TRANSFER PRICING ISSUES – THE ARM'S LENGTH PRINCIPLE

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Valeria NAPADAICĂ, PhD candidate
Bucharest University of Economic Studies, Romania
napadaicavaleria21@stud.ase.ro

Abstract: *As the globalization process and international trade has taken off, the number of multinational groups significantly increased. Especially for the past century. In this regard, it is important to address the consequences for the MNEs as well as for national tax authorities. Since, the topic of transfer pricing has become the top priority on the tax authority's agenda it is important to highlight the issues found within the documentation of transfer pricing, such as the arm's length principle. This paper provides an overview on the main considerations on the arm's length principle: applying steps, arm's length price determination, main issues encountered in tax practice. The paper is based on qualitative research according to the field literature/legislation as well as the author's practical perspective. As the results have shown there are several issues within the arm's length principle, more specifically: differences identified between controlled and uncontrolled transactions; identifying and applying reasonable search criteria in a specialized database; identifying comparable and independent companies suitable as benchmarks for comparability analysis; identifying a reasonable sample of comparable to determine the arm's length range; identifying and applying the most appropriate transfer pricing method. That's why it is fundamental to ensuring equitable taxation across borders, fostering openness in related-party transactions, and protecting national tax resources from erosion due to unlawful profit shifting by multinational corporations.*

Key words: *transfer pricing, arm's length principle, arm's length price, multinational groups.*

JEL: H25, H26

1. Introduction

Nowadays, in the context of globalization and international trade, the subject of transfer pricing is gaining more and more ground. Firstly, because in recent decades the number of multinational groups has increased significantly, as has their role in the global economy. Secondly, because of the tax implications of the topic – companies often use transfer pricing as a tool to shift profits to tax-favourable jurisdictions.

As a complex subject, transfer pricing has always been intensively debated among transfer pricing specialists and researchers. Therefore, intra-group trade is a developing issue. *(Ylönen, Teivainen, 2018, p. 441)*

Moreover, through the past decades there has been observed an increase in intra-group transactions. Due to the issues associated with international transfer pricing, the topic gained considerable attention in international taxation and is expected to become more significant.

In this context, both tax practice and specialized literature have tended to highlight the deficient aspects of the subject: the problems faced at the level of legislation, methodology, interpretation of terms etc.

An important role is played by the arm's length principle (for the purpose of this paper the following abbreviation will be used "ALP"), because it is the instrument, on the one hand to protect the tax authorities from the phenomenon of evasion, on the other hand to defend multinational groups by ensuring compliance with the prices charged by independent entities.

According to the academic literature as well as the legislative framework, the basic rule in a transfer pricing analysis is that transfer prices should be carried out at arm's length, i.e. in accordance with the arm's length principle. For this reason, the ALP has been and continues to be addressed in economic and tax circles, because it is the cornerstone when we talk about the compliance of the prices charged by affiliated entities in intra-group transactions, whether it is a question of goods, services, loans, intangible assets, with those practiced by independent entities. Thus, when the ALP is proved to be respected, the taxpayer has implicitly correctly established its profits and has not engaged in profit shifting activities.

Since there has been recorded an increase in cross-border transactions, it is important to highlight the arm's length principle issues, because: **(i)** it ensures fairness and compliance – helps to prevent profit shifting and the alignment with global standards; **(ii)** it avoids the double taxation phenomenon – if the ALP is not followed, it can lead to double taxation or a country's tax base erosion; **(iii)** transparency – supports transparent documentation; **(iv)** risk management – allows to avoid adjustments and penalties; **(v)** strengthens a MNEs position.

2. Literature review

The first country to implement transfer pricing legislation and to introduce the notion of the arm's length principle is the USA, as after the First World War increased the pressure regarding the allocated profits between the companies. *(Fulop, 2023, p.345)*

The arm's length principle is typically used by the tax authorities for the purposes of corporate taxation, more specifically to identify comparable arm's length prices, in order to assess the fair pricing by multinational companies (for the purpose of this paper the following abbreviation will be used "MNEs") in intra-group transactions. *(Keuschnigg, Devereux, 2013, p.432)* As the transfer prices can be used by MNEs for profit shifting purposes, is it important to ensure that the pricing policy applied is in line with the arm's length principle. *(Lemus, Moreno, 2020, p.78)* That's why world countries have started to adopt specific regulations in this area and pay close attention to the transfer pricing issue. *(Ignat, 2019, p.755)*

The ALP was adopted by the tax authorities worldwide, with very few exceptions according to Chongwoo and Matsushima *(2013, p. 119)*, as the key principle for multinational companies' taxation and as a tax base protection tool. *(Keuschnigg, Devereux, 2013, p.432)* The principle is defined in the OECD Guidelines ("Organisation for Economic Co-operation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations"), detailed information about it can be found in the Article 9. In the Romanian Tax Code (Law No. 227/2015) the definition on the ALP can be found under Article 7, paragraph 33.

The arm's length principle is one of the main tenets of previously established universally recognized taxation standards. *(Greil, Schwarz, Stein, 2018, p. 3)* Applying the arm's length principle involves comparing the actions of a tested entity with those of a genuinely independent entity under comparable or identical conditions. *(Keuschnigg, Devereux, 2009, p.3)*

Perhaps there are numerous issues within the ALP. *(Wilkie, 2012, p. 137)* The reliability and the plausibility of the data is one of the critical points when speaking about the ALP. *(Challoumis, 2019, p. 209)*

Nowadays, the effectiveness of the arm's length principle is being contested increasingly. *(Ylönen, Teivainen, 2018, p. 450)* If a transfer price is found to be set not according to the arm's length principle, tax authorities may perform adjustments accordingly. *(Yao, 2013, p.2)* Also, penalties can pe applied. *(Chongwoo, Matsushima, 2013, p. 119)*

The ALP is found challenging to implement, has no solid theoretical underpinnings, and provides opportunities for tax evasion tactics, thus applying the arm's length principle has been under strain for years. *(Greil, 2019, p.1)*

Considering all mentioned, the article provides practical examples regarding the issues faced by practitioners in the field of transfer pricing to audit the compliance of intra-group prices with prices charged by independent companies for comparable goods/services.

Reflecting on the preceding, the paper is found to be important for several reasons: **(i)** its usefulness for both the practitioners and national tax authorities; **(ii)** its informativeness on the particularities of the arm's length principle; **(iii)** its practical approach on the subject.

3. Research methodology

The research methodology was applied starting from the following hypotheses:

Hypotheses one: MNEs face certain difficulties when applying the arm's length principle.
Hypotheses two: the ALP issues need to be addressed for several reasons, including the need to ensure fair and consistent tax practices across jurisdictions, promote transparency in international transactions, and prevent tax avoidance through profit shifting.
For testing the two hypotheses mentioned above, qualitative research was performed based on the field literature/legislative framework as well as the author's practical perspective. For a better understanding of the ALP, the article presents an illustrative case study and includes legislative analysis.

4. The arm's length principle applying steps

The tax obligations of related businesses and the tax receipts of the host jurisdictions may be skewed when transfer prices fail to consider the market dynamics and the arm's length principle. *(OECD Guidelines, Chapter 1, p.29)*
The implementation of the ALP revolves upon comparability analysis *(Greil, 2019, p.3)* and can be considered as a three-step process (see **Figure 1** presented below).

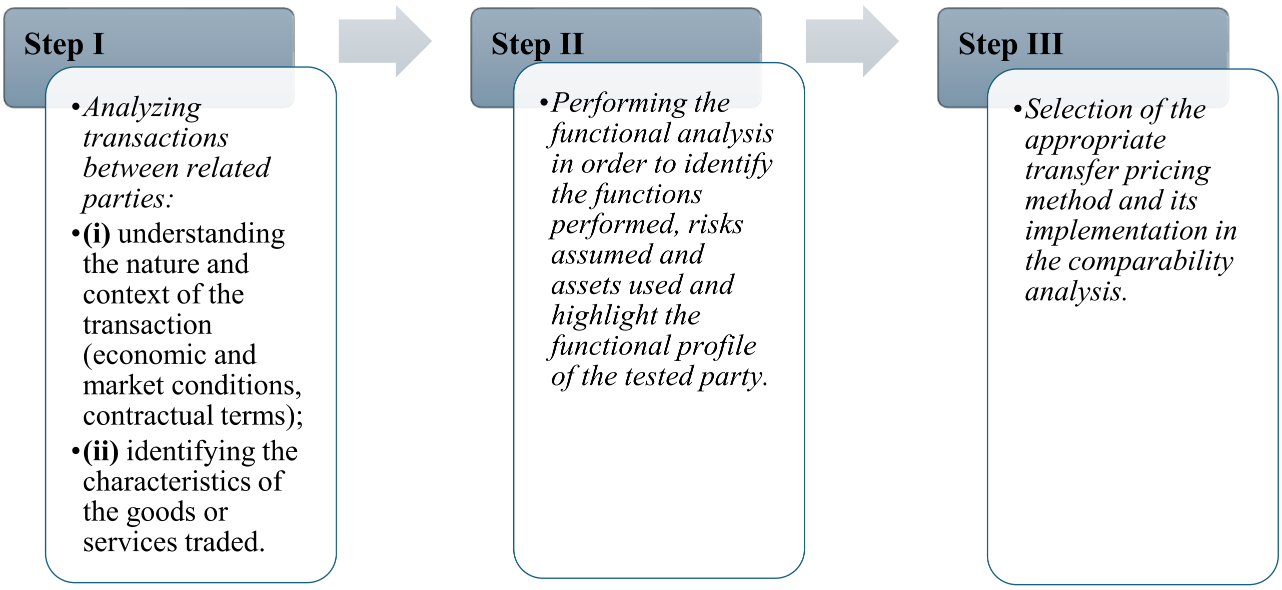

Figure 1. Steps to follow when applying the arm's length principle
Source: own processing

Applying the arm's length principle implies a good understanding of the performed transactions between related parties. First, the facts and circumstances associated with the intra-group transaction must be analyzed. It is a very essential step in the following analysis as it helps to understand what comparable should be identified or if there is any need of adjustment. Once the nature and context of the transaction has been understood, the character of the goods and services where identified the functional analysis should be performed. A functional analysis helps to identify the tested party and its functional profile taking into account the functions performed, risk assumed and assets used. To assure that the comparability analysis is an accurate one, it should be selected the appropriate method for the analysis (see below the transfer pricing methods – **section 6**).

5. Example case of arm's length price determination

One of the companies within the group (manufacturer/distributor/service provider) is in charge to perform certain activities within its functional profile (manufacture/sale/provide) for the benefit of its related party. The Company records a production/distribution/provision cost for the goods/services of 10 EUR. Furthermore, after adding a specific mark-up, the Company sales the goods/services at a price of 12 EUR to its related party – an entity operating in another jurisdiction (for this specific example the Company will be considered a resident of Romania and the related party a resident of Italy). The transactions' flow can be seen in the Figure 2 below:

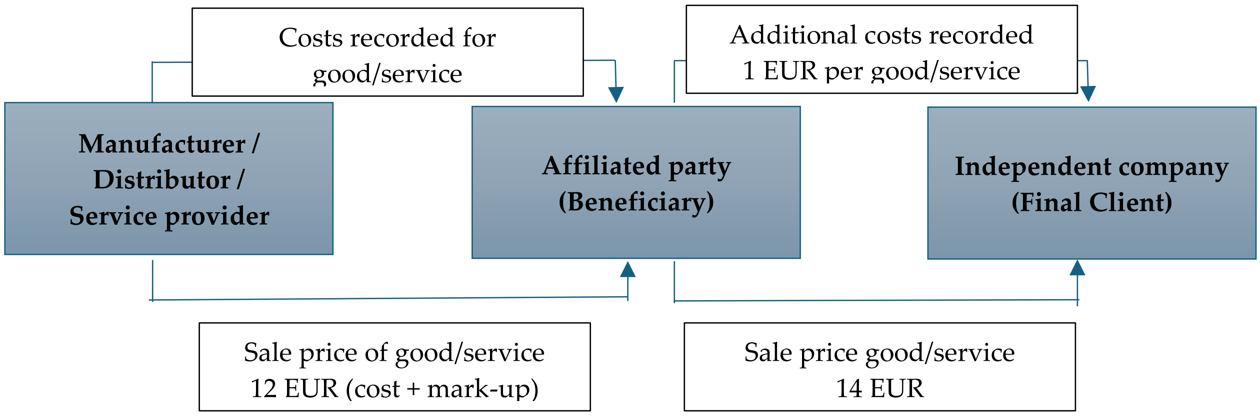

Figure 2. The transaction's flow

Source: own processing

In the case of independent entities with similar or identical functional profile, that are engaged in similar or identical transactions, the price charged for goods or services is considered to be between 8 – 14 EUR (fur the purpose of this specific example). Thus, the compliance with the arm's length principle is assured and the sale price of 12 EUR by the Company to the related party is to be considered an arm's length price. The range between 8 – 14 EUR is the arm's length range, determined based on a comparability analysis.

The profit recorded within the Group is 4 EUR, 2 EUR profit in Romania and 2 EUR profit in Italy. Considering that the tax rates in both countries are different, throughout the intra-group transactions the companies could be involved in profit shifting practices by artificially inflating or deflating the transfer price. As a result, the price would not be aligned with the arm's length principle.

6. The arm's length principle considerations and issues

Applying the arm's length principle practically might be challenging since related businesses might do things that independent businesses wouldn't. These kinds of transactions might not always be driven by tax evasion, but they might happen because members of an MNE group deal with each other under different commercial conditions than independent businesses would. *(OECD Guidelines, Chapter 1, p.32)*

The compliance of intra-group transactions with the arm's length principle is ensured through comparability analysis. In general, a comparability analysis involves analysing the terms and conditions of a controlled transaction (transactions between affiliated entities) compared to uncontrolled transactions (transactions that take place between independent entities under arm's length conditions).

Normally, any entity, when evaluating the terms of a potential transaction, compares the practical/realistic market options available. In this sense, the entity will not participate in the transaction unless it finds a more attractive alternative.

Checking compliance with the ALP can be difficult for several reasons:

1. Differences identified, if any, should not affect the conditions examined. The OECD Guidelines mention five important factors by which comparability is to be determined, namely: the service/goods specifications; the functional analysis (specifically the functions

performed, the risks assumed, and the assets used); the terms of the contract; the economic circumstances and the strategy of the entity.
2. Identifying and applying reasonable search criteria in a specialized database.
3. Identifying comparable and independent companies suitable as benchmarks for comparability analysis.
4. Identifying a reasonable sample of comparable to determine the arm's length range.
5. Identifying and applying the most appropriate transfer pricing method. The selection of a transfer pricing method is based on: **(i)** data availability and accuracy; and **(ii)** the feasibility of benchmarking between transactions under control and those carried out under conditions of economic independence.

To establish the arm's length price of intra-group transactions, the literature recommends the use of either traditional or transactional methods. The figure below shows the methods that can be used in transfer pricing analysis.

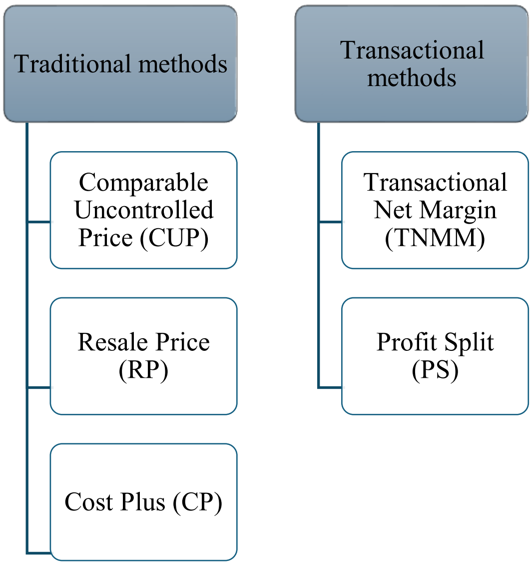

Figure 3. The transfer pricing methods
Source: own processing

Determining the transfer price at market level requires the use of an appropriate method, considering the following elements:
- The circumstances under which prices are set in comparable markets.
- The availability of financial information for both affiliated and independent entities.
- The accuracy and precision of adjustments required to be made for comparability purposes.
- The specific circumstances of the transaction, including the activities carried out, more specifically: market conditions, contractual terms, particularities of the goods/services traded, specificities of the business, market competitiveness etc.

Some methods have proven to have a higher practical applicability. However, in tax practice, the most frequently used method has proved to be the net margin method (TNMM). The particularities of each transfer pricing method are presented below.

1. *CUP* – is applied to identical or similar goods/services traded under identical or similar conditions, it refers to both controlled and uncontrolled transactions. In the case of this method, the price should not be influenced by differences identified at the product/service level or by the circumstances of sale. Among the differences that can have a significant impact on price are: quality, type of market (en-gross / en-detail), geographic criteria, etc. For comparability, either internal comparable (if available) or external comparable can be used.
2. *RP* – is used for transactions consisting of distribution activity, usually applied if no plus value is added on the good that has been traded. The method consists of comparing the resale price

in relation to an independent company, for a good purchased from an affiliated entity, considering the following flow: affiliated party (seller) – tested party (intermediary) – Independent party (end customer). The price is reduced by the resale price margin. The market price under this method turns out to be the price minus the gross sales margin, adjusted for costs (e.g. customs duties, transportation).

3. *CP* – used for activities of production/assembly of goods or rendering of services, in the affiliate-affiliate relationship. The method considers the gross profit margin related to the field of activity.
4. *TNMM* – consists in comparing the net profit margins of the tested party with those of independent entities. The profit indicator is established depending on the functional profile of the tested party, as well as on the availability of information of the companies included in the comparability sample.
5. *PS* – is based on the profit to be shared between the affiliated entities. In general, this method assumes the existence of significant intangible assets. At the same time, this method is feasible when transactions between affiliated parties cannot be segmented, being highly integrated.

As shown above, the research hypotheses have been validated. As long the legislation highlights certain issues when applying the arm's length principle and the field practitioners face those issues in a daily practice, consequently MNEs face certain difficulties when applying the arm's length principle. These issues must be addressed and diminished.

7. Conclusions

The topic of arm's length principle issues is of particular importance. It is fundamental to ensuring equitable taxation across borders, fostering openness in related-party transactions, and protecting national tax resources from erosion due to unlawful profit shifting by multinational corporations.

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