The background of the cover is a photograph of a large cable-stayed bridge with a tall, white, A-frame pylon. Numerous white cables fan out from the pylon to support the bridge deck. The bridge has yellow railings. In the background, there are green hills and a body of water under a clear blue sky. A bright yellow graphic element, resembling a stylized arrow or a wedge, points from the right side towards the center of the bridge.

# Ernst & Young Transfer Pricing Survey Report

Romania - 2013 edition





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This 2013 edition of the Transfer Pricing Survey Report provides:

- ▶ A unique source of transfer pricing knowledge and insights for the Romanian transfer pricing market;
  - ▶ Companies' practical considerations on the transfer pricing documentation requirements;
  - ▶ Comparison of the current Romanian transfer pricing environment with the one from 2008, when the first transfer pricing survey was conducted on the Romanian market by Ernst & Young Romania;
  - ▶ Probable tendencies and expectations concerning incoming transfer pricing audit experience from Romanian tax authorities' side;
  - ▶ A comparison between transfer pricing in Romania and other countries and how it is likely to develop in the future; and
  - ▶ Overall guidelines for transfer pricing strategy planning.
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Dear reader,

The first conclusion reached on reading this 2013 survey report drawn up by the Ernst & Young Romania Transfer Pricing Team in late 2012 shows that multinational enterprises ('MNEs') operating in Romania understand that transfer pricing is one of the tax aspects of greater importance faced by them over the next period.

This is similar to the findings of Ernst & Young's 2010 Global Transfer Pricing Survey whereby transfer pricing remains a key tax challenge for MNEs. And with good reason. Faced with a slowly recovering global economy and record deficits, governments are increasingly focused on raising revenues through taxation, transfer pricing being at the forefront of tax audit activities.

The 2013 Romanian survey report also shows that even if to date not all the survey participants have gone through focused transfer pricing audits by Romanian tax authorities, the majority of the MNEs operating in Romania expect undergoing such transfer pricing audits in the following period. Considering the increasing number of audits, avoiding disputes will be tougher and the number of litigations on transfer pricing matters will significantly increase. As such, it is of essence for MNEs to consider a more proactive approach to controversy management, including appropriately targeted APAs.

Service, intangibles and financing transactions are increasingly under the spotlight of tax authorities.

Our experience is that documentation of these categories of transactions often lags behind documentation for tangible goods transactions. Thus, MNEs should develop or enhance their documentation for these transactions.

This 2013 update report aims at continuing the work started by Ernst & Young Romania in 2008, by helping MNEs operating in Romania in better understanding and approaching the transfer pricing challenges in this period of downturn in the global economy. Also, since no other public or private institution in Romania has carried out a similar survey, making this report available, we believe that the information herein will aid a better understanding of transfer pricing issues facing enterprises operating in Romania.

Our report constitutes a compilation of respondents' opinions; we, the authors, did not wish to make our interpretations of answers received too profound. Our intention was to present the opinions of a significant number of MNEs, which should enable you to consider the state of your company's knowledge, experience and the action taken against the market situation. We trust that this 2013 edition of the Transfer Pricing Survey in Romania will be of help when you are managing the transfer pricing policy and the related tax risks in this respect.

We cordially thank all the representatives of the 111 companies who filled in the questionnaire for their time and their exhaustive answers.

On behalf of Ernst & Young Romania's transfer pricing team

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# Key insights and recommendations

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## Importance of transfer pricing issues

Ernst & Young's 2013 Romanian Transfer Pricing Survey results show that around 63% of the companies questioned regard at this stage transfer pricing as being a key issue at the highest level - the rise over the next 2 years in both the number and value of related party transactions (anticipated by 52% of respondents), transfer pricing being over the next two years a very important issue (anticipated by almost 60% of the respondents) and the predicted increase in the number of inspections in this area (82% of respondents) mean that more and more companies consider taking steps to get prepared for a possible transfer pricing audit of the Romanian tax authorities.

## Factors shaping transfer pricing policy

The most important factors taken into account when transfer pricing policy is considered are still compliance with regulations (82% of the respondents believe that this is a 'very important' factor) and compilation of documents for tax inspection purposes (50% of those asked indicated this as an 'important' factor). Respondents also pointed to the need to make a market evaluation of the results of each of the transaction parties (54% of respondents indicated this as an 'important' factor).

## Price determination method

The method preferred by the entities questioned when setting prices in transactions with related parties is still the cost plus method. The Organization for Economic Cooperation and Development ('OECD') revisions to Chapters I - III of the Transfer Pricing Guidelines signals a shift from the OECD's historically strong preference for transactional methods towards accepting profit based methods. Thus, despite the rather low use of profit based methods among the respondents, we expect the regulatory shifts to result in a dramatic increase in the use of profit based methods as corroborative, or sometimes primary transfer pricing methods in the following years.

## Transactions open to questioning

In the opinion of 47% of respondents, transactions involving consultancy and management services are the most open to tax authority scrutiny, the next ones being transactions with finished goods (16% of respondents) and intra-group financing and other financial services transactions (15% of respondents).

## Internal transfer pricing reviews

One concern is that many of the survey respondents (41%) did not perform so far an analysis of whether the prices applied in related party transactions comply with the arm's length principle. However, there can be noticed an increase in the number of Romanian MNEs undertaking transfer pricing analyses, since according to our 2008 Romanian Transfer Pricing Survey, 61% of the respondents had not performed an analysis of the transfer prices at that date.

Nevertheless, it appears that those who filled in our questionnaire treat as serious the risks arising from transfer prices applied being questioned by the authorities and take steps to limit them as 73% of the companies which have not performed such an analysis have the intention to perform it in the near future.

Firms are trying to monitor transfer pricing issues and take a more active part in working out transfer pricing policies - 41% of those questioned are taking steps to adjust the existing group transfer pricing policy to suit the Romanian transfer pricing regulations although only 16% have at this stage a transfer pricing policy adapted to Romanian requirements.

The percentage of respondents without a transfer pricing policy for their related party transactions has decreased in the last years (from 43% according to our 2008 Romanian Transfer Pricing Survey to 23% at the end of 2012), this being due to an estimated increase in audit and enforcement targets by the Romanian tax authorities and the increased awareness of the transfer pricing issues from the companies' side.



### **Degree to which companies are prepared for tax inspections**

The vast majority of the respondents to our survey (81%) declared that in case of a tax audit some disputable issues would arise, which the company would normally be able to defend, while 25% believe that many disputable questions are likely to arise and the disputable outcomes are hard to predict.

These figures show that at this stage a significant part of the MNEs operating in Romania are not yet prepared to defend their transfer pricing policy, however, we estimate that this percentage would decrease in the near future as a result of the large number of companies considering to take steps to limit their transfer pricing risks (participating in shaping transfer pricing policy, drawing up documentation in compliance with Romanian transfer pricing requirements, carrying out analyses of compliance of prices applied with market prices and applying for Advance Pricing Agreements - 'APAs').

Of an important concern is that only 3% of the participants to the survey believe that no significant transfer pricing issues would arise in case of an audit from the Romanian authorities.

### **Inspection experience and expectations of future inspections**

Even if almost 13% of the respondents to our survey have experienced a transfer pricing audit to date, as many as 65% of respondents expect to undergo a tax audit as regards transfer prices in the next two years.

### **Advance Pricing Agreements**

A very small percentage (i.e. close to 3%) of the respondents to our 2013 Romanian Transfer Pricing Survey submitted an APA application with the Romanian tax authorities. However, none of the applicants have concluded the APA with the tax authorities to date.

### **Business restructurings**

A relatively high percentage (i.e. 35%) of the respondents to Ernst & Young's 2013 Romanian Transfer Pricing Survey stated that they had experienced a business restructuring in the last 2-3 years. However, only 33% of those incurring such a restructuring per se have documented the restructuring from a transfer pricing perspective. Considering the current need of the companies to achieve a greater efficiency in all areas, we estimate that this percentage will constantly increase over the next years.

# Transfer pricing as an area of interest for the Romanian tax authorities

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Transfer pricing has become an important area of investigation for tax authorities in Romania, owing to an increasing number of tax audits and introduction of specific transfer pricing documentation requirements. Under the Fiscal Code, Romania's tax authorities may adjust for tax purposes incomes or expenses of a domestic company on its transactions with a related party (either Romanian or foreign), in order to reflect the market value of such transactions.

Records of related parties shall not be adjusted when transactions between related parties occur under market terms, as if taking place between independent entities.

Importantly, as per the change of the Fiscal Code in May 2010, the provisions regarding transfer prices apply not only to commercial relations between Romanian and foreign related parties, but also to commercial relations between Romanian related parties.

Romanian tax authorities also take into consideration the OECD Transfer Pricing Guidelines, which promotes the arm's length principle as the basis for determining transfer pricing for tax purposes.

## Romanian transfer pricing documentation requirements

Romanian entities performing transactions with related parties should make available upon request of tax authorities and within a required term, a file comprising the transfer pricing documentation for such transactions.

Even if the documentation requirements were introduced in the Romanian regulations from 2006, the specific content of the transfer pricing documentation file was formally announced on 19 February 2008 (Order 222/2008 on transfer pricing documentation requirements).

These requirements are aimed to align the Romanian transfer pricing regulations with those of countries with more advanced transfer pricing regulations and practices.

Specifically, these documentation requirements make reference to the guidelines on transfer pricing set by the OECD, as well as to the European Union Code of Conduct on transfer pricing documentation.

The transfer pricing documentation file should comprise information regarding the taxpayer, the group and related party transactions (including an analysis of functions performed and risks assumed by the related parties), as well as information on the transfer pricing method(s) used for determining the value of related party transactions and a set of relevant statistical comparables.

The term for the provision of the transfer pricing documentation file is set by the tax authorities depending on the complexity of transactions and it can be for a period of up to 3 months, which may be extended only once for a period equal to the initial one.

Failure to provide the authorities with the transfer pricing documentation file upon request and within the required term is sanctioned with a fine of around EUR 4,000.

Additionally, such failure or presentation of an incomplete file would trigger an estimation of the transfer prices by the tax authorities themselves. Such estimation would be performed by simply using the arithmetic average of prices for any three transactions identified as similar by the authorities. The adjustments would trigger a profits tax liability of 16% and certain late payment interest and penalties.

## Advance Pricing Agreements ('APAs')

Corporate taxpayers may enter into APAs for transactions to be carried out with related parties. An APA may be:

- ▶ unilateral (involving only one tax administration); or
- ▶ bilateral / multilateral (involving two or more tax administrations).

By means of an APA, the National Agency for Fiscal Administration (ANAF) will approve the specific transfer pricing methodology utilised by a MNE prior to the actual transaction. APAs are binding on the tax authorities as long as their terms and conditions are observed by taxpayers.

The term for issuing an APA is 12 months for unilateral agreements and 18 months for bilateral/multilateral APAs. The fees payable to ANAF for issuance/amendment of an APA are:

- ▶ EUR 20,000 / EUR 15,000 - in case of large taxpayers or for agreements on transactions with a consolidated value exceeding the EUR 4 million threshold; and
- ▶ EUR 10,000 / EUR 6,000 - in all other cases.

Taxpayers who have entered into APAs with ANAF are not required to prepare and submit a transfer pricing documentation file for the periods and transactions covered by such agreements. As a general rule, APAs are issued for a period up to 5 years; however this term may be extended in certain cases.

Comprehensive APA procedures and requirements are in effect in Romania from June 2007.



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# Romanian Transfer Pricing Survey – 2013 edition

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Since 1995 Ernst & Young has performed worldwide surveys of multinational enterprises ('MNEs') on international tax matters, with special emphasis on transfer pricing which continues to be the number one international tax issue of interest to them.

Continuing the work started in 2008 when Ernst & Young Romania conducted the first transfer pricing survey on the Romanian market, the 2013 edition of the Ernst & Young Romanian Transfer Pricing Survey re-emphasizes the fact that the taxpayers should be adopting efficient global documentation strategies, devising dispute resolution plans and embedding tax considerations in business change. Given the increasing transfer pricing audit experience whereby the Romanian tax authorities enforce compliance of the transfer pricing documentation requirements, the MNEs in Romania are under increasing pressure to manage transfer pricing risks with greater precision, since new enforcement tactics demand more focus and attention to this matter.

By aim of this second transfer pricing survey to be realised among the MNEs operating in Romania, Ernst & Young Romania also considers evaluating the tendencies, expectations and level of preparedness of taxpayers in Romania with respect to enforcement of the transfer pricing rules. The results of the survey are also addressing a comparison between Romania's and global transfer pricing environment and our comments on future prospects of the Romanian transfer pricing environment, by referring to the results of the transfer pricing studies carried out by Ernst & Young globally, comparing national transfer pricing tendencies with those observed at worldwide level.

This survey was based on a questionnaire addressed to financial directors and tax managers of MNEs operating in Romania. It was drawn up on the basis of answers obtained in late 2012 from 111 surveyed companies, of which the most part were Romanian subsidiaries (69% of the respondents), while 11% were parent entities and 20% were both parents and subsidiaries. Questions were formulated in a way which enabled answers to be analysed in detail and broken down into specific sectors (the sectors covered by this report are discussed below). Structuring the questionnaire in this way made it possible to analyse average data about phenomena and trends occurring among companies operating in all sectors and to analyse the results for specific sectors in the light of the average for the total tested sample.



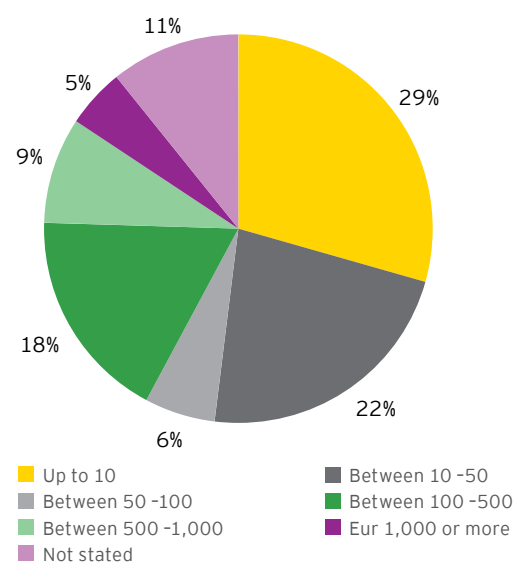


### Test sample structure broken down into industry sectors

Industry sector	Percentage participation in test sample
Consumer Products / Home appliances	5%
Construction and Real Estate	11%
Mining, Oil & Gas	8%
Power and utilities	3%
Banking and Capital Markets	13%
Insurance	3%
Technology and Biotechnology	2%
Telecommunication	3%
Pharmaceuticals	5%
Transportation	3%
Automotive	12%
Professional Services	5%
Media and entertainment	3%
Retail and wholesale	8%
Diversified industrial products	6%
Chemicals	1%
Other	11%

Moreover, a breakdown per consolidated income was considered, so as to establish the trends in the area of transfer pricing for companies of various sizes in terms of business activity.

**Figure 1: Companies' consolidated income (million EUR)**



The results of the survey reflect the intensity and the shifting focus of transfer pricing enquiries. Taxpayers find themselves in the challenging position of documenting and defending their transfer pricing in more and more transactions. Controversy is on the rise as the tax authorities apply more sophisticated and sweeping transfer pricing tools.

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# Importance of transfer pricing aspects in Romania

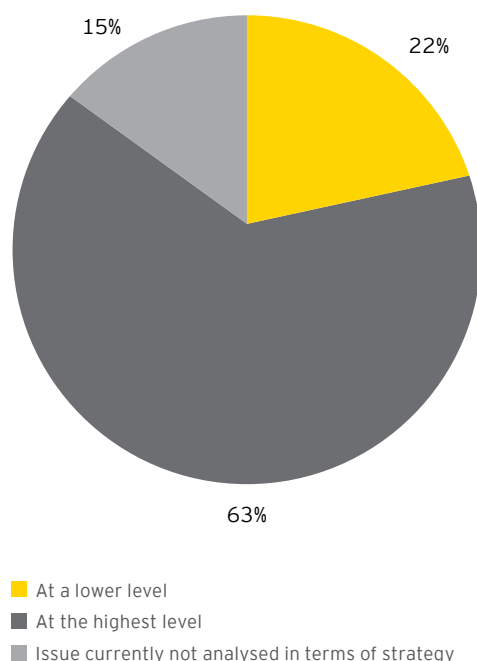
## Scale of the problem – related party transactions in firms surveyed

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The results of the survey set out in detail later on in this report, show that MNEs operating in Romania perceive transfer pricing as representing a key issue at highest level.

The survey also shows that companies expect the number of issues in respect of transfer pricing to grow; they anticipate that there will be more transfer pricing inspections and they consider taking some steps to prepare themselves for inspections. The importance that the Romanian MNEs examined attach to transfer pricing is confirmed by the fact that it is considered as a key issue at the highest level by 63% of respondents (see diagram below). Another rather concerning indication resulting from the survey is that 15% of the respondents have not considered the transfer pricing issue in terms of the strategy of the tax function within the company.

**Figure 2: Level at which transfer pricing issue is considered**



We believe that this high percentage of 63% of companies considering transfer pricing as a key issue, is due not only to the increase in the number and value of related party transactions undertaken in the last years by the MNEs operating in Romania, but also to the increasing enforcement by the Romanian tax authorities of the specific Romanian transfer pricing documentation requirements.

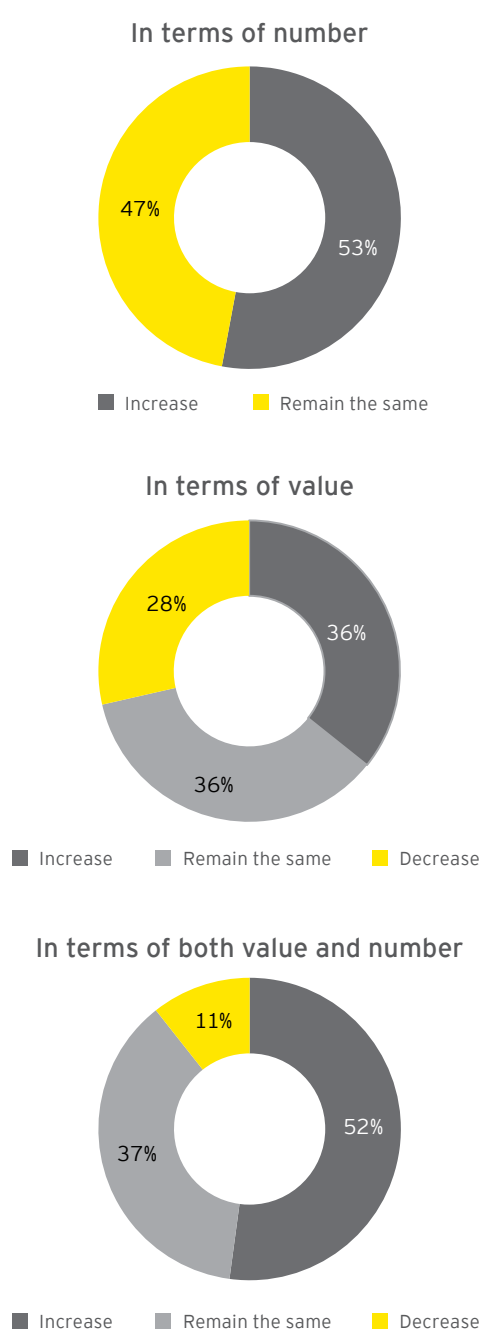
Ernst & Young's 2010 Global Transfer Pricing Survey continues to demonstrate the high degree of importance that tax departments assign to transfer pricing. 30% of tax directors in parent firms worldwide identify transfer pricing as their most important tax issue. Moreover, 32% of the respondents to Ernst & Young's 2010 Global Transfer Pricing Survey consider that transfer pricing will be 'absolutely critical' in the next two years, as compared to 29% in 2007. Since tax authorities typically target industries with high value, portable intellectual property and those that generate high margins, it is not surprising that more respondents to Ernst & Young's 2010 Global Transfer Pricing Survey in the pharmaceutical and technology and biotechnology industry rank transfer pricing as their most important tax issue than in any other industry.



## The number of transactions concluded with related parties is increasing

The results show that 52% of the respondents expect to see an increase in the number and volume of transactions concluded with related parties over the next two years. Moreover, only 37% of the respondents currently think that the numbers and values will not change.

**Figure 3: Trend of related party transactions in Romania, in the next two years**



None of the respondents estimate a drop in number of related party transactions, while 28% estimate a decrease in their value and overall only 11% consider that a decrease in both number and value of related party transactions will occur in the next two years.

An interesting point is that the highest expectations as to the increase in related party transaction numbers and values are found in the consumer products / home appliances industry and pharmaceutical industry (83%, respectively 80% of companies questioned).

This is in line with the trends observed at global level, whereby since pharmaceutical companies typically deploy valuable intangibles in more than one tax jurisdiction, transfer pricing concerns typically loom large.

At the opposite pole, only 25% of companies in the construction and real estate sector, respectively 28% of companies in diversified industrial production estimate an increase in the number and value of related party transactions. Ernst & Young's 2012 Global Transfer Pricing Tax Authority Survey reveals that tax authorities continue to target sectors that typically report high margins and rely on significant intangible assets, such as the pharmaceutical industry, or that rely on significant international content in their production, such as the automotive industry. Consumer products are also an area of emphasis, perhaps because of the industry's economic importance and the thorny issues and differing views on so-called 'marketing intangibles'.

Despite the prevalence of international flows in the industry and the relative ease of transferring financial profits across borders, tax authorities have applied a relatively light touch to financial services. This may be understandable during the recent financial turmoil, which has resulted in substantial accumulated tax losses, but greater scrutiny is only a matter of time.

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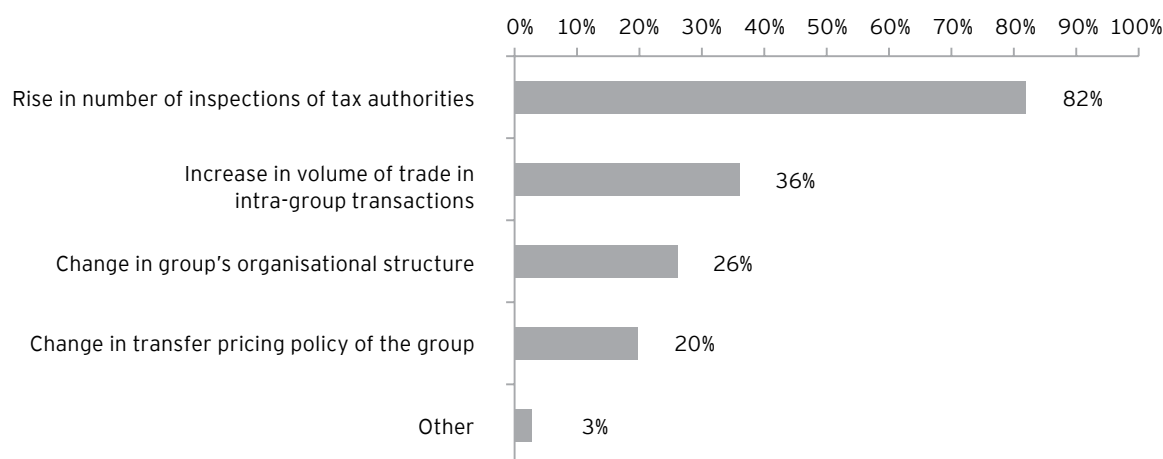
## Enterprises' concerns of a rise in transfer pricing related issues

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According to the results of the survey, 36% of respondents believe that the expected increase in the volume of trade in related party transactions could lead to more issues for their companies related to transfer pricing. In our view, such increase in the volume of related party transactions automatically increases the level of risk arising from the potential questioning of transfer prices by the tax authorities.

**Most of the companies foresee transfer pricing related issues due to the rise in the number of inspections of tax authorities (82% of respondents).**

**Figure 4: Reasons for taxpayers' concerns of increase in transfer pricing related issues**



The above mentioned higher than average expectations of companies in the consumer products / home appliances industry of an increase in the number and value of related party transactions correlate with the percentage of companies in this sector forecasting a rise in the number of inspections of tax authorities (83%). Taxpayers' concerns are centered on the rise in the number of inspections of tax authorities, 82% of the respondents believe that the main reason for the rise of transfer pricing issues is the increase in the inspections of the Romanian tax authorities, while the next reasons in this respect are the increase in the volume of

trade in intra-group transactions (perceived as such by almost 36% of respondents) and changes in their organisational structure (26% of respondents).

Furthermore, about 54% of the respondents to our survey consider that the parent's finance / tax department is responsible for transfer pricing within the organization. Consistent with their broader risk approach, at global level, respondents cite tax audit activities as the most influential factor in determining their transfer pricing compliance. This finding seems to suggest some degree of recognition by respondents

of increased tax audit activity. 50% of the respondents from the professional services and technology and biotechnology sector mentioned that they do not have a transfer pricing documentation for the related party transactions undertaken. The Romanian MNEs display a reactive approach towards preparing a transfer pricing documentation, since around 35% of the respondents cite audit defense (tax audit demanding such documentation) as their primary motivation in preparing the transfer pricing documentation, while the percentage of respondents citing the mitigation of transfer pricing controversy risk as their primary motivation for preparing documentation is of 33%.



This is consistent with the trend noticed at global level by Ernst & Young's 2010 Global Transfer Pricing Survey, in which 36% and respectively 20% of the respondents identified risk mitigation and audit defense as their key triggers for preparing the transfer pricing documentation. More issues are anticipated in the technology and biotechnology, pharmaceutical, insurance and banking and capital markets sectors. The concerns of the companies from these industries go hand in hand with assessments of the degree to which Romanian MNEs have performed an analysis of prices in related party transactions and are prepared for potential inspections or action to justify the level of prices applied. Specifically, 67% of the companies operating in insurance and 60% of those from pharmaceutical sectors and most of the respondents from the technology and biotechnology sector have not analysed at this stage whether the prices applied for related party transactions are in compliance with arm's length standard.

Additionally, concerns about future issues could arise from changes in the organisational structure in groups (44% of companies surveyed from the mining & oil sector anticipate such issues in comparison to the 26% average) and from changes in transfer pricing policies of the group (33% of telecommunication companies and 50% of professional services companies surveyed anticipate such issues in comparison to the 20% average). According to Ernst & Young's 2012 Global Transfer Pricing Tax Authority Survey, tax authorities target high-margin industries and transactions with major trading partners, rather than tax havens specifically.

Given that many of the respondents (41%) have not performed to date an analysis of the prices applied in related party transactions, it is expected that the audits to be undertaken by the tax authorities may lead to significant transfer pricing adjustments and related penalties. However, it is encouraging that out of the companies which have not performed such an analysis, 73% of them consider undertaking such a transfer pricing analysis in the near future. Despite the potential effect of the economic downturn on resources, the number of respondents that do not prepare transfer pricing documentation remains low at 3%, according to the results of the Global Transfer Pricing Survey conducted in 2010 by Ernst & Young.

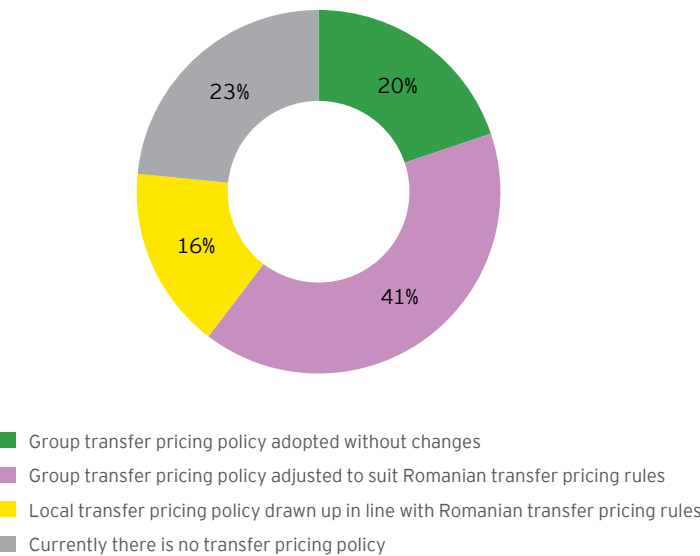


# Adapting transfer pricing policy and documentation to Romanian requirements

The survey results show that only 16% of the respondents seem to have a local transfer pricing policy drawn up in line with Romanian transfer pricing rules, while 20% of respondents have a group transfer pricing policy adopted without any changes or adaptations to suit local transfer pricing requirements. A considerably higher than average result is in the telecommunication sector where according to the surveyed MNEs, 67% of respondents mentioned that they adopted the group transfer pricing policy without any changes to Romanian requirements.

However, though the percentage decreased from 43% in 2008, one concerning aspect is that 23% of the respondents do not have available at this stage a transfer pricing policy for their related party transactions.

**Figure 5: Implementation of the group transfer pricing policy at the level of the Company**



41% of the questioned MNEs (as compared to 29% in 2008) are taking steps to adjust the existing group transfer pricing policy to suit the Romanian transfer pricing regulations. We estimate that in the near future the number of companies shaping their transfer pricing policy in accordance with Romanian transfer pricing rules would continue to increase as the companies would want to address the transfer pricing related risks if, in their view, the existing transfer pricing policy does not fully correspond to Romanian market reality or does not comply with local tax authority regulations and documentation requirements. Also, this tendency would be accelerated by the increase in number of transfer pricing audits from the tax authorities and increased awareness of the issue on the part of persons responsible for finance and tax affairs in MNEs.

On the transfer pricing documentation side, out of the respondents to the survey, 50% have mentioned that the documentation is focused on the specific Romanian transfer pricing requirements, while 26% have a transfer pricing documentation at group's level but it was not adapted to Romanian specifics.

## Appreciation of existing transfer pricing documentation

Company's appreciation of transfer pricing documentation for substantiation of related party transactions	Percentage
The transfer pricing documentation is focused on the specific Romanian transfer pricing requirements	50%
There is a transfer pricing documentation at group's level but was not adapted to Romanian requirements	26%
There is no transfer pricing documentation for the Romanian entity	24%

An area of concern is that many respondents (24%) do not have any transfer pricing documentation focused on the related party transactions undertaken by the Romanian entity. Hence, in our view the number of transfer pricing issues that could be faced by these companies without any transfer pricing documentation or without Romanian specific documentation may be significant.

## Factors shaping transfer pricing policy

**Survey results confirmed that one of the key factors considered by taxpayers when shaping transfer pricing policy is compliance with tax regulations.**

This was indicated as a 'very important' factor by 82% of respondents. Also, compiling of documentation for tax inspection purposes is regarded by 50% of companies examined as an 'important factor'. Market evaluation of the results achieved by each of the transaction parties was also given as a factor to be considered when drawing up transfer pricing policy (54% of respondents indicated this as an 'important factor').

### Factors influencing transfer pricing policy and their importance

Factors influencing transfer pricing policy	Very important	Important	Unimportant
Compliance with tax regulations	82%	18%	0%
Optimisation of tax burden	45%	49%	6%
Market evaluation of results achieved by transaction parties	23%	54%	23%
Maximising company operating results	33%	48%	19%
Compiling documents for tax audit purposes	42%	50%	8%

The answers above show that transfer pricing may be seen by Romanian MNEs as a question of observing tax regulations and documentation requirements, but also as a matter of optimizing their tax burden (45% of respondents indicated optimisation of tax burden as a 'very important factor', whereas 49% of them indicate this factor as being an important one). The tax burden optimization is especially important at the level of MNEs in this period of economic downturn, where companies need to achieve greater efficiency in all areas – business and tax alike. This increased awareness of the need to adjust policy in line with Romanian tax regulations and documentation requirements goes hand in hand with the rise expected by the companies questioned in both the number of tax inspections carried out and of the issues connected with transfer pricing matters.

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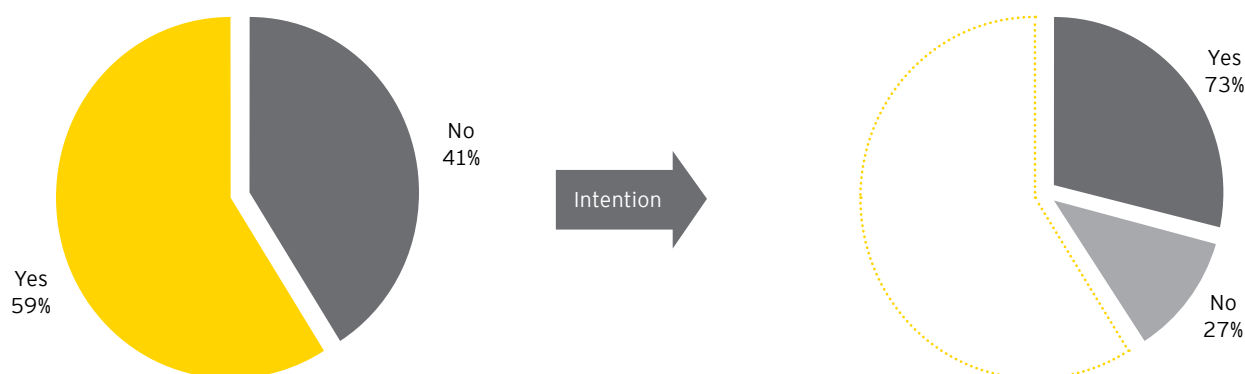
## Preparing a company for a transfer pricing inspection

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The survey indicates that many of the respondents have not performed to date an analysis of whether prices of related party transactions are in compliance with market prices (41% of the respondents).

73% of firms asked which have not carried out an analysis of whether the prices they apply are in compliance with market prices intend to perform such an analysis in the near future.

**Figure 6: Percentage of companies that analyse / intend to analyse whether prices of related party transactions are in compliance with market prices**



We believe that the high percentage of companies intending to perform such an analysis is also due to the fact that 65% of respondents expect a transfer pricing audit in the next two years and almost 25% of those expecting such an audit anticipate that many questions are likely to arise upon a tax audit with disputable outcomes which are hard to predict.

Within the analysis of prices in related party transactions, most respondents (64%) rely on pan-regional comparables. This trend is also noted at global level, since most respondents to the 2010 Global Transfer Pricing Survey undertaken by Ernst & Young state that they use regional comparables in their analyses.

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# Methods for setting the transfer prices

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In managing transfer pricing risk, it is helpful to have a general sense of the transfer pricing methods commonly applied by other taxpayers for the various types of transactions.

## Choosing a method – without experiments

The Romanian transfer pricing regulations specifically provide that the transfer pricing methods provided by the OECD Transfer Pricing Guidelines are accepted by the Romanian tax authorities. These methods include the so-called traditional methods: the comparable uncontrolled price method (CUP), the cost plus method (C+) and the resale price method (RPM); and also transactional profit methods: the profit split method (PSM) and the transactional net margin method (TNMM).

More specifically, when possible to apply, CUP is the preferred traditional method for assessing the market value of related party transactions.

The results of the survey reveal little willingness to use theoretically more complicated methods, e.g. transactional profit methods and relatively high readiness to use methods other than those mentioned in tax provisions. Despite the increased importance of profit based methods further to OECD's revisions of Chapter I through III of the Transfer Pricing Guidelines, we still observe a minority of respondents using the profit based methods.

Considering the global shift from the OECD's historical preference for transactional methods toward accepting profit – based methods, survey readers should begin to consider the importance of profit based methods in their transfer pricing planning and documentation. Moreover, the tax authorities are now armed with increasingly sophisticated and broad transfer pricing tools and, as such, the risk of adverse assessment by using less common methods does not seem even theoretically possible anymore. Nevertheless, as per the Romanian transfer pricing regulations, a thorough explanation should be provided when the traditional methods are not used in the analysis of transfer prices.

It is also worth noting that, according to the Romanian transfer pricing rules, in order to assess the market value of related party transactions for a company, the transfer pricing method used by the respective company would also have to be used by the tax authorities, except for the case when the application of a certain method would not reflect the market value for the goods or services involved in the related party transaction. Thus, when the two sides – the tax authorities and the company – apply the same method, it increases chances of a favourable outcome of the inspection and should help the taxpayer to easier justify the prices it applies.

The use of other methods is most frequently applied in transactions involving research and development (20% of respondents), next in line are transactions involving intangibles (18% of all alternative methods applied) and raw materials (16%).



## Methods for setting transfer prices by respondents

Methods for setting transfer prices	CUP	RPM	C+	PSM	TNMM	Other
Finished goods	13%	17%	41%	0%	17%	13%
Raw materials	12%	16%	39%	0%	16%	16%
Distribution of goods	8%	21%	38%	0%	19%	15%
Intangibles	14%	10%	42%	6%	10%	18%
Research and development	8%	2%	53%	8%	8%	20%
Intra-group financing and other financial services	40%	3%	28%	9%	8%	12%
Consultancy and management services	14%	1%	51%	9%	14%	11%
Other types of services (e.g. IT, legal and tax services)	11%	1%	60%	4%	12%	12%

## Cost plus – most frequently applied method

The method most often applied by companies is by far the cost plus method. Survey results show that the percentage of companies that set prices on the basis of this method fluctuates, depending on the transaction type, between 28% for intra-group financing and other financial services to 60% for general services transactions (e.g. IT, legal and tax services). Not surprisingly, the cost plus method is the most commonly used method to benchmark intercompany services.

When appraising the methods most often used and clearly appropriate for certain types of transactions, it should be noted that, in order to choose the best transfer pricing method for a given transaction, a detailed analysis is needed. It could turn out that the best method in theory cannot for various reasons be used in a specific case. For example, a high percentage of companies (39% of respondents) apply the cost plus method for raw

materials transactions, while the fact that the comparable uncontrolled price method, which is theoretically a more appropriate method for transactions of this type, is applied relatively rarely (12% of respondents) could be due to difficulties in gaining access to information on comparable transactions between unrelated parties (this being the usual obstacle to applying this method).

This wide use of a method not theoretically appropriate for a given transaction type can be due not only to the wrong choice of method but also to market conditions and access to comparable data.

Similar popularity of the cost plus method was observed in the results of Ernst & Young's 2010 Global Transfer Pricing Survey - 30% of firms questioned have applied the cost plus method for transactions involving tangible goods and 52% of the respondents used cost plus method for establishing service transaction pricing.

# Tax audits and Advance Pricing Agreements

## Transactions most open to questioning in respondents' opinion

Based on their audit experiences, MNEs have developed reliable perceptions regarding the audit vulnerability of the various types of intercompany transactions.

### Related party transactions most open to questioning in respondents' opinion

Transactions especially open to questioning in the respondents' opinion	Percentage
Finished goods	16%
Raw materials	2%
Distribution of goods	4%
Intangibles	5%
Research and development	2%
Intra-group financing and other financial services	15%
Consultancy and management services	47%
Other types of services (e.g. IT, legal and tax services)	9%

Consultancy and management transactions are regarded by 47% of the companies surveyed as the most likely to be questioned by the tax authorities.

### Inspections confirm companies' concerns about transactions open to questioning.

Consistent with the results of the 2012 Global Transfer Pricing Tax Authority Survey, there can be noticed a considerable reduction in the number of respondents to the 2013 Transfer Pricing Survey conducted by Ernst & Young Romania that believe that intra-group financing and other financial services are open to questioning, from 59% in 2008 to 15% of the respondents to the Romanian survey. Additionally, transactions with finished goods are in the view of 16% of respondents susceptible of being scrutinised by the authorities.

## Inspection experience to date

Over the last years, transfer pricing has become a dynamic area in Romania, due to the increasing expertise of the Romanian tax authorities in this field. Moreover, the recession and regulatory uncertainty have determined more intrusive transfer pricing examinations, with requests for all categories of sources and documents.

### Transfer pricing issues usually come up during general tax inspections and also during VAT reimbursement inspections.

Even if according to the polled respondents, only 13% of them have experienced to date a tax audit with transfer prices related inquiries from the Romanian tax authorities, 65% of the survey respondents believe that such an audit is likely in the next two years.

57% of the respondents which underwent a tax audit with transfer pricing related inquiries stated that an in-depth scrutiny of related party transactions was performed by tax authorities. Moreover, close to 50% of the respondents consider that they have managed to provide a transfer pricing documentation that was satisfactory for the Romanian tax authorities. The absence of transfer pricing documentation resulted in a suspension of the tax audit for 21% of the respondents that have experienced a transfer pricing related audit.

In respect of the analysis of the transfer pricing documentation, 45% of the respondents stated that the Romanian tax authorities reviewed their transfer pricing file within 1-3 months, while for only 36% of the respondents the tax authorities' analysis of the transfer pricing documentation lasted for more than 3 months.

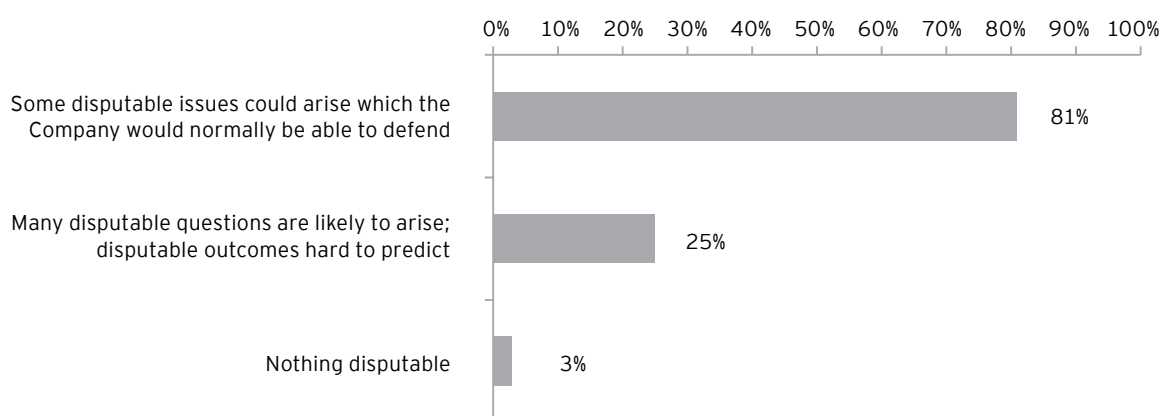
On a global level it was noted that an increasing number of respondents are experiencing the pains of transfer pricing audits. As such, 68% of parent respondents indicate their transfer pricing policy had been examined by tax authorities. Nevertheless, according to Ernst & Young's 2010 Global Transfer Pricing Survey, the range of countries in which audits occur is shifting, with mature transfer pricing jurisdictions apparently scaling back and emerging jurisdictions scaling up dramatically. The increasing pressure on governments to raise revenues and the dedication of additional transfer pricing enforcement resources are likely to lead to reinvigorated scrutiny in all markets. As such, tax authorities continue to increase their transfer pricing staffing. Considering these aspects, taxpayers should not be complacent about their transfer pricing risk.



## Companies' concerns about inspection outcome

81% of the respondents who expect to be subject to a tax audit with transfer pricing related inquiries over the next two years estimate that in case of an audit some disputable issues could arise which the company would normally be able to defend. Moreover, 25% of the respondents expecting a tax audit in the near future believe that many disputable questions are likely to arise in a transfer pricing audit and the disputable outcomes are hard to predict, indicating that a significant part of the Romanian MNEs are not yet prepared to defend their transfer pricing policy via appropriate transfer pricing documentation.

**Figure 7: How do companies assess their preparation for a transfer pricing inspection**



90% of the Romanian MNEs operating in the automotive industry, 78% of the companies operating in the banking and capital market industry and 71% of the companies operating in the mining, oil and gas industry believe that some disputable issues would arise in case of a transfer pricing audit by the Romanian tax authorities. Moreover, a vast majority of the respondents in the pharmaceutical and technology and biotechnology industry, expecting to undergo a transfer pricing audit in the next two years, consider that many disputable questions are likely to arise within the respective audits, with disputable outcomes which are hard to predict.

We expect in the near future a rise in the number of inspections regarding transactions involving intangibles, demonstrating that the tax authorities are increasingly better prepared to analyse the related transfer pricing issues.

Globally, in line with the increased scrutiny of the commercial basis for intercompany pricing policies, tax authority requests for access to company operational personnel increased significantly. Moreover, tax authorities have expanded their analyses beyond a single party to examine effects on the profit of the counterparty, requests for foreign affiliate financial records and management accounts have increased. Intercompany agreements stood out as an almost universal request in transfer pricing audits.





## What are the chances of a penalty?

Despite being well prepared, in the respondents' view, for a transfer pricing inspection, the majority of the respondents anticipated that they would have transfer pricing issues further to such tax audit, mainly in view of the expected increase in the number of inspections and the increase in the value and number of related party transactions. In our view, the general increase in the level of companies' preparation for transfer pricing inspections would also correspond to the growth in the knowledge and experience of the Romanian tax authorities in this area. During the tax audits incurred by the respondents to our survey, 31% of them are of the opinion that the tax authorities had a high level of sophistication on transfer pricing matters, while 23% of the respondents estimated that the experience of the Romanian tax authorities in their transfer pricing issues was rather low.

The degree to which companies are prepared and the quality of their preparation is increasingly put to the test by the tax authorities.

At present, as regards the outcome of this challenge from the Romanian tax authorities, in our view, normally no adverse transfer pricing issues should arise at level of the MNEs as long as these have an appropriate and updated transfer pricing documentation for their related party transactions.

Moreover, 14% of our respondents that incurred a tax audit with transfer pricing related issues mentioned that the tax audit resulted in certain transfer pricing adjustments. The level of transfer pricing adjustments varied significantly across respondents, with MNEs incurring transfer pricing adjustments that in some cases were even significantly over EUR 1 mil.

When such transfer pricing adjustments were performed, 80% of the respondents mentioned that they have contested them with the relevant tax authorities. Moreover, 75% of the respondents decided to go to court with their case, since the decision of the appeal proved to be unfavourable to them.

The results of Ernst & Young's 2010 Global Transfer Pricing Survey indicate a substantial increase since 2005 in the percentage of adjustments resulting in penalties.

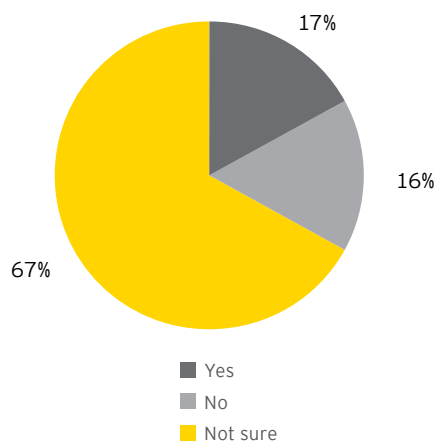
According to the survey results, there is now a 1 in 5 chances of suffering a material penalty compared with 1 in 25 chances in 2005. Two of the most commonly cited reasons for suffering audit adjustments were insufficient local tailoring of facts and insufficient local benchmarking of prices or margins. The increasing imposition of penalties is a function of increasing tax authority resources, as well as the tax authorities' obvious need to raise more revenues. As such, similar to global level, it is expected that the trend toward increased penalties will continue also in Romania.

## Advance Pricing Agreements

It is worth mentioning that countries worldwide have increased their investment in the APA process in recent years. The main APA jurisdictions remain those with well-developed transfer pricing regimes, such as the United States, the United Kingdom, the Netherlands, Australia and Japan. On a global level, despite the increasing number of taxpayers applying for APAs, the time taken from submission to approval has decreased significantly in the last years.

Despite the increase in APA use at a global level, only 3% of the respondents to our survey have applied to date for an APA with the Romanian tax authorities, although, 17% of the survey participants believe that an APA would represent a controversy management tool. However, none of these applications submitted by the participants to our survey resulted in an approval from the Romanian tax authorities until the date of conducting the survey.

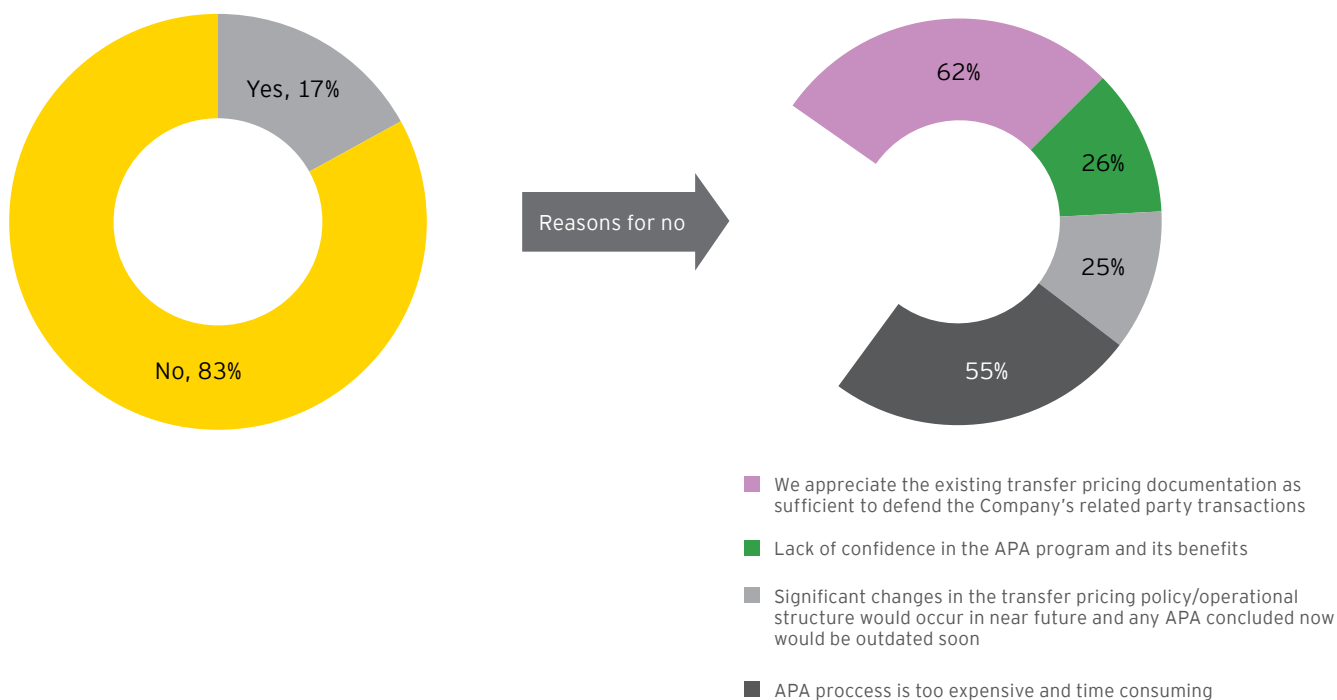
**Figure 8: Perception of APAs as a controversy management tool**





Still, many of the respondents (83%) remain unconvinced or unaware of the benefits of APAs, with only 17% of respondents saying they would consider applying for an APA with the Romanian tax authorities over the next two years.

**Figure 9: Application for APAs**



55% of the respondents which do not intend to apply for an APA believe that APA process is too expensive and time consuming while 26% of these respondents have lack of confidence in the APA program and its benefits. An interesting aspect is that 25% of the respondents believe that significant changes in their transfer pricing policy / operational structure would occur in the near future and any APA concluded now would be outdated soon.

At a global level, 79% of parents report that they are generally satisfied with the APA process. However, many remain unconvinced or unaware of the benefits of APAs: fewer than half (47%) of parent respondents not already using APAs say they would consider using

them in the future. Moreover, although only 23% of parent respondents indicate using APAs as a controversy management tool, the level of satisfaction with the APA process among users is high. 90% indicate that they would seek an APA in the future.

Contrary to the results of Ernst & Young's 2010 Global Transfer Pricing Survey and even though in Romania APA regulations have been introduced from 2007, at this stage it appears that the vast majority of MNEs participating to our 2013 Romanian Transfer Pricing Survey are not aware of APA benefits or lack confidence in these benefits.

# Transfer Pricing and Tax Effective Supply Chain Management Services (TESCM)

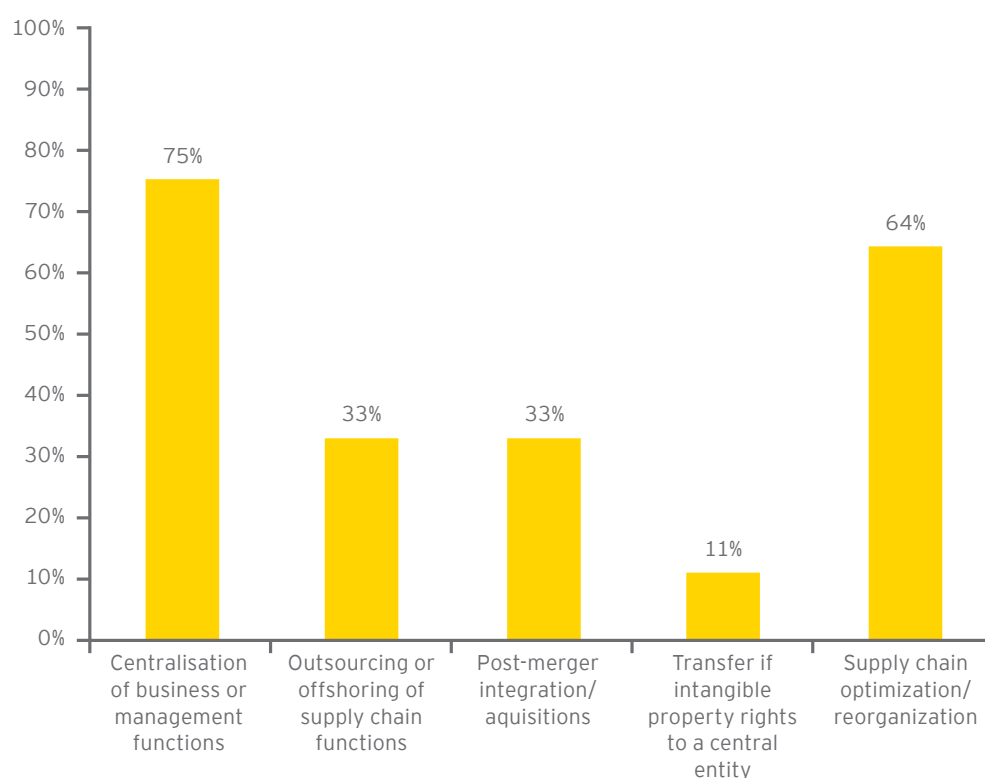
At a time when companies need to achieve greater efficiency in all areas, the tax effects of business restructurings are receiving increased scrutiny from the MNEs and the tax authorities. Cost reduction is the most common category of business change, a focus which is unsurprising in the context of the current economic downturn.

Moreover, with the increasing relative growth opportunities provided by emerging markets, companies are shifting focus to these markets, such shifts providing opportunities and motivation for supply chain reengineering.

Chief financial officers and tax directors of MNEs operate in an environment of intense scrutiny and challenge. Transactions, inter-company pricing, supply chains, structuring and funding are increasingly under the spotlight. More than ever, transfer pricing and tax effective supply chain management that supports the business strategy can help maintain competitive advantage and give value to shareholders.

35% of the respondents to our 2013 Romanian Transfer Pricing Survey experienced a business restructuring affecting the operations of the respective MNE within the last 2-3 years. The most common business restructurings were related to the centralization of business or management functions (75%) and to the supply chain optimization / reorganization (64%).

**Figure 10: Category of business restructuring implemented by Romanian MNEs for the last years**





Of the MNEs undergoing such business restructuring operations, 33% documented the restructuring per-se from a transfer pricing perspective, with only 1 of our respondents being actually challenged by the Romanian tax authorities in respect of the restructuring process.

On a global level, in spite of greater complexity and added documentation requirements, companies are still pursuing a wide array of business restructuring, streamlining and supply chain reconfiguration due to business necessity. Given the significant role intangibles play in today's businesses, restructurings focused on intangibles, including contract research and development are particularly prevalent. Less popular are centralized procurement and global or regional principal structures. Limited-risk manufacturing structures are the least common forms of restructuring.

Moreover, Ernst & Young's 2010 Global Transfer Pricing Survey reveals that a significant portion of business restructurings involve intangibles. Given government's focus on intangibles - both incentives to retain or attract to their jurisdictions - we can expect continued examination, controversy and litigation activity in this area.

The survey also shows that respondents are generally aware of the need to consider tax implications in the planning and implementation of business restructuring projects.

The table below summarizes the consideration of tax implications in business change for parent companies, at global level.

Consideration of tax implications in business change (parents)	Yes	No	Don't know/ not stated
Post merger integration	91%	7%	2%
Outsourcing or off-shoring of supply chain functions	81%	17%	2%
Entry into new market / new product lines	79%	19%	2%
Centralization of business or management functions	77%	22%	1%
Supply chain optimization	75%	23%	2%
IT systems implementation / improvement	66%	32%	2%
Cost reduction	62%	37%	1%
Other forms of business change	62%	23%	15%

As noted above, awareness of the need to consider tax implications is foremost in post-merger integration (91%) and outsourcing / off-shoring (81%) projects.

Despite the OECD paper on restructuring, Ernst & Young's 2012 Global Transfer Pricing Tax Authority Survey reveals that only few tax authorities ranked restructurings as a top target for review. This relative inattention is probably the result of a lag between audit practice and regulatory standards. Therefore, taxpayers should remain alert should audit practice catch up with regulatory pronouncements.



## Conclusion and recommendations

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Ernst & Young Global Transfer Pricing Group expects the next few years to be dynamic and exciting as MNEs exercise greater rigor to meet increasingly onerous requirements. MNEs must take a more proactive approach to transfer pricing, since, in their quest for more revenues, tax authorities have become better at auditing, with higher hit rates for adjustments and higher levels of penalties.

We anticipate more movement across transfer pricing areas - preparing documentation to meet compliance requirements and mitigate penalties; managing audits, resolving disputes and eliminating double taxation and harnessing business change in a tax efficient manner.

MNEs must take a proactive approach to transfer pricing. The risk of challenge by the authorities continues to increase. In their quest for more revenue, tax authorities have become better at auditing, with higher hit rates for adjustments and higher level of penalties.

Moreover, MNEs should pursue a more proactive and extensive use of APAs where there is reliable availability. MNEs will see more instances of potential double taxation. Instead of waiting to react to controversy, MNEs will need to plan for it by learning how to handle domestic appeals, competent authority proceedings, alternative dispute resolution mechanisms and APAs. Although more than a third of the respondents to Ernst & Young's 2010 Global Transfer Pricing Survey prefer the Mutual Agreement Procedure for dispute resolution, we anticipate more litigation where it is not an option.

Our multidisciplinary TЕСSM teams work with you on supply chain design, business restructuring, systems implications, transfer pricing, direct and indirect tax, customs and accounting. We can help you build and implement the structure that makes sense for your business, improve your processes and manage the cost of trade.

Our transfer pricing professionals are ready to help you review, document, manage and defend your transfer pricing policies and processes - aligning them with your business strategy. Whether you are changing business structures or models, managing the impact of major transactions or negotiating with the tax authorities, we bring you a global perspective based on our long-standing experience of what really works.

Our talented people have backgrounds in tax law, tax authorities and business economics. We deploy those skills to build the proactive, pragmatic and integrated strategies that address the tax risk of today's businesses and help your business achieve its potential. It's how Ernst & Young makes a difference.

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