tax regulations. These measures are subject to constant improvements in line with the development of the economy in general and the market as a whole and, in particular, the way in which taxpayers - entrepreneurs operate. (Cipek & Pereira, 2018)

The reliability of data encountered in transactions related with transfer pricing is frequently disputed both by practitioners and by academics. Transfer pricing is the most important problem in international taxation that the governments and the international entities have to deal with. (Olibe & Rezaee, 2008)

As a consequence of globalization, more and more businesses form multinational groups which locate activities across countries. This structure challenges the tax systems incorporated worldwide as intercompany transactions may involve many different jurisdictions. While there are risks associated with the taxation of group income, e.g. the double taxation of income, a group structure also offers opportunities for tax planning. (Lohne et al., 2012)

Although not every country in the world is a member of the Organization for Economic Cooperation and Development in many of them, when it comes to determine prices and other contractual relations between associated enterprises, transfer pricing, profit tax regulations as well as regulations on tax procedures and separate laws, the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations represents the base of the legislative framework for determining transfer pricing.

The approach taken by the EU member states for estimating the price applied to transactions between associated enterprises is the arm's length principle, which requires that the prices used in transactions between associated enterprises correspond to the prices that would be applied between unrelated enterprises for the same transaction.

In the past years, in Romania, tax audits on transfer pricing has increased significantly thus we believe that the interest of tax authorities is to reduce losses and increase the profitability of controlled companies. The preventive approach and voluntary compliance are beneficial to taxpayers when it comes to transfer pricing. Prevention means risk assessment, proper documentation preparation and transparency in how pricing is set.

Another important issue for the tax administration is how to provide legal certainty for taxpayers in legitimate tax compliance and avoid long-term court proceedings with uncertain results both for taxpayers and for the tax administration, i.e. the state budget, particularly because of the complexity of the transfer pricing issue.

The Romanian regulation is in line with OECD regulation regarding transfer pricing for multinational entities and for fiscal administrative. It also complies with the line established by the European Union Joint Transfer Pricing Forum (EUJTPF).

A voluntary compliant multinational has a solid plan with regards to the transfer pricing policy within the group, most of the times they have one policy with modifications made as needed to meet specific local requirements, the documentation of the TP file is updated

annually and it is oriented to the requirements in each jurisdiction where the business operates.

2. Research methodology

The goal of our research is to investigate whether and to what extent taxpayers, part of multinationals/ groups, respect the arm's length principle and are voluntarily compliant with regard to transfer pricing by verifying if the profit margin obtained in the period analyzed is similar to other independent companies. The taxpayers analyzed activate on the market of manufacture of electrical/ electronic equipment, other parts and accessories for motor vehicles which represent the NACE codes 2931 and 2932.

The taxpayers taken into consideration are 60 medium size companies from the Bucharest Regional Directorate area of administration and also 50 companies from the large taxpayer category as presented on NAFA website, identified as being part of MNE groups or that were owned for more than 25% by legal entities, making them affiliated entities according to the national law.

Because the activity researched consists in production/manufacturing of goods and accessories, we chose as operating profit indicator the Return on Total Cost (ROTC) which has the following formula:

$$\text{Return On Total Cost (ROTC)} = \frac{\text{EBIT}}{\text{Operating Revenue} - \text{EBIT}} \quad (1)$$

The ROTC values of the entities will be compared with the interquartile range (IQR) resulted from the ROTC values of a number of independent companies from the same industry category.

In descriptive statistics, the interquartile range (IQR) is a measure of statistical dispersion, being equal to the difference between 75th and 25th percentiles, or between upper and lower quartiles, $IQR = Q3 - Q1$.

The research of independent companies was made with the database TPSoft. According to the description of TPSoft, this is the only on-line database in Romania constructed to help, in any moment, minimize the risk associated with transfer pricing files for any commercial entity and to prepare it for an audit from the fiscal administration.

The search steps used in the database to find the independent comparables that activate in the same industry are presented in the following table:

Table no. 1 Search steps for independent companies in TpSoft database

NACE codes	2931, 2932
Geographical area:	Romania
Exclusion of companies which are owned more than 25% by a legal entity?	yes
Exclusion of companies which own subsidiaries more than 25%?	yes
Exclusion of companies which are owned more than 25% by a person?	no
Include companies that are part of a group?	no
Include only active companies?	yes
Minimum turnover (RON)	1,000,000.00
Maximum turnover (RON)	none
Minimum number of employees	50.00
Maximum number of employees	none
Profit indicator	ROTC
Research period	2011 - 2015
Exclude companies that registered operational losses	none

Source: TpSoft database

After using the search steps, the database returned 19 companies on which a qualitative screening was made using the following criteria:

- No companies with extreme results for more than a year was accepted. Extreme results mean that the profit indicator is exceeding a lower limit of -50% or a higher limit of 50%;
- Companies that did not have financial information on all years of the research was rejected from the final comparative sample.

After the qualitative screening no companies was rejected, leaving the final comparative sample with a total of 19 companies.

Table no. 2 Interquartile range (1st – 3rd quartile) for the period 2011-2015

Indicator Quartile	ROTC 2011	ROTC 2012	ROTC 2013	ROTC 2014	ROTC 2015	Average ROTC 2011-2015
Lower limit (0%)	2.32%	1.59%	0.81%	-12.72%	-5.41%	-0.97%
1 st Quartile (25%)	4.30%	5.44%	4.37%	2.29%	3.56%	3.72%
Median (50%)	9.36%	8.87%	5.69%	4.29%	4.62%	6.40%
3 rd Quartile (75%)	21.15%	22.95%	20.36%	19.16%	13.34%	19.32%
Upper limit (100%)	46.33%	35.72%	44.15%	35.15%	45.89%	40.61%

Source: TpSoft database and author computations

The research will reveal how many taxpayers have a behavior of voluntary compliance, taken into consideration that a profit margin within the interquartile range emphasizes that the transfer pricing policy and the transaction with the affiliated entities, of the company analyzed, respects the arm's length principle and is considered as voluntary compliant taxpayer that declares and earns a well enough profit margin within the market trend.

The transfer pricing method that was used to compare the profit margins of the large taxpayers to the independent companies that resulted from TpSoft was the transactional net margin method. According to the OECD guidelines on transfer pricing the transactional net margin method examines the net profit relative to an appropriate base (for example costs, sales, assets) that a taxpayer realizes from a controlled transaction.

3. Results and discussion

In accordance with the IQR resulted from the study made in TpSoft database for every year of the period examined, representing 2011-2015, as well as for the average of the whole period, we compared the values obtained by 60 middle taxpayers identified, as being part of MNE groups or were owned for more than 25% by legal entities, making them affiliated entities according to the national law, with the range between the 1st quartile and the 3rd quartile.

The results of the research made on the middle taxpayers will be then compared with the results of the research made on the large taxpayers, concluding which category of taxpayer is more voluntary compliant.

Research on middle taxpayers assigned to the Bucharest Regional Directorate

The results were set up in 2 categories:

- YES = stands for the operating margin – ROTC of the entity is in the IQR and respects the arm's length principle;
- NO = stands for the operating margin – ROTC of the entity is not in the IQR and does not respect the arm's length principle.

Table no. 3 Results for comparison of ROTC of middle taxpayers with the IQR

	ROTC 2011	ROTC 2012	ROTC 2013	ROTC 2014	ROTC 2015	AVG. ROTC 2011-2015
YES	25	26	25	36	25	30
NO	35	34	35	24	35	30
TOTAL	60	60	60	60	60	60

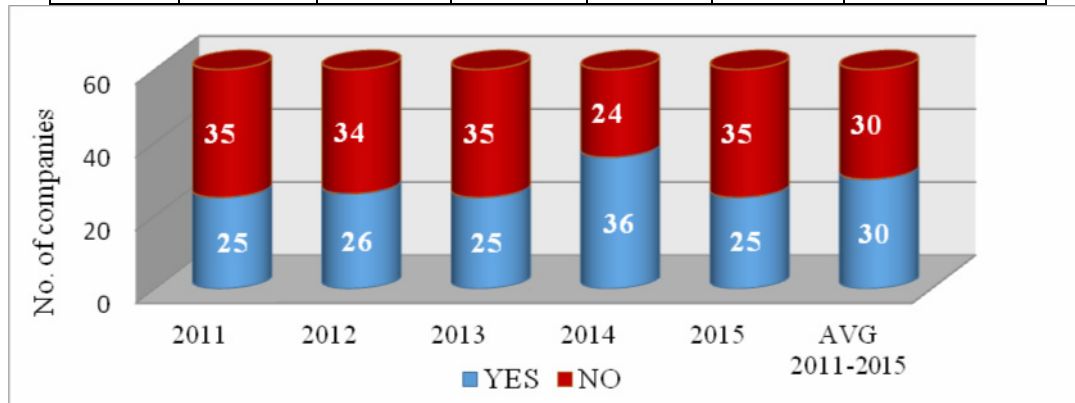


Fig. no. 1 Results for comparison of ROTC of middle taxpayers with the IQR

The results of the middle taxpayers with a value of ROTC that is not within the interquartile range will be split in 2 categories:

- (L) - if the value of ROTC is under the lower limit of the interquartile range (quartile 1) then we can conclude that the entity does not respect the arm's length principle making it a possible non-voluntary compliant taxpayer;
- (U) - if the value of ROTC is over the upper limit of the interquartile range (quartile 3) then we can conclude that the entity does not respect the arm's length principle but it is a voluntary compliant taxpayer;

Table no. 4 Number of middle taxpayers with ROTC outside the limits of the IQR

	ROTC 2011	ROTC 2012	ROTC 2013	ROTC 2014	ROTC 2015	AVG. ROTC 2011-2015
L	27	28	28	18	25	25
U	8	6	7	6	10	5
TOTAL	35	34	35	24	35	30

According to the results of the first research study made on the middle taxpayers from the Bucharest Regional Directorate we present the following conclusion for each year analyzed:

A) In the year 2011, 42% of the taxpayers (25 entities) analyzed had a ROTC within the interquartile range while 58% (35 entities) did not. Out of the 35 taxpayers 27 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 8 recorded ROTC over the upper limit of the interquartile range (quartile 3);

B) In the year 2012, 43% of the taxpayers (26 entities) analyzed had a ROTC within the interquartile range while 57% (34 entities) did not. Out of the 34 taxpayers 28 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 6 recorded ROTC over the upper limit of the interquartile range (quartile 3);

C) In the year 2013, 42% of the taxpayers (25 entities) analyzed had a ROTC within the interquartile range while 58% (35 entities) did not. Out of the 35 taxpayers 28 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 7 recorded ROTC over the upper limit of the interquartile range (quartile 3);

D) In the year 2014, 60% of the taxpayers (36 entities) analyzed had a ROTC within the interquartile range while 40% (24 entities) did not. Out of the 24 taxpayers 18 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 6 recorded ROTC over the upper limit of the interquartile range (quartile 3);

E) In the year 2015, 42% of the taxpayers (25 entities) analyzed had a ROTC within the interquartile range while 58% (35 entities) did not. Out of the 35 taxpayers 25 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 10 recorded ROTC over the upper limit of the interquartile range (quartile 3);

F) For the period analyzed 2011-2015, 50% of the taxpayers (30 entities) analyzed had an average ROTC within the interquartile range while the other 50% (30 entities) did not. Out of the last 30 taxpayers 25 had an average ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 5 recorded ROTC over the upper limit of the interquartile range (quartile 3);

Research on large taxpayers assigned to the Large Taxpayer General Directorate

The results were set up in the same 2 categories: YES meaning the ROTC of the entity is in the IQR respecting the arm’s length principle and NO, the ROTC of the entity is not in the IQR and does not respect the arm’s length principle.

Table no. 5 Results for comparison of ROTC of large taxpayers with the IQR

	ROTC 2011	ROTC 2012	ROTC 2013	ROTC 2014	ROTC 2015	AVG. ROTC 2011-2015
YES	21	20	22	34	22	25
NO	29	30	28	16	28	25
TOTAL	50	50	50	50	50	50

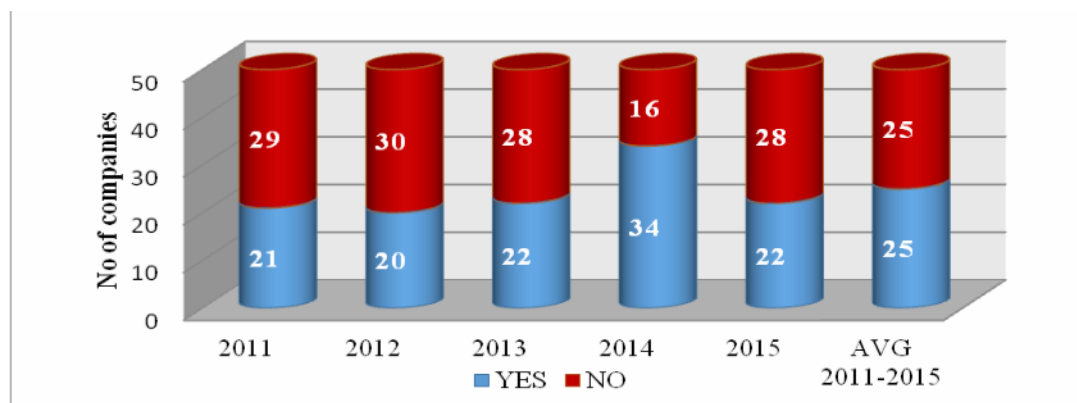


Fig. no. 2 Results for comparison of ROTC of large taxpayers with the IQR

The results of the large taxpayers with a value of ROTC that is not within the interquartile range will be split in the 2 categories:

- (L) - if the value of ROTC is under the lower limit of the interquartile range (quartile 1) then we can conclude that the entity does not respect the arm's length principle making it a possible non-voluntary compliant taxpayer;
- (U) - if the value of ROTC is over the upper limit of the interquartile range (quartile 3) then we can conclude that the entity does not respect the arm's length principle but it is a voluntary compliant taxpayer;

Table no. 6 Number of large taxpayers with ROTC outside the limits of the IQR

	ROTC 2011	ROTC 2012	ROTC 2013	ROTC 2014	ROTC 2015	AVG. ROTC 2011-2015
L	26	27	25	13	21	22
U	3	3	3	3	7	3
TOTAL	29	30	28	16	28	25

According to the results of the second research study made on large taxpayers assigned to the Large Taxpayer General Directorate we present the following conclusion for each year analyzed:

A) In the year 2011, 42% of the taxpayers (21 entities) analyzed had a ROTC within the interquartile range while 58% (29 entities) did not. Out of the 29 taxpayers 26 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 3 recorded ROTC over the upper limit of the interquartile range (quartile 3);

B) In the year 2012, 40% of the taxpayers (22 entities) analyzed had a ROTC within the interquartile range while 60% (30 entities) did not. Out of the 30 taxpayers 27 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 3 recorded ROTC over the upper limit of the interquartile range (quartile 3);

C) In the year 2013, 44% of the taxpayers (22 entities) analyzed had a ROTC within the interquartile range while 56% (28 entities) did not. Out of the 28 taxpayers 25 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 3 recorded ROTC over the upper limit of the interquartile range (quartile 3);

D) In the year 2014, 68% of the taxpayers (34 entities) analyzed had a ROTC within the interquartile range while 32% (16 entities) did not. Out of the 16 taxpayers 13 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 3 recorded ROTC over the upper limit of the interquartile range (quartile 3);

E) In the year 2015, 44% of the taxpayers (22 entities) analyzed had a ROTC within the interquartile range while 56% (28 entities) did not. Out of the 28 taxpayers 21 had a ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 7 recorded ROTC over the upper limit of the interquartile range (quartile 3);

F) For the period analyzed 2011-2015, 50% of the taxpayers (25 entities) analyzed had an average ROTC within the interquartile range, the other 50% (25 entities) did not. Out of the last 25 taxpayers 22 had an average ROTC situated under the lower limit of the interquartile range (quartile 1), making them possible non-voluntary compliant taxpayers while 3 recorded ROTC over the upper limit of the interquartile range (quartile 3);

Limits of the research:

- the ROTC was calculated on the whole activity of the entities tested, due to the fact that the values/percentages of the related party transactions are not public;

- the independent comparables were selected with the help of TPSoft database and it was considered that the primary NACE code is the real principal activity of the companies;
- the comparables from the final comparative sample were accepted and presumed that they have the same functions and risks as the large taxpayers tested, according to every market researched.

Conclusions

The present paper proposes a model to see the level of voluntary compliance in the area of transfer pricing of large and middle companies. The model is based on public financial data, on qualitative data and on the ability of TPSoft database to identify independent comparables, based on the search criteria's imputed.

For every independent comparable resulted from the TPSoft database it was calculated the profit indicator, in accordance with the type of activity carried out, for every year from the period 2011-2015, the average of the period the interquartile range as well as the lower limit, upper limit and the median.

After the IQR was settled for every year of the period examined, as well as for the average of the whole period, we compared this values with the values obtained by the middle and large taxpayers identified, as being part of MNE groups or that were owned for more than 25% by legal entities, making them affiliated entities according to the national law.

Based on the research presented we can conclude that both the middle taxpayers and the large taxpayers have approximately the same level of voluntary compliance with regard to transfer prices and the arm's length principle. From the data resulted in the analysis we observe that in each year the percentage of the middle and large companies that have a ROTC within the IQR is the same or with a small deviation of 1% to 3%. Also we observed that in 2014 in both researches the number of companies which had an ROTC within the IQR was higher than in the other years with at least 18%.

From the average calculations we can conclude that both types of companies, middle and large, have the same level of voluntary compliance, in each case the percentage of companies that had an average ROTC within the IQR was 50%.

Possible future research is possible in order to identify the trend of the voluntary compliance in the area of transfer pricing, regarding the two types of taxpayers analyzed.

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