CONCEPTUL ȘI APLICAREA PRINCIPIULUI LUNGIMII DE BRAȚ
CONCEPT AND APPLICATION OF THE ARM'S LENGTH PRINCIPLE

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Abstract: *This article includes the overview of the arm's length principle (ALP), its description, evolution, examples of transactions which are made using such a principle, and the methodologies it applies.*

The arm's length principle is the key for ensuring the transparency of trade affairs. An arm's length transaction is a transaction in which the buyers and sellers of a product act independently and have no relationship to each other. This transaction is concluded at the arm's length price, which would have been determined if such transactions were made between independent entities under the same or similar circumstances.

This principle is a subject of particular interest due to the fact that it is not applied in Moldova, while it is used in international practice, and in the nowadays integration process of the Republic of Moldova in the European Union and more active participation of our country in world trade the study of this principle becomes a necessity.

Key words*: an arm's length transaction; transparency; legislative framework; transfer pricing; double taxation.*

Introduction. The arm's-length principle (ALP) of transfer pricing states that the amount charged by one related party to another for a given product must be the same as if the parties were not related.

An arm's length transaction is a transaction in which the buyers and sellers of a product act independently and have no relationship to each other. An arm's-length price for such a transaction is therefore what the price of that transaction would be on the open market [3].

For commodities, determining the arm's-length price can sometimes be as simple a matter as looking up comparable pricing from non-related party transactions, but when dealing with proprietary goods and services or intangibles, arriving at an arm's length price can be a much more complicated matter.

Investigation results. As the arm's length principle plays a particular role in international transactions, it is relevant to investigate how this principle has developed.

For the first time the „arm's length" term was included in an official document, in the draft multilateral treaty of the League of Nations in 1933, and later in the US Regulations of 1935.

The purpose of the principle was to ensure the correct application of the separate entity or independent enterprise approach, which was qualified as the primary method for the allocation of profits to permanent establishments.

After 70' years, the arm's length principle seems to have reached the limits of its development. The main reason for this is that the emphasis in the legislation and regulations of many countries and in the OECD Guidelines 1995.

The Organization for Economic Co-operation and Development (OECD) has adopted the principle in Article 9 of the OECD Model Tax Convention, to ensure that transfer prices between companies of multinational enterprises are established on a market value basis.

The arm's length principle, despite its informal sounding name, can be also found in the framework for bilateral treaties between OECD countries, and many non-OECD governments, too.

The World Customs Organization (WCO) and World Trade Organization (WTO) have also adopted, in effect, the arm's length principle in Customs valuations [4]. Arm's length principle methodology is presentment in figure below.

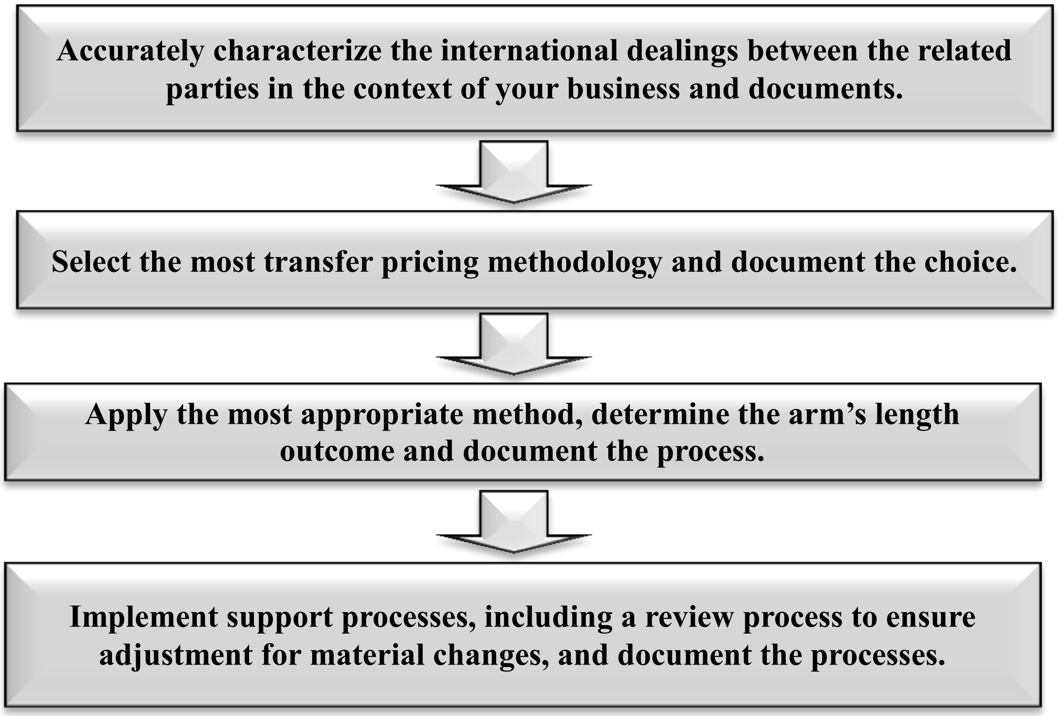

Figure 1. Arm's length principle methodology.

Source: *developed by authors based on source number 4.*

Transactions subject to Arm's length principle include:

- ✓ purchase at little or no cost,
- ✓ payment for services never rendered,
- ✓ sales below market price
- ✓ purchase above market price,
- ✓ interest free borrowings,
- ✓ exchanging property,
- ✓ selling of real estate at a price different from market price,
- ✓ use of trade names or patents at exorbitant rates even after their expiry.

In order to understand better how the arm's length principle works let us take an example.

Example 1. *The British company „Prima Dental" is a medical equipment producer that distributes its equipment through a subsidiary in France. The equipment costs € 900 to make and it costs the French company € 100 to distribute it. The UK company sets a transfer price of € 1 000 and the French part retails the equipment at € 1 100. Overall, the French company has thus made € 100 in profit, on which it expects to pay tax. However, when the French company is audited, the auditors notice that the distributor itself is not showing any profit: the € 1 000 transfer price plus the French unit's € 100 distribution costs are exactly equal to the € 1 100 retail price. The auditors suggested the transfer price should be shown as € 900 so that the French unit shows the company's € 100 profit that would be liable for tax.*

But this issue will cause a problem for the UK company, because „Prima Dental" it is already paying tax in Great Britany on the € 100 profit per equipment shown in its accounts. Since it is a group, it is liable for tax in the countries where it operates and in dealing with two different tax authorities it cannot just cancel one out against the other. Nor should it pay the tax twice.

Solution: *in a bid to avoid such problems, current OECD international guidelines are based on the arm's length principle – that a transfer price should be the same as if the two companies involved were indeed two independents, not part of the same corporate structure.*

The OECD Transfer Pricing Guidelines provide a framework for settling such matters by providing considerable detail as to how to apply the arm's length principle.

Yet transfer pricing has gained wider attention among governments and NGOs because of another risk: that it could be used to shift profits into low tax jurisdictions. This leads to trade distortions, as well as tax distortions [1].

While they help corporations to avoid double taxation, they also help tax administrations to receive a fair share of the tax base of multinational enterprises. However, abuse of transfer pricing may be a particular problem for developing countries, as companies might take advantage of it to get round exchange controls and to repatriate profits in a tax free form.

The OECD provides technical assistance to developing countries to help them implement and administer transfer-pricing rules in a broadly standard way, while reflecting their particular situation.

Transfer pricing is the process through which parent companies and/or subsidiaries of the same parent, in different countries, establish a price for goods or services between themselves.

Transfer mispricing is the abusive manipulation of this process for the purpose of avoiding or reducing taxes across all entities.

This takes place when related firms agree to manipulate the price of their internal transactions in order to declare less profit in higher-tax jurisdictions and therefore reduce their total tax payments. It deliberately generates profit and hides or accumulates money in the jurisdiction where the tax bill is low.

The mispricing is said to be based on *,,arm in arm"* principle, the opposite of *,,the arm's length principle".*

In order to comply to the last, the companies should identify the appropriate price, using one of the following methodologies [2]:

- ✓ **Comparable uncontrolled price method (CUP)** - compares the price transferred in a controlled transaction to the price charged in a comparable un-controlled transaction. It is the most direct and reliable way to apply the arm's length principle.
- ✓ **Resale price method** - begins with the price at which a product is resold to an independent enterprise by an associate enterprise. The focus is on the resale price margin. This margin should ideally be established from comparable transactions between the reseller (involved in the controlled transaction) and other independent parties.

In the absence of such transactions, the resale price margin may be determined from sales by other resellers in the same market. The resale price margin is expected to vary according to the amount of value added by the reseller.

ARM'S LENGTH PRICE = Resale price – (Resale price x Resale price margin)

RESALE PRICE MARGIN = (Sales price – Purchase price) ÷ Sales price

Resale price margin must be comparable to margins earned by other independent enterprises performing similar functions, bearing similar risks and employing similar assets.

✓ **Cost plus method** - first the cost incurred is determined. An appropriate cost plus mark-up is then added to the cost to arrive at an appropriate profit. The resultant figure is the arm's length price. It is useful in the case of semi-finished goods, which are sold between associated parties.

ARM'S LENGTH PRICE = Costs + (Cost x Cost plus mark-up)

COST PLUS MARK-UP = (Sales price – Costs) ÷ Cost

Cost plus mark-up must be comparable to mark-ups earned by independent parties performing comparable functions, bearing similar risks and using similar assets.

✓ **Profit split method** - used when transactions are inter-related and is not possible to evaluate separately. The method is based on the concept that profits earned in a controlled transaction should be equitably divided between associated parties involved in the transaction according to the functions performed.

✓ **Transactional net margin method** - the method examines the net profit margin relative to an appropriate base such as costs, sales or assets. Compares the functions in the related party dealings with third party dealings and the arm's length net margins obtained taking into account the assets used and risks assumed.

In the figure presented below, you can see some comparability issues in methodology selection of the arm's length principle provided by OECD.

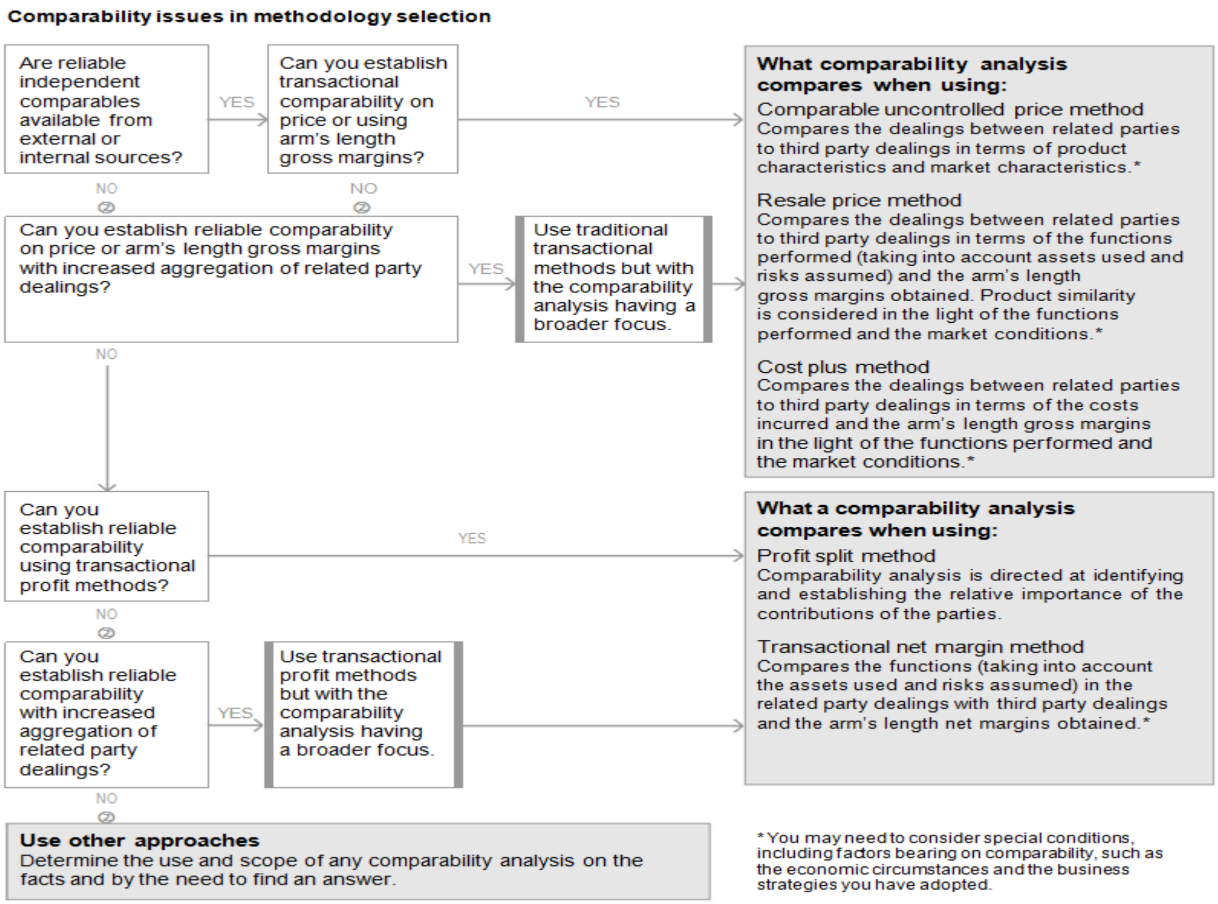

Figure 2. Comparability issues in methodology selection of the arm's length principle.

Source: *developed by authors based on source number 5.*

No country – poor, emerging or wealthy – wants its tax base to suffer because of transfer pricing. That is why the OECD has spent so much effort on developing its Transfer Pricing Guidelines.

Applying transfer-pricing rules based on the arm's length principle is not easy, even with the help of the OECD's guidelines. It is not always possible – and certainly takes valuable time – to find comparable market transactions to set an acceptable transfer price.

Companies should ensure high levels of corporate transparency, since this allows citizens to hold companies accountable for the impact they have on their communities. Multinationals operate through networks of related entities incorporated under diverse legislation that are interrelated through myriad legal and business connections. Without transparency, many transactions are almost impossible to trace.

Conclusions: Among the barriers why in the Republic of Moldova this principle cannot be adopted in near future we can mention:

- ✓ intervention/influence of prudential regulators,
- ✓ cultural aspects,
- ✓ economic crisis,
- ✓ transparency lack,
- ✓ legislative framework is young and in flux,
- ✓ Implications of state ownership.

The arm's length principle is based on real markets. It is tried and tested, offering governments a single international standard for agreements that avoid double taxation problems. Moreover, it is flexible enough to meet new challenges, such as global trading and electronic commerce. The arm's length principle remain the key for ensuring the transparency of international trade affairs.

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