

## Transfer Pricing and the Manifestations of Tax Evasion

Andreea - Lavinia Cazacu (Neamtu)<sup>1</sup>

### Abstract

---

The attraction of capital is a justified phenomenon, being attracted by certain factors, mainly the tax factors, because capital migrates from a market with high level of taxation towards one with a low level of taxation, its purpose being their optimal growth. With the expansion of economic globalization phenomenon, interstate financial flows increase, being generated mainly by transfer pricing, and the internationalization of economic crime gains new valence.

---

**Keywords:** licit evasion, illicit evasion, transfer pricing, tax haven, offshore companies

### Introduction

During the past few years, transfer pricing have been a sensitive issue both of national and international interest. They appeared in the context where groups of companies present in several countries carry out economic activities in those countries, thus representing a complex endpoint. The evolution of transfer pricing is fully related to globalization phenomenon, through the development of trade relations between the countries and the apparition of the first groups of multinational companies operating in various countries. Transnational companies treat transfer pricing as tax optimization, and the State wants to adopt some measures to protect the collection of taxes, especially measures to somehow avoid the outsourcing of the tax base of the contributors towards affiliated companies, in order to obtain a more favorable tax regime. Most of the time, the transactions performed by affiliated companies are at the border between licit and illicit, therefore trying to take advantage of certain tax system malfunction from the countries where they have their activity. Practically, there are many forms of tax evasion used by multinational companies that we are going to discuss in this article.

### 1. Tax evasion and transfer pricing

Tax evasion is an extremely important social and economic phenomenon that most of the countries face with, nowadays. Although many measures to eradicate this phenomenon are taken, this is almost impossible; all that can be done is to put some limits to this phenomenon. Practically, there are several definitions of the term, but this phenomenon can be briefly defined as being the taxpayers' failure to fulfill tax obligations. Tax evasion is acting in various areas, but abundantly in the direct taxation field, modifying its efficiency. If we refer to the way it acts, this phenomenon takes two forms: licit and illicit tax evasion.

#### 1.1. The licit tax evasion

The first form represents "withdrawal of a part from the taxable incomes, without being considered contravention or crime"<sup>2</sup>. In order to avoid tax obligations, within the legal limits, require help and guidance from competent persons, specialized in tax matters, such as accountants o lawyers. This specialized consultancy requires relatively high costs, that smaller taxpayers cannot afford, thus resorting to tax evasion, because it doesn't require high costs.

---

<sup>1</sup>Ph.D. Candidate, University of Craiova, Faculty of Economics and Business Administration, Romania, [cazacu.andreea21@yahoo.ro](mailto:cazacu.andreea21@yahoo.ro)

<sup>2</sup> <http://www.scripgroup.com/finante/Caracterizarea-si-formele-evaz13268.php>

It is well known that transfer pricing is considered to be a legal business opportunity for transnational companies, and are often used to financially distort the result of transactions and to avoid taxation. Starting from the definition of tax evasion companies from all over the world, now more than ever, try to proactively alleviate the risks associated with transfer pricing – reducing the risk of an improper audit or preventing a double or triple taxation, the result the implementation of a wrong strategy. Transfer pricing is ultimately used to determine whether the taxable income across borders is at arm`s length, and if it fits within the calculated range. The licit tax evasion in the context of transfer pricing is influenced by the tax facilities, payment scheduling, postponements or exemption from taxes, given by the government, and so taxpayers who did not honor their tax obligations are in advantage. It should be specified that the transfer pricing have a major importance in tax risk management because they can affect: tax due, cash flow, investment decisions, performance indicators and the border value. In the same time, transfer pricing can generate adjustments of incomes/expenses, which can lead to a double economic taxation. This can be used by transnational companies as an opportunity to deliberately and artificially not pay the income tax. For a transnational company to operate in legal limits, it must comply with the arm's length principle and even if it`s desired to minimize the tax burden or if there is a "not so legal" capital transfer across national borders, it must be done "utilizing a legislators unforeseen combination and tolerated by being out of sight" (Saguna, Tutungiu 1995).

At an international level, the principle that regulates the way of establishing and testing transfer pricing is represented by "the arm`s length principle". Transfer pricing Romanian law follows the guidelines of the Organisation for Economic Cooperation and Development (O.CDE) and requires that the transactions between affiliated parties to conclude a transaction at the right market value. If transfer pricing is not set at the arm`s length principle, Romanian tax authorities have the right to adjust the contributors incomes and expenses, in order to reflect the market value. Transfer pricing topic is quite controversial and has both supporters and critics, but all depends on their skills of using them in order to reduce tax burden. There are various acts of legal tax evasion, and practically they are mainly based on the favorable interpretation of the law, depending on the taxpayers intelligence and ability to take advantage of some "gaps" of the tax system.

## 1.2. Illicit tax evasion or the fiscal fraud

The fraudulent tax evasion consist in the dissembling of the taxable object underestimating the amount of taxable matter or by using other possibilities of avoiding taxes, through violation of the law. The illicit tax evasion is more prevalent than the licit tax evasion and involves the violation of the legal provisions, based on illegality and bad faith. It is used more, when there are changes in the tax legislation and there is an incomplete, imprecise and ambiguous system, thus creating room for the tax dodger to avoid the payment of taxes. Regarding the transfer pricing regime, tax evasion can be achieved by the following methods:

- a. the accounting fraud, which is often difficult to identify, because it can create the impression of the existence of fair accounting records by using fake documents in order to reduce the taxable income by increasing the costs and reducing the incomes, thereby reducing tax obligations owed to the state;
- b. the legal fraud, consisting in some omissions of the taxpayers in terms of avoiding to pay the taxes and fees, as they make themselves maneuvering space and taking advantage of the legal systems gaps;
- c. the traditional fraud refers to certain taxpayers omissions derived by drawing incorrect documents or by not drawing them as required by law, leading to the avoidance of paying taxes;
- d. the fraud via evaluation consists in carefully monitoring the value of inventories, in order to reduce the provisions and amortizations value for the purpose of their growth, as to displace the profit in the future.

A major factor that leads to the apparition of tax evasion in Romania is the legal levels of the main taxes and fees, which are above the European average, for example: in Europe, Romania has the 3<sup>rd</sup> highest standard VAT rate and the 7<sup>th</sup> highest labor tax burden, generated especially by C.A.S. (Health Insurance Company). It should be noted that there are other important factors that generate tax evasion:

- administrative and legislative factors refer to the taxpayers perception both on the fairness of the method of establishing the tax, the collected amounts and the destinations established by the state for them, and on how the state applies the law;
- psychosocial factors, refer to taxpayers features and beliefs, and the influences of the social environment upon him;

➤ economic factors refer to the possibility of the taxpayer to satisfy his needs using the incomes that remain after paying the contributions to the budget of the state.

These factors do not act independently, there are conjugated influences on the tax evasion, such as: trust the government, its legitimacy, equality before the law, the degree of tolerance towards other people, retrieval of the individual in the democratic constitutional country, attachment to religious precepts (Hayoz, Hug 2007); all these influences are potential causes of an escapist behavior. Fraud is extremely widespread, especially in terms of income declared by taxpayers, such as global income tax and profit tax or corporation profit.

The problem of transfer pricing is extremely complex because in the opinion of many economic analysts they represent the central vector of the way of extension of economic crime. Once with the expansion of the economic globalization phenomenon, interstate financial flows grow and are mainly generated by transfer pricing. This is the reason why quite many taxpayers believe that transfer pricing are real "collecting canals" of important amounts of money, acquired through tax avoidance practices, more or less legal.

## 2. International tax evasion: tax havens and offshore companies

The international tax evasion has been influenced by the development of multinational companies, entities with special status, known as tax havens or "tax shelter". The generic term "tax haven" represent those jurisdictions where the tax burden is either very low or null (the definition is taken from the English term- tax haven). The advantages of tax havens result not only from fiscal reasons; for the companies they are highly attractive because of the confidentiality of their operations, the existing infrastructure or the political and social stability. All these aspects have contributed to securing a very well organized financial structure and increasing the economic operations performed through them, in this way "turnover tax havens would be 50% of the world economy, compared to 5% as it was 20 years ago" ( Buziernescu 2010).

"Some experts believe that associating tax havens with tax fraud is forced as long as using their benefits is not sanctioned as it is, pecuniary or penal. But no one can deny that this privileged tax regime and the obscure features of the transactions have become a real "magnet" in attracting the financial resources from mafia groups, thus leading to the internationalization of economic crime, although their activities are carried out under an apparent tint of legality ( as examples of multinational companies whose practices are at the limit of legality we can mention Google, whose incomes earned in the United Kingdom were reported in Ireland; and Apple, by the lack of taxation of significant income parts as a result of tax residency in the United States of America and Ireland)."<sup>3</sup>

Currently, more than 40 regions around the world are considered tax havens. They are positioned in insular republics (Republic of Nauru), small countries (Panama, Cyprus) or archipelagos (British Virgin Islands, Isle of Man, Cayman, Bahamas etc.). Among multinational companies a question is asked: which is the perfect tax haven?... "a certain tax haven becomes optimum in relation with the users quality and the purpose that the user pursues" ( Pătroi et al. 2013). Therefore, tax havens can be classified depending on the quality of the future user of the tax haven and according to the type of taxation:

- 1) countries where tax rates are low: Switzerland, Ireland, Isle of Man, Liechtenstein;
- 2) countries where income tax is zero (in this case, the condition is that non-resident companies have to carry out transactions out of tax haven): Bahamas, Bermuda, Cayman Islands, Monaco, Nauru, etc.
- 3) countries used as a "base location" of the subsidiaries (which are exempt from tax, provided to perform certain operations outside the national borders) Costa Rica, Panama, the Philippines, Venezuela, etc.
- 4) countries where offshore or holding companies have a privileged status: Luxembourg, Netherlands, Singapore (a topical example is the company Hexipharma that through Cypriot offshore companies, located in a tax haven, managed to evade the payment of taxes).

In practice, there are several factors that influence the decision of establishing in a specific tax haven:

---

<sup>3</sup> Vigi Radu, How Apple use the transfer pricing to pay less tax?- available at (<http://www.wall street.ro/editorial/689/Cum-a-folosit-Apple-preturile-de-transfer-pentru-a-plati-mai-putine-taxe.html>).

- general factors that are related to the safety provided by the legal system, the stability of the political, economic and currency system etc.
- particular factors that are related to tax haven location, its accessibility, the cost of living and residence of individuals and companies;
- specific factors, which may vary depending on the purpose of the user of tax haven.

Regarding tax havens, taking into account the global effects that are not insignificant at all, there have been adopted a series of measures. By Resolution no. 2009/2174 (INI) of 10<sup>th</sup> of February 2010 on promoting good governance in tax matters, the European Parliament condemned the role played by tax havens. Also, there is agreement concluded on 15<sup>th</sup> of June 2009 between the Cayman Islands and the United Kingdom, allowing the exchange of information between the parties, based on a set of rules structured on the international standards of transparency. However, even if a lot of work is done in order to stop this phenomenon of evasion, it is hard to believe that it can all come "clean" as long as U.S.A holds such a tax haven (Delaware state) or while these tax havens can be found in the community space, in countries such as Switzerland, Cyprus and other "extravagant" locations in Europe, such as Monaco, Gibraltar and Lichtenstein.

All tax havens have certain common features, most important being the following ones:

- a) holding well-developed infrastructure and position in some exotic locations, politically neutral;
- b) confidentiality of the operations: the operations of entities are protected by law, but there are situations when one can talk about violations of criminal law, from another national territory and providing the information is established depending on the type of license purchased by the corporation;
- c) low tax rates or zero taxation - here there are countries that do not tax the income, Zero havens type countries (Bermuda, Cayman, Bahamas, etc.) and others with reduced taxation (Switzerland, Ireland, Liechtenstein, etc.);
- d) performing banking system, free of excessive regulations.

Tax havens represent for most taxpayers escapist true oases of "whitening" money from various activities prohibited by law. Currently, multinational companies prefer to enter new markets through offshore companies, wishing to diminish their risks. The term "offshore" refers to jurisdictions that offer many tax advantages to the companies registered in those jurisdictions (UNCTAD - World Investment Report 2001, Promoting Linkages). Thus, the term "offshore financial center" can be defined as representing "the states where most financial transactions are carried out by institutions located on their territory are led for the benefit of customers with residence in other countries" (Bisa 2003). A common feature of the implementation of transfer pricing refers to the difference between the taxation of profits produced in the country of residence of the parent company and other tax rates, existing in the countries where other companies within the group are registered, the earnings being stored where is the lowest level of taxation. When tax havens are combined with transfer pricing, tax benefits increase considerably. From using tax havens these companies benefit not only of tax advantages such as the absence of tax or reduced taxation, but also the non-fiscal advantages, such as considerations relating to prestige, benefits of exchange control or bank privacy.

Legal entities use tax havens to "modify" the economic and financial results and to "embellish" the annual financial statements depending on the types of operations they perform, with the same purpose: avoiding tax burden in the country of residence. As long as the existing taxes on a national market will be perceived as a "confiscation" of the incomes, taxpayers will always seek certain "loopholes" more or less legal, to avoid the tax burden to which they have to pay. Transfer pricing is the correlation element between tax regulations that appear on different national markets, and "a group that uses tax havens can pay high transfer pricing towards its subsidiary located in a country with normal taxation, increasing its profits in tax havens and decreasing them in countries with normal taxation" ( Brémont, Gélédan 1993).

### 3. Conclusions

Through the initiatives set out in this article, countries make great efforts in fighting against tax evasion, but because of the complexity of the transition process and the accelerated pace of globalization, this is extremely complicated. In the current international context, the rising of offshore industry is favored by the investment planning trend, specific to multinational companies, which prefer to act on a new market through offshore companies, with the desire to minimize their risks.

Also, by using tax havens, multinational companies can assure the possibility of implementing an efficient fiscal management, in terms of foreign currency repatriation of dividends, and transfer the control of ownership confidentiality, management and operations. It should be noted that tax revenues recorded in Romania represents about 28% of GDP, this level being one of the lowest in the EU. The local underground economy reaches alarming levels (related to GDP) in the EU - which is between 25-30%. These statistics are quite alarming, and in Romania the numbers should arouse categorical reactions from those who deal with the public interest. The main effect of tax evasion is the impoverishment of the state budget and other budgets. Tax regime in Romania should develop a strategy to reduce the tax evasion phenomenon that affects the entire society, so it will be necessary to create a legal framework responsible for combating tax evasion, using a unique mechanism of control, to eliminate duplication of the same economic transactions. Along with fiscal innovation, it is necessary to create a modern system of risk management, augmentation of tax rates and of the existing taxes.

## References

- Anitei N.C., Lazar R.E, (2016), Tax evasion between equality and crime, Ed.Universal juridic, Bucharest, pp. 37-48  
 Bisa C., (2003), the use of tax havens - between legal tax evasion and tax fraud, Ed. Rosetti, Bucharest, pp. 35  
 Buziernescu R., (2010), Tax of day, Ed. Universitaria, Craiova, pp.120  
 Hayoz N., Hug S., (2007), Tax evasion, trust and state capacities, Ed. Peter Lang, Berna, pp. 129  
 J. Brémont, A. Gélédan, (1993), Dictionnaire économique et social, 5e édition augmentée, Ed. Hautier, Paris, pp. 27  
 Patroi D, Cuciureanu F., Radu V.,(2013)- Prices transfer- border between tax optimization and tax evasion, Ed. C.H Beck, Bucharest, pp.117-141  
 Patroi D, Cuciureanu F., Sasu H., (2009), Practice avoiding registration and payment taxes- to limit fraud and beyond, Ed. C.H. Beck, Bucharest  
 O.E.C.D, (2009), Transfer pricing guide for transnational companies and tax administrations, Irecson Publishing House, Bucharest  
 Saguna Drosu D., Tutungiu M., (1995), Tax evasion, Ed. Oscar Print, Bucharest, pp. 22  
 UNCTAD - World Investment Report 2001, Promoting Linkages

## Sites

- Vigi R., Google investigated in the UK for tax practices interpretable; Available at: <http://www.wall-street.ro/editorial/709/Google-investigated-in-UK-for-tax-practices-interpretable.html> –Accessed at: 15<sup>th</sup> February 2017  
 Vigi R., How Apple use the transfer pricing to pay less tax? Available at: <http://www.wall-street.ro/editorial/689/how-use-the-transfer-pricing-to-pay-less-tax.html> - Accessed at: 15<sup>th</sup> February 2017  
[www.scribtub.com/stiinta/drept/EVAZIUNEA-FISCALA224714311.php](http://www.scribtub.com/stiinta/drept/EVAZIUNEA-FISCALA224714311.php) [www.ipex.eu/IPEXLWEB/dossier/files/download/082dbcc54c2f5559014c31895e5600bd.do](http://www.ipex.eu/IPEXLWEB/dossier/files/download/082dbcc54c2f5559014c31895e5600bd.do)- Accessed on 29<sup>th</sup> of January 20 <http://contabilul.manager.ro/a/12485/valul-nou-de-masuri-anaf-cu-obiective-pana-in-2017.html>- Accessed on 15<sup>th</sup> February 2017  
<http://www.ziare.com/impozit/evaziune/evaziunea-fiscala-loveste-in-robustetea-economiei-1440906> - Accessed on 19<sup>th</sup> of February 2017  
[www.transferpricing.com](http://www.transferpricing.com)- Accessed on 19<sup>th</sup> of February 2017