

TRANSFER PRICES AND TRANSACTIONS WITH RELATED PARTIES

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Abstract

The transfer prices, according to which the transactions between taxpayers are valued, are one of the main areas with whom the domestic and international companies and their tax administrations are dealing. The essence of the transfer pricing formation is in determining their height in accordance with the usual market prices.

The general concept incorporated in the Profit Tax Law is that transactions between related parties should be made at market prices. The topic of transfer prices is becoming more and more controversial. The governances of the countries around the world, are trying to cope with tax evasion and transfer profits in different jurisdictions.

When the independent enterprises enter into mutual transactions, the conditions of their commercial and financial relations (for example, the price of the transferred good or the provided services and conditions for transmission or giving) are usually determined in compliance with the market conditions. When related enterprises perform transactions with each other, it is possible that their commercial and financial relationships are not directly affected in the same way by the external market forces, although associated enterprises often seek in their mutual transactions to replicate the dynamics of market forces.

An appropriate calculation of transfer pricing is important for determining the profits of the company, which is the basis for taxation of the corporate income tax. Tax regulations require, the prescribed transfer pricing methods shall be taken into account in transactions within an international company or related entities among themselves. Such a method is a comparison with the market price, which is a result of the supply and demand on the market. In doing so, the company (taxpayer) must provide documentation of related entities, the extent and nature of their business relationships and the methods used in their mutual transactions. In addition, they must keep the documentation for a period of ten years.

Key words: arm's lenght, transfer price, company, profit tax, transaction

1. Introduction

Transfer price is a price that is formed in connection with transactions in assets or in connection with liabilities between related parties. [1] The price that would be realized on the market for the same or similar transaction, in the same or similar circumstances if it was not for affiliated persons, is called price at arm's length. [2] Determining objective criteria for determining the price at arm's length is a necessary condition for efficient calculation of the costs and results of the operation of the parts of the enterprise and the enterprise as a whole. [3]

Given that the transfer price can significantly affect the amount of tax revenue they become a subject of interest to the national tax administrations. The tax administration should exercise a control over the transfer pricing to prevent the opportunities for tax evasion or double taxation. However, transfer pricing control is a very complex task for the tax administration, because they often lack complete and accurate information about the groups of affiliated enterprises and their mutual transactions. Even when such information exist, it is very difficult to make an assessment, first: whether transfer prices are objective and equal to market prices (prices that are realized between unrelated individuals) and secondly: to estimate prices at arm's length if the transfer prices are different from the market prices. [4]

The issue of transfer pricing is an international problem, and it means that there is a need for a single and harmonized settling. To achieve that goal, the OECD has adopted the guidelines for transfer pricing for multinational enterprises and tax administrations. [5]

Transfer prices are the most important tax issue on the agenda of financial bodies and institutions. Given that almost 60% of world trade is taking place among multinational companies, the need for an effective tax structure has increased significantly. Today, facing the problem of transfer prices requires centralized treatment and access to transfer prices.

The above indicates that the transfer prices area in the coming years will grow into one of the more important, if not the most important tax area. Namely, inadequate tax treatment of transfer prices can have serious implications not only on the state budget, but also on the economic flows on a global scale.

2. Transfer prices

The goal of every company is maximizing profits, but also long-term growth and development. One of the ways to achieve these goals is to minimize the profit tax. Transfer prices play a huge role in this minimization process. [6]

Transfer prices are referred to as the prices for which goods, services, rights and other assets are traded between related parties. The transfer prices may be:

- Internal - turnover within the operating segments of an enterprise
- External - turnover between individual legal entities, members of a grouping, such as:
 - Within the same country
 - Between residents from different countries

Internal transfer prices, usually cause lower interest among the tax authorities because the taxation is done to the enterprise as the only legal entity, and not separately on its segments. The subject of interest of the tax authorities are the external transfer prices realized in the turnover between dependent legal entities in the same country or between residents of different countries, because of the possibility of influencing the calculation of the profit tax.

Dependent legal entities in the same country are subject to the same taxation system, which in turn may cause less interest to the tax authorities. Dependent legal entities in different countries are subject to different tax systems; hence intended or unintended influence on the calculation of the amount of the tax on profits is possible, therefore these relations / transactions cause more interest among the tax authorities.

As part of the internal pricing policy, the enterprise can increase the transfer prices of the goods, services and rights to its subsidiary to transfer the income to its home country if there are lower tax rates or incentives. Similarly, the expenses of the subsidiary in the parent company can be transferred to reduce the tax base if there are higher tax rates. [7]

For a better explanation of transfer pricing issues, it is necessary to consider the following categories:

- Affiliated persons
- Arm's length principle
- Transfer pricing methods

The term "Related Persons" is also used for both legal entities and individuals. Legal entities and natural persons can be considered related on the basis of:

- Capital and voting connection
- Contractual relationship
- Relational Connection

According to the Law on Trade Companies (Article 491): "Associated companies are legal independent companies that connect and establish mutual relations as:

- A company that has a share, significant participation, majority ownership or majority right in the decision-making or mutual participation in another company, and

- Depends, governing company and companies acting jointly

The term "market principle" (Arm's Length Principle), can also be translated as: - "voluntary relationship", "fair relationship", "fair market conditions", can be explained in several ways: - As a legal term, means voluntary contracting between two independent and free parties. - - In the economy, the market principle is the free creation of relations between independent parties in accordance with the market conditions that existed at the moment of creating the relationship between them.

Due to the importance of the term "market principle" (Arm's Length Principle), in order to better understand and apply the pricing rules, the Organization for Economic Development and Cooperation (OECD) defines the market principle as an "international standard" to be used in adopted form by the legal entities and tax authorities of the OECD member states. According to the OECD, the market principle exists when independent enterprises enter into a mutual

transaction, in accordance with market conditions. - Example: the price of the goods or service is in accordance with the usual market price for that type of goods or service. Any behavior outside this principle is a violation of the market principle.

The related parties, or dependent enterprises of a multinational enterprise - MNP, are expected to apply and abide this principle when defining their mutual business relationships. If their mutual relations are not based on the market principle, there is a risk of a breach of the amount of income tax in a (one or more) dependent company - a related entity within the grouping, by: reducing the amount of taxable profit in tax areas with a high tax rate and an increase in the amount of taxable profit in taxable areas with a low tax rate.

Although theoretically well-placed, in practice, the market principle is very difficult to function because of:

- Different market conditions in different countries,
- Different economic interests between independent and dependent enterprises,
- Existence of a free market,
- Participation of many entities on the market,
- Insufficient data for determining real market conditions,
- Various impacts on enterprises by several state and regulatory bodies.

For these reasons, the OECD in its model of an international agreement on the avoidance of double taxation of income and capital taxes (OECD Model Tax Convention on Income and Capital) provided in Article 9: "... if, between the two (related) enterprises in their trade or financial relations created or imposed conditions other than the conditions that would have been created between independent enterprises, the profits that would accrue for one of the enterprises, when those conditions would not exist, or because of these conditions did not occur, may be included in the profit of that enterprise and taxed accordingly. "

In order to satisfy the requirement of the market principle, the MNE needs to carefully define the transactions within the group, while paying attention to:

- The nature of the transaction - whether the transaction would have occurred (if it happened) if it was concluded between independent enterprises
- Transfer prices - whether the prices determined between the members of a grouping are within the usual prices on a particular market.

In order to reduce the risk, the MNP needs to make a "comparative analysis" of the market conditions in the countries in which it operates. The procedure for determining the prices at arm's length and the inclusion of the difference between the transfer and the market price in the tax base can be a very complicated, costly and uncertain procedure. [8]

Macedonian tax regulations do not prescribe which elements are mandatory, so that we can orient towards the elements prescribed in the OECD Guidelines. In practice, this means that during the control of transactions between related parties, the PRO has the right to request the following information: a review of the business operations, the structure of the organization, the ownership link in the group of the multinational enterprise, the amount of the achieved resultd from sales and the operations in the last few years before the transaction, the level of transactions the taxpayer performs with foreign affiliates (such as: the volume of the sale of goods and supplies, the provision of services, ing real estate for rent, use and transfer of real estate and interest on loans). [9]

3. Transactions with related parties

The specificity of transfer prices in relation to market prices is that they are realized in transactions between related parties. Without the existence of related parties, there can not be a matter of transfer pricing; ie, transfer prices exist only in the context of transactions between related parties. For the law, only the transfer prices formed between undertakings that can be subject to the legal definitions of affiliated persons are relevant.

According to the Law on Trade Companies, [10] related companies are legally stand-alone associations that connect and which establish mutual relations like:

- a company that in another company have:
 - participation (10% - 20% of the basic equity),
 - significant participation (21% - 50% of the basic equity),
 - majority participation or majority right in deciding (over 50% of the basic equity) or
- mutual participation;
- dependent, governing company and operating companies acting jointly.
- A company that has acquired in another company a stake or shares representing at least 10%, but not more than 20% of the basic equity, is considered a company that has a participation in another company.
 - A company that has acquired in another company a share or shares representing more than 20% in the basic equity of the other company, but not more than 50% of the company's equity or when at the assembly of the partners or the assembly it belongs more than 20% but not more than 50% of all votes, shall be deemed to be a company with significant participation.
 - A company that has acquired a share in other company, ie shares representing more than 50% in the basic capital of the other company, or when more than 50% of all votes are held at the assembly of the founders or the assembly of the other company, is considered for a company that is in another company majority participation.
- The company to which the majority holding or shares belongs, ie the majority of votes in another company shall be considered, in the sense of this law, for a majority company, and the other company for a majority company ownership.
 - Dependent company is a legally independent company over which another company (the governance company) has a direct or indirect dominant influence.
- A company that has a direct or indirect dominant influence in depending on him company is a governing company.
 - Companies that have jointly acquired stakes, ie. shares, so that each company has a stake, ie. shares that participate with more than 20% in the basic

equity in the other company, or if in the assembly, ie. in the assembly of the partners of the other company belongs more than 20% of the votes are considered as companies having mutual participation.

For affiliated individuals with the taxpayer, the members of the same family are considered, if they belong to one from the following mutual relations, as follows:

- married comrade;
- relative in straight line;
- brothers and sisters;
- children and spouses of brothers and sisters;

- the brothers and sisters of spouses and parents of spouses;

- parent's siblings; and

- breadwinners and foster parents.

Transactions between related parties and the opening balances with other entities within the group are disclosed in the financial statements of the group. The transactions between related parties within the group and the opening balances are eliminated in the preparation of the consolidated financial statements of the group.

The relations between related parties is a normal feature of commercial and business operations. For example, entities often carry out part of their activities through subsidiaries, affiliated entities and joint ventures. In these circumstances, the entity's ability to influence the financial and operational policies of the entity in which it has invested is exercised through the presence of control, joint control or significant influence.

The relations between related parties could have an impact on the profit or loss as well as the entity's financial position. Related parties can be involved in transactions in which unrelated parties would not participate. For example, an entity that sells goods to its parent company according to their purchase value may not sell those goods to other consumers under the same conditions. Also, transactions between related parties may not be made in the same amounts as between unrelated parties

The profits or losses and the financial position of the entity may be affected by related party relationships, even if there are no transactions between them. The very existence of relationships may be sufficient to affect the transactions that an entity exercises with other parties. For example, a subsidiary may terminate its relationship with a trading partner at the time when it will be acquired by the parent company or sister subsidiary is engaged in the same activities as those of the former trading partner. Alternatively, one party may refrain from exercising certain activities because of the significant influence of another party - for example, a subsidiary may be instructed by its parent not to go into commitments for research and development.

For these reasons, knowledge about the transactions of related parties, their opening balances and relationships may affect the assessments by the users of financial statement about the entity's operations, including evaluating the risks and opportunities facing the entity.

4 . Regulation framework for transfer prices

In Macedonia the transfer prices are regulated by the Law on Income Tax [11] and the Companies Act, their application in detail is explained in the Rulebook on calculation and payment of tax on profits and prevention of double exemption or double taxation, the Custom law, but the guidelines for transfer prices for multinational enterprises and tax administrations of the OECD which contain instructions for the application of the "principle fingertips" are respected as well.

In *the Law on income tax* the transfer prices are included in Article 11, 12, 13 and 14 , which defines:

- The scope of the application
- The methods that determine the differences between transfer and market price

A basis in the process of selftaxation and the determination of tax on profits is through making *annual tax balance* by the taxpayers themselves, which stipulates:

- tax base
- unrecognized expenses
- tax exemptions and reductions
- tax credit ...

Unrecognized expenses for tax purposes are unpaid receivables arising from transfers of financial assets that in their economic essence are loans, unless they are returned in the same year in which the transfer is made on the loan. Unrecognized expenses for tax purposes is the difference between the price of the transaction of assets or incurrence of liabilities between related parties - transfer price and the market price.

In determining the difference between the market and the transfer price a method of comparable market prices is used, ie taking into consideration the prices achieved on the domestic market or comparable foreign market, that would not have worked for the respect of related parties, and when it is not possible a method of cost is used, ie prices set according to the cost of production plus the usual income (difference in prices, fee) are taken into account.

The legal treatment of the transfer prices is further elaborated in the *Rulebook on calculation and payment of tax on profits and prevention of double exemption or double taxation*. [12]

Unrecognized expenses for tax purposes is the amount of penalty interest arising from relationships with affiliated entity which is not a bank or other authorized credit institution.

Expenses and the less reported income from related parties represent:

- The difference between the transfer price and the market price achieved between related parties. Determining the difference between commercial and financial transactions between related persons is conducted according to the arm's length principle, or the conditions in which these transactions do not differ from those between unrelated parties in comparable circumstances. Taxpayer's upon a request by the tax authority should present sufficient information and analysis for verifying the conditions of the transactions between related parties according to the arm's length principle;
- The amount of the portion of interest on loans obtained from affiliated person who exceed the applicable interest rates in case of loans obtained from unrelated parties. For loans obtained from affiliated entity which is not a bank or other authorized credit institution, or not received e directly or indirectly from international financial institutions and loans guaranteed by the Republic of Macedonia, in determining the interest expense is

recognized accrued interest up to the interest rate that would be achieved between unrelated parties at the time of approval of the loan, or up to the amount of the EURIBOR rate for foreign currency loans with appropriate maturity and SKIBOR rate for denar loans increased by one percentage point. In determining the income from interest on loans granted to related parties are recognized accrued interest, at least to the level of interest rates, which would be achieved between unrelated parties at the time of the loan approval, or at least up to the EURIBOR rate for foreign currency loans with appropriate maturity and SKIBOR rate for denar loans increased by one percentage point;

- The amount of penalty interest between related parties;
- The amount of interest on loans obtained from the partners or shareholders residents with at least 25% participation in the company's capital, which for more than three times exceed the share of such member or shareholder. For loans are considered loans from third parties guaranteed by the partner or shareholder, as well as loans obtained from banks based on deposit of such member or shareholder in that bank. The interest that is not recognized as an expense, is determined such that the total interest of the current year will be multiplied by the portion of loans which exceeds the ratio 1: 3 (one for the capital: three for the loan) and is divided by the total amount of loans. The share of the member or shareholder in the equity of the borrower shall be determined as the average of the state of:
 - Basic equity reduced by the unpaid portion;
 - reserves (excluding revaluation reserves) and
 - undistributed profits, reduced by the amount of uncovered losses, on the first and last day of the tax period: the year in which the loan is used.

The amount of unrecognized expenses is reduced by the amount of the tax credit on the basis of costs deferred recognition that in the previous tax periods was made increasing of the tax base, according to the taxable amount.

According to the Customs Law [13], custom value of imported goods is the transaction value or price actually paid or price payable for the goods when sold for export to the customs territory of the Republic of Macedonia, provided that the buyer and seller are not related, or if related, the transaction value is acceptable for customs needs.

In determining whether the transaction value is acceptable for application, the fact that the buyer and seller are related is not a sufficient reason that the transaction value is considered unacceptable. In that case you should investigate the circumstances under which the sale is done and the transaction value is accepted provided that the relationship did not influence the price. If the information provided by the declarant or otherwise, the customs authority has reasons to consider that the relationship influenced the price, these reasons should be announced to the declarant and give him a reasonable opportunity to respond. At the request of the declarant, the reasons shall be submitted in written form. In a sale between related persons, the transaction value is considered as acceptable wherever the declarant demonstrates that such value is approximately the same to one of the following occurring at or about the same time:

- Transaction value in sales, between buyers and sellers who are not related, of identical or similar goods for export to the Republic of Macedonia (sales to unrelated parties);
- Customs value of identical or similar goods,

In applying the foregoing tests, the demonstrated differences in commercial levels,

quantities and costs incurred by the seller in sales in which the seller and the buyer are not related and not shown in sales in which the seller and buyer related should be taken into account.

Price actually paid or price payable is:

- The total payment that is done or should be done by the buyer to or for the benefit of the seller for the imported goods and includes all payments that are made or should be made as a condition of sale of the imported goods by the buyer to the seller or the buyer to another person to satisfy the liability of the seller. The payment is not necessarily needed to be made by a transfer of money. Payment can be made via credit or negotiable instruments, directly or indirectly;
- activities, including marketing activities, that the buyer takes on his own account.

If the customs value can not be determined according to the agreed transaction price, then identical goods sold for export to the Republic of Macedonia and exported at or about the same time in the same quantity as the goods being valued are compared. When such sale is not found, the transaction value is compared with the value of identical goods sold at a different commercial level and / or in different quantities, with the necessary adjustments for differences in the commercial level and / or amount, provided that such adjustment can be made on evidence making clear the justification and accuracy of the adjustment regardless of whether the adjustment increases and / or decreases value.

When the costs are included in the transaction value, we need to make adjustments in order to take into account the substantial differences of those costs of the imported goods and the identical goods arising from the difference in distance and type of transport. Costs that should be included in the customs value of goods are presented in the following picture.

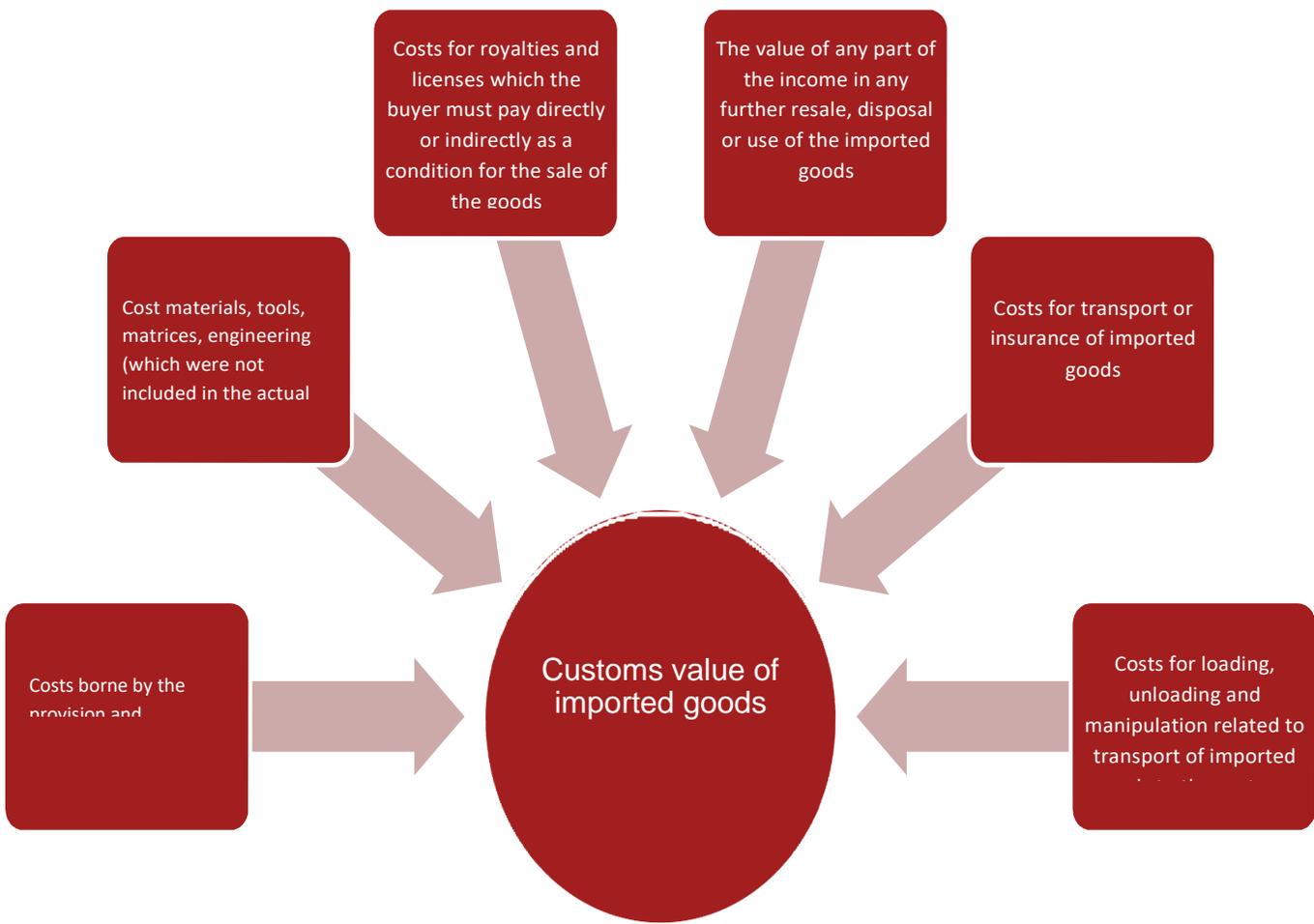


Figure 1. Costs that should be included in the customs value of goods

For this issue OECD prepare on a regular basis in a clear and transparent process update " *Transfer Pricing Guidelines for multinational enterprises and tax administrations include instructions for applying the " principle of arm's length "* [14]. In brief guidelines of OECD are consensus set on international framework for transfer prices for the taxation of cross-border transactions between associated enterprises. Guidelines underscore are recommended guidelines for the application of Article 9 of the *Model Convention of the OECD for taxation of tax revenue and capital*, which model is starting negotiating basis for concluding bilateral agreements on avoidance of double taxation.

In the guidelines is emphasized that the simplified tax regimes can potentially result in insufficient tax revenues internationally, to the extent that they result in prices or profits that are approximate close to the "arm's length principle" and allow taxable revenue to be shifted to countries with lower tax rates or the so-called "tax heavens".

5. OECD recommended methods for transfer prices / methods applicable to Macedonia

OECD recommends several methods for determining transfer prices of which some are and some are not applicable according to the legislation in the country.

OECD methods recommended in the Guidelines	Income Tax Law - methods applicable to PM
<i>Traditional transaction methods</i>	
Method of the comparable uncontrolled price (SNC method)	Method of the comparable uncontrolled price (SNC method)
Method of trade prices	Not applicable
Method of cost plus normal earnings	Method of cost plus normal earnings
<i>Transactional profit methods</i>	
Method of division of transactional profit	Not applicable
Method of transactional net margin	Not applicable

Figure2 . Recommended methods for transfer prices according to the OECD and their applicability in Macedonia

Method of the comparable uncontrolled price (SNC method) – means comparison between the price charged to the supply of goods or services within a controlled transaction, and the price to be charged for the supply of goods or services within a comparable uncontrolled transaction, in comparable circumstances. The difference may indicate that the terms of trade and financial relations between associated enterprises do not comply with the "arm's length" principle and that the price applied within the controlled transaction may need to be replaced with the price applied within the uncontrolled transaction

The uncontrolled is comparable to the controlled transaction if one of the following conditions is fulfilled:

- no difference (if any) between the transactions being compared or between the enterprises that carry out these transactions can not substantially affect the price of the free market; or
- can be made acceptable reasonably accurate adjustments to eliminate the material effects of such differences.

This method is applicable for goods that are traded on a stock exchange and certain financial transactions such as borrowing.

Method of cost plus normal earnings. The starting point of this method are the costs of the supplier of goods (or services) within a controlled transaction, which covers trade in goods or services to a related buyer. To these costs an appropriate margin that reflects a certain profit in the context of the functions performed and the market conditions is added. Once added margin of the previously mentioned costs, price in accordance with the "arm's length" principle of the original controlled transaction is made.

The margin on the cost of the supplier in a controlled transaction is most appropriate to be determined based on the margin that the same supplier accomplishes under the comparable uncontrolled transactions ("internal comparable transactions"). Additionally, the margin of comparable transactions would be accomplished by an independent company ("external comparable transactions") can be taken as a guidance.

The uncontrolled transaction is comparable to the controlled transaction if one of the following conditions is fulfilled:

- none of the differences between the transactions being compared or between the enterprises that carry out these transactions do not affect the substantial margin the cost of the free market; or
- reasonably accurate adjustments can be made to eliminate the material effects of such differences.

The method is most appropriate when it sells semi-products between related enterprises when they have entered into joint production agreements or long-term contracts, or when the transaction concerns the provision of services, especially when:

- The controlled transaction is selling products by a manufacturer that does not add unique immaterial value neither is exposed to unusual risks in the controlled transaction.
- The controlled transaction is a service with which the service provider does not add unique immaterial value neither is exposed to unusual risks in the controlled transaction.

Conclusion

In the context of changes of the international taxes and the imperative need for transparency, information sharing and compliance, it can be assumed that the issue of transfer prices is the most important tax issue on the agenda of the financial bodies and institutions. Given that almost 60% of world trade takes place between multinational companies, the need for an effective tax structure has significantly increased. Today, facing the problem of transfer prices requires centralized treatment and approach to transfer prices. Taxpayers should be in a position to defend their transfer prices strategy and consider the tax benefits of which they can benefit as well as the overall design of their transfer prices policy in order to limit potential tax exposure.

The taxpayer must : be aware of the legislation and the risks of transfer prices; to avoid situations and areas where transactions of high risk between related parties had occurred ; always be awoken to new risks, new opportunities and alternatives.

The requirements for establishing real impact on transfer prices taxation require preparation of procedures and actions that will not lead to unnecessary additional taxation, nor to an outflow on the basis of transfer prices to tax in other countries. It requires real training and education of taxpayers and tax authorities and administration.

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[1 2] Rulebook on the manner of calculation and payment of income tax and preventing release or double taxation

[13] Customs Law

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