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DIPLOMOVÁ PRÁCE

Transfer Pricing and the Arm's Length Principle

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Prohlášení

Prohlašuji, že jsem diplomovou práci vypracovala samostatně a použila pouze uvedené prameny a literaturu

V Praze dne Hana Hájková

Poděkování

Děkuji vedoucí diplomové práce Ing. Ireně Kemény nejen za cenné odborné rady, ale i za vstřícnost a individuální přístup.

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ABSTRAKT

Diplomová práce se věnuje problematice převodových cen, přičemž jsou zde definovány pojmy převodních cen a principu tržního odstupu jako takové, dále jsou zde prezentovány relevantní pasáže českého a slovenského daňového zákona a v neposlední řadě práce popisuje různé metody stanovení převodních cen a jejich aplikaci v praxi.

Práce je rozčleněna do 7 částí, přičemž části 1 - 5 se věnují teoretickému popisu výše uvedených témat. Část 6 komentuje aktuální situaci a vývoj v oblasti převodních cen ve světě a konečně část 7 demonstruje na příkladu praktické využití analýzy převodních cen se všemi relevantními aspekty. Cílem analýzy bylo prezentovat možné způsoby určení vhodné metody stanovení převodních cen a hodnocení finančních údajů při užití zvolené metody.

Předložená případová studie je založena na analýze skupiny tří společností a orientuje se na dva odlišné typy transakcí. Studie prezentuje užití různých metod stanovení převodních cen a komentuje správnost stanovení podmínek transakcí.

ABSTRACT

The Diploma Thesis is devoted to the Transfer pricing problematic, whereby the Transfer Pricing and the Arm's length principle as such are defined, further the Czech and Slovak transfer pricing law is presented and the different transfer pricing together with their possible usage are described.

The work is divided into 7 sections, section 1 – 5 is basically a theoretical description of the topics stated above. Section 6 comments the actual situation and development in the transfer pricing area around the world and finally section 7 demonstrates on an example the practical transfer pricing analysis with all its relevant aspects. The aim of the analysis was to present the possible ways of determining the appropriate transfer pricing method and the evaluation of the financial data when applying the selected method.

The presented case study was based on an analysis of a group of 3 companies and was in general oriented on two different kinds of transactions. The application of various transfer pricing methods was demonstrated and the correctness of the transaction conditions was commented.

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INTRODUCTION

Transfer pricing is worldwide a rapidly developing tax area as far as the taxpayers' and the tax administrators' side are concerned. The transfer pricing legislation has been modernized continuously in many countries, which resulted in the obligation of preparing and retaining specific documentation bz the companies ensuring each country that the arm's length principle has been followed and thus each country gets a fair of the companies' profit in form of a collected tax. Furthermore, the tax authorities have developed specialist transfer pricing groups to conduct detailed and complex transfer pricing investigations. As a result, multinational enterprises devote their resources on developing and maintaning a global transfer policy. The basic characteristics of such global transfer policy should be its consistency across the group in which the policy is applied and the acceptance of the levels of earnings regarding to the relevant jurisdictions.

Transfer pricing as such is a term that should describe all factors and aspects of intercompany pricing arrangements between associated enterprises including the transfer of tangible and intangible assets among the groups. These transfers could be for example transfer of final goods or services, payment of royalties, payment for sharing the licenses etc.

This Diploma thesis is divided into 7 sections, whereby sections 1 – 5 provide a theoretical description of the transfer pricing policy and related issues. Section 6 comments the actual situation and development in the transfer pricing area around the world and finally section 7 demonstrates by using an example the practical transfer pricing analysis with all its relevant aspects. The presented case study was based on an analysis of a group of 3 companies and was in general oriented on two different kinds of transactions. The application of various transfer pricing methods was demonstrated and the correctness of the transaction conditions was commented.

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1 INTRODUCTION TO TRANSFER PRICING

Transfer pricing remains the most significant tax issue facing international business today and in the foreseeable future. It is clear that transfer pricing has the full attention of the tax authorities as the related party trade continues to play an increasing role in international commerce. Among the most observed areas regarding the transfer pricing policies we can find the sales of tangible goods, services, intangibles, intercompany financing and technology cost sharing agreements.

As already sad, transfer of goods, intangible assets and services among multinational enterprises (further "MNE") that allocate their trading and production and other various activities into different countries represent an important issue in the today's worldwide business. As there was an intention to unify and make the valuation of these transaction more simple, an OECD Report named Transfer pricing Guidelines for Multinational enterprises and Tax Administrations (further "OECD Guidelines") was produced by the OECD Fiscal Issues Committee. The principles and procedures described in the OECD Guidelines are applied internationally and in the accordance with the international Double Taxation Treaties signed by the countries and the valid law. The main reason for issuing the OECD Guidelines was to support a unified approach to the taxation of controlled transaction within MNE's on the side of the tax payers as well as on the side of the tax administrators. The OECD Guidelines explain the application of basic principles in the tax administration rather than describing the whole transfer pricing issue in extreme detail.

As a transfer process in the simplest way we consider the prices used in the transactions undertaken between two or more associated enterprises in economic or personnel way. These prices should be determined at the same level as if applied on transaction between independent enterprises, which are in general based on arm`s length principle.

The enterprises are seen as associated, where:

- an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

- the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

"When conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."[1]

When independent enterprises deal with each other, it is the market and the market forces, what determines the conditions of their commercial and financial relations as for example the price of transferred goods or provided services and the conditions of the transfer and provision. However, when associated enterprises deal with each other, then, even though they try to copy the dynamics of the market forces, their commercial and financial relations may not be directly affected by them in the same way as by the independent enterprises. In the absence of market forces or when adopting a commercial strategy, it could be extremely difficult to determine the market price accurately or to adjust the price to approximate the arm's length dealings. This need arises irrespective of any contractual obligation to pay a particular price or of any intention of the parties to minimize the tax burden.

OECD member countries have agreed that for the tax purposes the profits of associated enterprises may be adjusted if necessary to correct any distortions in the tax liabilities. This procedure should satisfy the arm's length principle. The comparison financial and commercial relations that are expected to be found

[1] Paragraph 1, Article 9, OECD Model Tax Convention

between independent enterprises in similar transactions under similar circumstances could be used to achieve appropriate conditions between associated parties.

Not only the tax consideration may lead to a distortion of commercial and financial relations and the transfer prices. Also other factors as for example the governmental pressure or cash-flow requirements within an MNE group may have such influence.

It is usual that associated enterprises in MNEs are autonom to some extend, thus often bargain with each other as if they were independent enterprises and we can not assume the conditions established in commercial and financial relations between them to be invariably deviated from what the open market would demand. It can also be the interest and pressure from the shareholders what forces the local managers not to introduce such prices that would reduce the profits of their own companies. This is what supports the argument that the arm's length principle is being used against the possible claims of tax administrators.

The arm's length principle places the associated and independent enterprises for tax purposes into a same position and avoids the possible tax advantages or disadvantages resulting from the different economic structures and positions of companies. With the use of the arm's length principle many transaction including purchase and sale of commodities or lending of money of associated enterprises can be compared to similar transaction under comparable circumstances undertaken by comparable independent companies. Nevertheless, we would also find certain cases, where the arm's length principle is not easily applicable such as dealing with highly specialized goods, in unique intangibles, in the provision of specialized services and generally as far as special transaction are concerned, that the independent enterprises in contrast to the associated enterprises do not undertake, thus, there is no evidence of what the conditions by independent enterprises would have been. This could be for example the case of a sell of an intangible with unknown future profit potential for a fixed price. An independent enterprise would not risk an outright sale being aware of the fact, that the price might not reflect the potential profit of the intangible. It would rather exploit the intangible itself or license it to another independent company. For an MNE group there is no risk for overall groups profit from a transaction of this kind.

In general, when comparing the controlled and uncontrolled transactions, the comparability is achieved if:

- no difference between the controlled and uncontrolled transactions exists,
- the existing difference do not materially affect the condition being examined, or
- reasonably accurate quantitative adjustments can be made to eliminate the effect of any differences.

Some specific situation need to verify comparable transactions and market conditions that have taken place few years sooner when trying to use the arm`s length principle. In such cases it may cause an administrative burden for both the taxpayer and the tax administrator as well.

Also the existence of an intentional set-off should be mentioned. An intentional set-off means, that one enterprise provides a benefit to its related party that is balanced by different benefit received from this party in return. Thenafter, the parties may claim that the received benefits should be set off and only the net gain or loss from the transaction should be considered when assessing the tax liability. This kind of transaction could also be made between independent enterprises and the arm's length principle should also be applied.

2 CZECH AND SLOVAK TRANSFER PRICING REGULATIONS

2.1 Czech Transfer Pricing Regulation

In the domestic law the arm's length principle is regulated in the Section 23, paragraph 7 of the Income Tax Act 586/1992 Coll. (further "ITA"), which regulates the conditions for the use of a usual price for income tax as follows:

„If the prices agreed between enterprises associated in economic or personnel sense or between otherwise associated enterprises differ from prices which would be agreed effected between independent enterprises in usual business relations under the same or similar conditions, and if the difference is not reasoned in a satisfactory manner, the tax administrator shall adjust the taxpayer's tax base applying the difference...[2] *"*

"...if it is impossible to ascertain the prices which would have been agreed between independent persons in common commercial relations under the same or similar terms, the price established under another act[3] *shall be used.."*

The Section 23 (7) of ITA also defines the associated enterprises in economic or personnel sense as follows:

Legal status before 31. December 2003:
„Enterprises associated in economic or personnel sense mean the situation when one person/enterprise is engaged directly or indirectly in management, control or assets of other enterprise, or if there are the same legal or natural persons involved directly or indirectly in management, control or assets of both persons/enterprises or related natural person. Engagement in control or assets means the possession of more than 25% share in registered capital or right to vote share."[4]

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[2] ITA, Section 23, paragraph 7 (presented in Directive D-258 on the application of the international standards of taxation of transactions between associated enterprises – transfer pricing
[3] Act on property valuation no. 151/1997 Coll., as amended.
[4] Directive D-258 on the application of the international standards of taxation of transactions between associated enterprises – transfer pricing

In national law the range of persons whom the tax authority could adjust their tax base using "usual prices" was expanded to the persons associated also differently in following way:

„Persons associated differently mean persons establishing business relations mainly for the purposes of tax base reduction or tax loss increase."

The tax base adjustments with respect to transactions between related/close persons can be accordingly to the law applied only regarding the transaction between two or more persons, who are residents of the Czech Republic or a resident of a state with which the Czech Republic has concluded the Double Taxation Treaty.

Legal status since 1. January 2004:
With the effect from 1.1.2004 the ITA has been modified also in 23 (7), whereby the term Persons associated in economic or personnel or different way has been replaced by the term associated persons (entities). The new wording of the law is more precise and transparent after the modification:

„For the purposes of the ITA, the term "associated persons" means

1. capitally associated persons, while

- *if one person is directly involved in capital or right to vote of another person, or if one person is directly involved in capital or right to vote of more persons, and person's share represents at least 25% of registered capital or 25% of right to vote, all the persons concerned are the capital associated persons,*

- *if one person is indirectly involved in capital or right to vote of another person, or if one person is directly or indirectly involved in capital or right to vote of more persons, and person's share represents at least 25% of registered capital or 25% of right to vote, all the persons concerned are the capital associated persons,* *2. persons associated in a different way, namely*

- *when one person in engaged in management or control of another person,*
- *when the same persons or close persons*[5] *are engaged in management or control of other persons, these other persons are associated persons*
- *controlling and controlled persons, and also persons controlled by the same controlling person*
- *persons next of kin/close 20c)*
- *persons which established legal relation mainly for the purpose of tax base reduction or tax loss increase*

The Act on Property Valuation stipulates in Section 2 (1) that: "Property or a service shall be valuated at fair market value unless this act provides otherwise. The fair market value shall, for the purposes of Act on Property Valuation, mean a price which would be obtained when selling an identical or similar property, or when rendering an identical or similar service, in the common commercial relationships in the Czech Republic at the day of valuation. All circumstances influencing the price shall be taken into account, nevertheless the influence of extraordinary market circumstances, the personal situation of the seller or the buyer and the influence of any special preference shall be disregarded."

The other relevant regulations in the Czech Republic are the Directive D-258 discussing the application of internal standards in the taxation of transaction between associated enterprises, Directive D-292 explaining detailed the requirements of Section 38 nc of ITA and further the Directive D-293 specifying the requirements of the transfer pricing documentation accordingly to the EU Transfer Pricing Documentation requirements created by the EU Joint Transfer Pricing Forum. The above mentioned Directives are not binding for the tax payers, however, in practice they are usually followed by the tax authorities. Also the

[5] "close persons" as defined in Act no 40/1964 Coll., Civil Code, as amended

OECD Transfer pricing guidelines are generally accepted in the Czech Republic[6].

However, the OECD Guidelines are not implemented in the Czech tax law directly and there is also no direct reference to them in the Czech tax law. Nevertheless, the Czech Republic signed a multilateral international Vienna Convention on the Law of Treaties in 1987 and as a result the OECD Guidelines have a binding effect for this country. The definition of arm's length principle is same in both documents, in the ITA and in the OECD Guidelines.

Even though an enterprise follows the OECD guidelines and uses the methods to determine the arm's length price, it is possible that a dispute will arise. This dispute could be not only between the tax administrator and the taxpayer, but also between two tax administrators. The consequence of different tax position taken by two different tax administrators could be the double taxation of the enterprise.

The transfer pricing compliance practices depend in every country on their domestic tax practices and on the tax legislative. As the usual target of transfer pricing analysis are the MNEs, it is obvious that the transfer pricing procedures and administrative of one country have consequences on the administrative and overall situation of the enterprise in another country. Thus, the tax administrator should be aware of the transfer pricing principles applied in the foreign transaction partner of observed enterprise when applying the domestic transfer pricing practices.

The basic compliance practices are built on three stages, the examination practices, the burden of proof and the penalty system. The examination practices are different among the countries and content the analysis of many different areas, such as market analysis, industry information, comparability analysis etc. The tax administrator should bear in mind the method that has the tax payer chosen to determine the price following the arm's length principle.

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[6] The OECD Guidelines were published in the Czech Republic in Financial Newsletter no. 10 on October 6, 1997 /Finanční zpravodaj č. 10 ze 6.10.1997/ (chapters I-VII) and Financial Newsletter no. 6 on June 30, 1999 /Finanční zpravodaj č. 6 ze 30.6.1999/ (chapter VIII and following guidelines).

2.1.1 Burden of proof

The jurisdiction is in the OECD member countries not same as far as the burden of proof is concerned. In some countries the burden of proof is on the side of the tax administrators, which means, that the tax payers is not obliged to provide the tax administrator by special documentation or information and in the first step it is the duty of the tax administrator to proof, that the price is not arm's length when there exist such suspicion. However, the tax payer might by obliged by law to cooperate with the tax administrator to the extent, that it is acceptable and possible for the tax payer. It is also usual, that the burden of proof is shifting, which means, that at the beginning the burden bears the tax administrator and after revealing argumentation that the settled price is not arm's length the burden shifts to the tax payer. In some countries the burden of proof is directly on the tax payer, as for example in the Czech Republic. A Problem might arise, when there is a controlled transaction between enterprises from different jurisdictions.

2.1.2 Documentation

On the field of the documentation there are no specific requirements in the Czech Republic, but obviously the tax payer has to have sufficient documentation supporting his procedures in case of auditing the transactions by the tax authorities. During the audit of the controlled transaction the tax authorities have the right to request any documentation that substantiates the character of the examined transaction and among other information also the selected method.

As already mentioned above, the documentation that might be required is described in the Directive D-258, but as the Directive is not binding, this is not a obligation for the tax payers. Basically the documentation should always contain the information on the group, information on the company, information on business relationship, information on all relevant circumstances that can affect the relationship and information on the selected method.

The information on the group should content the description of business activities and property and organizational structure of the whole group, legal forms of the associated persons, business results of the related persons as well as the legal structure within the group. The information on the group also concerns the allocation of functions and risk within the group, allocation and ownership of the intangible assets and the flow of the licensing fees, application of transfer pricing policies, overview of expense sharing agreements etc.

The information on the enterprise should basically describe the performed business activity and the property and organizational structure as by the whole group, business strategy, business results and relevant financial indicators.

Information on the business relationship takes especially the price description of the traded goods into account, the terms and conditions of the agreements between associated enterprises, all relevant contracts concluded between the enterprises, volumes of the transactions as well as the function and risk connected to the business relationship.

Information on the relevant circumstances considers all circumstances that have or might have an impact on the commercial relationship of the associated enterprises, as for example the marketing strategy, the overall economic conditions on the relevant market, legislative regulation etc.

Information on the selected method should in general cover the explanation of which method was applied by determining the prices of goods being transferred, explanation why this method was chosen, information on comparable commercial relationships not only among the group, but also with other independent business partners etc.

As there are no specific statutory requirements about the documentation, there are also no specific deadlines for filing this documentation with the tax authorities as it is for example by the tax return. In case of a transfer pricing challenge, the tax payer must file the required information within the statutory deadline, which is generally in 15 days after receiving the request of the tax authorities. The tax payer may officially ask for the deadline extension whereby the decision is upon the tax authorities.

In the Czech Republic, the tax authority has the right to challenge the tax payers tax return statements within three years from the end of the taxable period in which the duty to file the tax return arose. If there is such an act of assessment of tax, then the three years limit starts again from the beginning. Also in case of a supplementary tax return or carrying forward of the tax losses is the three year limit prolonged. However, tax may not be assessed later than in 10 years or in 17 if the losses were incurred.

2.1.3 Penalties

Under penalties we understand monetar and also non-monetar penalties like shifting the burden of proof towards the tax payer in cases where the tax administrator suspects the tax payer not to act in a good faith or in case where the tax payer did not act in a cooperative way. The typical monetary penalties are payments for understatement or late payments.

In the Czech Republic there are no specific transfer pricing penalties. Generally, in case of a successful challenge of transfer pricing prices by the tax authority, a penalty of 20% of the unpaid tax may be applied. Connected to the late payment an interest is settled on the level of 14% above the repo rate of Czech National Bank. The Ministry of Finance has the right to decide about a penalty relief, but in general there is no specific relief or reduction of penalties for transfer pricing.

2.2 Slovak Transfer Pricing Regulations

According to the Slovak tax law, the tax base could be adjusted if the related parties do not deal with each other in the same manner as independent parties would have acted with each other. The specific wording of this requirement is stipulated in Section 17 (5) of the Slovak Income Tax Act (further "SITA") as follows:

"The tax base of a foreign related party shall also include the difference between the prices agreed in business transactions of foreign related parties (including the prices of services, loans and credits), and the prices applied between unrelated parties in comparable business transactions, as long as such a difference results in a

reduction of the tax base. The difference above shall be determined in accordance with the Section 18 below..."

"Section 18

Adjustments of Tax Bases of Foreign Related Parties

(1) The difference referred to in Section 17 subsection 5 above shall be determined using any of the methods based on comparison of prices. if none of the methods based on comparison of prices may be reliably used, methods based on comparison of profits or a mutual combination thereof shall be used, or, as appropriate, other methods, which are not described in subsection 2 or 3 below. Only such methods ay be used, the use of which complies with the principle of independent transactions (arm`s length basis principle). The arm`s length basis principle is based on a comparison of the terms agreed in any business or financial transaction between foreign related parties, and the terms which would have been agreed between unrelated parties in similar business or financial transactions in comparable circumstances. A review of the comparability of the terms is made by confronting in particular the business conducted by the parties, including, but not limited to, their production, assembly works, research and development, purchase and sale, etc., the scope of their business risks, the characteristics of the compared property or the service, the terms agreed between the parties to the transaction, the economic environment on the marketplace, and the business strategy. The terms shall be considered comparable if there is no difference at all or if only minor adjustments would compensate for any such a difference.

(2) The following are the methods based on a comparison of prices:

a) fair market price method consisting of a comparison of the price of a transfer of property or service agreed between foreign related parties, and the comparable fair market price agreed between foreign related parties. If there is any difference between foreign related parties shall be replaced by the fair market price, which would be used by unrelated parties in comparable business or financial transactions on similar terms, *b) subsequent sale method, whereby the price of the transfer of the assets purchased by a foreign related party is converted to the fair market price, using the price at which the foreign related party resells the assets to an unrelated party, after deduction the trading margin, which is usually applied by comparable independent resellers,*

c) increased costs method, whereby the fair market price is determined with reference to the actual direct and indirect costs of the assets or service transferred between foreign related parties, increased by the trading margin applied by the same supplier vis-a-vis unrelated parties, or by a trading margin, which would be applied by an unrelated party in a comparable transaction on comparable terms.

(3) The following are the methods based on a comparison of profits:

a) profit split method, which is based on such a split of the anticipated profit generated by unrelated parties, which would be expected from unrelated parties engaged in a joint venture, while respecting the arm's length basis principle;

b) net trading margin method used to determine a profit margin in a business or financial transaction between related parties in relation to costs, revenues or a different basis, which is than compared with a profit margin used vis-a-vis unrelated parties.

(4) A taxable party may file with the tax administration a written request asking for the approval of the use of a specific method referred to in subsection 2 or 3 above. If the tax administration approves the method suggested by the taxable party, such a method shall apply for at least one tax period, while it shall not be replaced by another method in the course of the tax period.

(5) The correct application of the method and the determination of the difference pursuant to Section 17 subsection 5 above shall be inspected by tax authorities 81) through tax audits 820 while making reference to the arm's length basis principle, the method used and the analysis of comparability of prices."

3 ARM`S LENGTH PRINCIPLE

3.1 Comparability analysis

In general, we can describe the procedure of applying the arm's length principle as a kind of comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises under similar circumstances of all aspects being involved. Thus, the basic assumption is a sufficient comparability of all economically relevant characteristics. If there is a difference between the two or more compared situations, this difference should not be of that scale, that it can materially affect the examined condition or that adjustments can not be done to eliminate the effect of this difference. An obvious fact is, that simply an industry average of compared character without taking all relevant aspects into consideration can in no way represent the only value following the arm's length principle. These aspects could be for example the characteristics of the property or transferred services, used assets and potential risk, function performed by the parties, terms of contracts, business strategies of the parties or the economic circumstances of the parties etc.

3.2 Factors determining comparability

3.2.1 Characteristics of property or services

Characteristics of property or services should by the comparison of controlled and uncontrolled transaction always be taken into account, especially when prices applied in undertaken transactions are compared. Under the relevant characters we understand for example the assumed benefits from use of the property, the type of the property, duration of protection, nature of service, quality and reliability of the property or service, availability or supplied volume.

3.2.2 Functional analysis

The functions that different enterprises perform are always reflected in dealings between them, thus, the comparison of the functions is unavoidable. This is what leads to the functional analysis, the observation of responsibilities and various activities undertaken. Under the specific functions we usually understand research, distribution, marketing, development, management, financing etc. When analyzing these functions, it is mainly their frequency, nature or value what determines their dominancy.

3.2.3 Contractual terms

The contractual terms specify how the responsibilities, risk and benefits are divided between contractual parties and we should never exclude the analysis of this. As far as independent parties are concerned, the contractual terms will be modifies or ignored only if this is the interests of both parties. This is not the case of associated parties, we have to take in consideration, that in case of associated parties one can use its influence and modify the contractual terms to be better of or not to use the arm's length principle.

3.2.4 Economic circumstances

Economic circumstances that we have to take into account are for example the size of the market, the position of the firm and of the competitors, position of buyers and sellers to each other, availability of substitute goods and services, governmental regulation, cost of production factors, consumer purchasing power or for example geographic location.

3.2.5 Business strategies

Business strategies as for example the market penetration may significantly influence the charged price for a product and a comparable product would have been sold for a different price. By market entry or increasing of market share also higher costs may often occur. Then, it is quite complicated for the tax authority to prove that the tax payer is not following a business strategy and the decrease in profits is only temporal.

3.3 Combined and separate transactions

When evaluating the transactions, we should do it case base case or transaction by transaction. However, sometimes separate transaction might be so dependent on each other or combined that it is impossible to evaluate them separately. This could for example be the case of linked products and their pricing or long term contracts. It is sometimes reasonable to evaluate two or more transaction together rather than on a separate basis. On the other hand, some transaction sold together might in order to follow the arm’s length principle be evaluated as a combination of single transactions.

3.4 Arm’s length range

When simulating the conditions for controlled transactions that would have been used by uncontrolled transaction it is always only an approximation, thus, by using special methods, we do not necessarily get only one concrete value, but very often there is a whole range of values that all of them are acceptable and do not violate the arm`s length principle. The other reason for this existence of a range of figures might be the fact, that all comparable transaction might not be comparable in exact same way or of a same degree or just simply the fact, that more methods have been used. Every method differs more or less and every method produces different results. It is important to choose the most appropriate one and a detailed analysis of the used data is necessary.

3.5 Multiple year data

The data and the transfer price that we are analyzing in the observed year might also be influenced by the data and its development in the prior year. Thus, also data from years that already passed may be of a high importance and should be in some cases taken into account. This past data can for example show us, if an observed product is at the beginning, in the middle or at the end of its “life”. This is also important if there is a comparable product that should be taken into account as far its development of prices is concerned. When applying this logic, we can also use the data that are predicted to occur in following years.

3.6 Profit and loss among MNE

A very interesting case arises if among an MNE group that is consistently profitable exists an enterprise, which year after year suffers under losses. This is a suspicious situation for a tax administrator as far as the transfer pricing mechanisms of these MNE group is concerned and has a detailed control and analysis as a consequence. the problem is to identify the reason for the loss situation, if it is because this is due to the contractual system applied under the MNE and it is for purpose or just because unfavorable economic situation, crisis in the enterprise etc. Such situation would be unsustainable for an independent enterprise. For an MNE a single business might be beneficial as a whole even though it produces losses. There might be some loss making products, that will never bring a member of a MNE group to a profit, but still the product is an important article for the MNE for example for the competition purposes. An independent enterprise would never perform this product, unless it is paid by a different price. For a taxpayer, this potential charge could be used as a basis when trying to estimate the price adequate for the arm's length principle.

3.7 Government policies

it is possible that in some case the price that fulfills the arm's length principle is influenced by governmental interventions what might be for example control of interest rates, control of prices of special products, governmental subsidies, exchange rate control or other specific forms of interventions. The taxpayer and the tax administrator, both must take these aspects into account by creating the enterprises decision policy.

Very often the MNE members try not to be affected by these interventions and rather act to shift these limitations towards the final sellers. The price is being changed in the last phase then, what means by selling the product to the final consumer. Another possibility is to split the burden levied from the government between the member enterprise and the final consumer. In any case, the tax administrator must take these facts into consideration and also evaluate the position of an independent enterprise in similar situation, how would the management of an independent enterprise act and manipulate the price being under same conditions.

3.8 Custom valuation

The determine price fulfilling the arm's length principle is feasible for a custom administrator by transferring the goods from one country to another. This custom administrators evaluation is then used as a bases by the tax administrator, as the custom administrator might have relevant documentation regarding the transaction prepared by the taxpayer.

Interesting is that a taxpayer might have different intentions towards the custom administrator and the tax administrator. First a taxpayer wants to have the value of the imported goods as low as possible due to the levied custom duty and value added tax or other taxes but on the other hand wants to report as high as possible deductible costs paid. Currently customs officials cooperate with tax administrators much better, but this was not the case in the past and it happened often that the custom valuation of the goods was unacceptable for the tax purposes.

4 BUSINESS MODELS OVERVIEW

The understanding of the business models that is applied is the key factor for the proper determining of the functions and risks of all parties involved in selected transactions.

4.1 Fully-fledged Distributor

The fully-fledged distributor is a arrangement, where the enterprise purchases the goods, stores them, promotes them and undertakes marketing activities, resells the goods, whereby taking all the risks or the majority of them connected to the activity. The appropriate award for taking he risk among controlled transaction should be reflected in the price.

The costs that relate to the above described activities should be covered by the margin generate by the difference between the purchase and the sale price. These costs are for example the storage or transportation costs, marketing costs etc.

4.2 Limited risk Distributor/Agent

Among independent enterprises the distributor might agree an arrangement different to the above when shifting for example some services to the producer. These services could be for example the marketing and promotional services etc. The result of this is a situation where the producer takes the majority of the risk and the distributor acts as an agent of the producer. As a result, the buy-sell margin does not appear as an appropriate method to set the price for the resell of the goods by the distributor as the market risk is born by the producer and not by the distributor.

4.3 Strategic leaders

A strategic leader is a company that undertakes all the entrepreneurial and operational activities in respect to the company among the respective industry. A strategic leader also undertakes the strategic activities as quality control, research and development, development of purchasing policies, strategy of distribution activities etc. As a consequence, strategy leaders also bear the risk connected to these activities and enjoy the benefits of intangibles that are developed as for example the trade mark, reputation etc.

4.4 Service providers

Compared to the strategic leader, a service provide usually undertakes only operational functions, which could be marketing, production or distribution. There is usually no intangible asset development or the risks connected to the service providers. Consequently the returns of service provider are usually lower than those of for example fully-fledged producers from the same industry.

In practice, there are no enterprises that could be seen as pure representatives of the above stated categories, usually, the combination of more of them or a mutual relations between enterprises should be taken into account.

5 TRANSFER PRICING METHODS

Usually, the determination of arm's length principle does not require a use of more than one method even though the specification of appropriate method is often not straightforward. For analyzing the collected data, we can use five main methods or combine them, these methods can be divided into two groups:

- Traditional transaction methods
- Transactional profit methods

5.1 Traditional transaction methods

These methods are based on comparison of uncontrolled prices with prices or gross margin of controlled transaction.

5.1.1 CUP – Comparable Uncontrolled price method

The comparable uncontrolled price method is possibly the simplest method, but it requires quite a high degree of comparability. It is based on comparison of prices of goods or services being charged in a controlled transaction to the prices being charged for the similar goods or services in comparable uncontrolled transactions and under comparable circumstances. The existence of difference between these two prices is an evidence of the fact, that the price of controlled transaction is not arm's length.

As already described, to be able to use an uncontrolled transaction as a comparable measurement to a controlled one, several conditions must be fulfilled. These are that no difference between the transactions could materially affect the price on the open market or that adjustments can be made to eliminate these differences. However, it is usually quite complicated or almost unable to find such a transaction between independent companies or enterprise that is identical or at least similar enough. The consequence is that the more we have to adjust our transaction that we want to use as a basis for the comparison, the more are our results unreliable.

The example of possible usage of the comparable uncontrolled price method is for example a situation, where the independent enterprise sells the same product as a associated enterprise. There must be, of course, also other conditions fulfilled, as the time of the transaction, the quality of the product and its quantity being sold and also the conditions of the transaction. If for example the quantity is not the same, the possible volume discount should be taken into consideration.

5.1.2 Resale price method

The resale price method is based on the calculation, where in the first step such price is taken, that is being charged when a product that has been purchased from an associated enterprise is being sold further to an independent business partner. The second step is reducing such price by a margin that should cover the expenses of the seller and of course generate the desirable profit. Such a price after subtracting above described items could be taken as a arm's length price for our transaction between dependent bodies.

There are also several conditions that must be met to use the transaction between independent enterprises as a comparable to our transaction undertaken between associated bodies, which are the fact that the there is no difference between the compared transactions affecting the resale price margin in the open market and if there are such differences, there also are adjustments that can be made to eliminate the effect of this differences. Under the resale price method there are usually not that many adjustment needed to be made in comparison to the usage of the comparable uncontrolled price method, as the profit margins are not that affected by small product differences as the prices. In general we can say that the resale price method requires less product comparability. However, the higher the comparability is, the better the result of the comparison.

The resale price method might also be used in situations, where the uncontrolled and controlled transactions are comparable in all characteristics other than the product itself and it might generate better results than the comparable uncontrolled price method. Also the time aspect should be taken into account, the resale price margin method is more suitable if the resale is taking place in short time period after the purchase of the good. a very important factor is also the existence of the risk in the transaction, in other words, if the situation where the reseller is only forwarding the good we can surely expect a different margin than in a situation where the ownership of the good is being changed during the whole transaction and the reseller owns the good after purchasing and before reselling it again. The other activities that contribute to generate the margin are for example marketing and advertising the good, transport of the good, giving guarantees for the good or the distribution. It is extremely important to be aware of the fact who is taking the responsibility of all these activities as these have also extremely big influence on the resale margin. By comparing the uncontrolled and controlled transaction, we have to take into account all these crucial factors and elements that can influence the margin and the conditions of the transaction.

The uniqueness of the transaction undertaken plays an important role as well, it is meant whether the reseller is the only enterprise acting on the market as far the sell of the good is concerned. In other words, the market position together with the potential monopolistic position of the reseller have to be taken into account when comparing the margin of an uncontrolled transaction with a margin of a controlled one.

5.1.3 Cost plus method

The cost plus method is based on adding a cost plus mark up to the costs of producing the good by its seller. The costs incurred plus the mark up could be seen as the arm's length price and compared to the price used in a controlled transaction under similar circumstances. This method is mostly used when selling semi-finished goods in controlled transaction between economically related enterprises. Also this method does not differ in the conditions that must be met to ensure the adequate usage of it, these conditions are again no existence of any factor or difference between the controlled and uncontrolled transactions being compared that can influence the cost plus mark up and if there is such difference, the adjustments eliminating these difference are possible.

In this method, we should first carefully analyze the costs incurred by producing the good, what generates the costs, what sort of inputs are being used, if the inputs are for exampled owned by the producer or simply leased and all other factors that can determine the size of the cost. All this should be taken into account when comparing the uncontrolled and controlled transactions.

The problem connected to the cost plus method might be the allocation of the costs among the seller and the buyer or estimating the exact amount of the costs when the cost are related to the whole amount of different goods being sold the different buyers (this could be for example the case of cost of employees, costs of advertisement, fixed costs of the factory and other).

In general, the whole method of calculating the costs could be the hardest part on comparing the costs in the transaction. Basically, the method applied by calculating the costs of the good in a controlled transaction should be the same method as the one applied by calculation the costs in the uncontrolled transaction. This is the basic rule that guarantees the comparability of the costs as far as the calculation of the costs is taken into account.

All the above mentioned traditional transactions method are the mostly used methods to determine whether the price charged in a controlled transaction is arm's length. However, there are some cases where the traditional transaction methods are not appropriate. This might be the case of transaction where there are no available data of an uncontrolled transaction to compare it with or there are data available but these that are of insufficient quality. In cases like this we should think about using different methods than the traditional ones, which are described below.

5.2 Other methods

The other methods different from the traditional are used in situations when the traditional can not be alone or at all. These other methods are called transactional profit methods and as obvious from their name they concern the profit of associated the enterprises taking part in the transactions. Among transactional profit methods we can find the Profit split method and the Transactional net margin method

5.2.1 Profit split method

This method is concerned on analyzing the profit generated in the controlled transaction between dependent enterprises and compared to the profits gained in transactions between independent enterprises under similar circumstances. In a transaction undertaken by associated enterprises the profit of the enterprises is split between them in the first step. this profit split should follow the market situation and simulate the profit that would have been achieved in the situation when two independent enterprises undertake a transaction and the agreement is arm`s length.

To be able to determine the share on the profit of both enterprises the functional analysis is required. This means to analyze carefully the contribution of each enterprise undertaking the transaction as far as their functions, risk and other factors are concerned. Comparison of the situation between independent enterprises under similar circumstances is useful as well.

As other method also the profit split method has its advantages and disadvantages or better to say, strong and weak points. One of the biggest strong aspects of this method is the fact that this method does not necessary need to have a comparable transaction to compare the controlled one to, it can be applied solely on the selected one. The profit split method relies on the external data when determining the contributions of each enterprise on the transaction, however, these shares does not have to represent the split of the gained profit. This is probably the main reason why this method really takes into account the specific factors of the transaction and does not need comparable transaction among uncontrolled cases, where also the unique circumstances of controlled transaction might never appear. The uniqueness of the controlled transaction is taken into account while still following the arm’s length principle.

As the profit split method takes both participants of the transaction into consideration, it is more than less guaranteed, that none of the involved enterprises would be evaluated with unrealistic profit. The result of involving both parties of the transaction into account is the evaluation aspects as involving the intangible property, bearing the risk connected to the transaction or considering the economies of scale etc.

On the other hand, among disadvantages of this method we can mention the disability to determine the expenses related to goods subjected to the transaction. Sometimes, it could be impossible to measure exactly the costs resulting from the production or other activities connected to the good being sold. Also different accounting methods and principles may cause difficulties in observing and analyzing both enterprises at the same moment.

The profit split method could also be applied as so called two-stage model. Part of the gained is split among the participating enterprises so that it covers the ordinary basic return taking the actual market situation into account. What is left from the profit is then after divided accordingly to the situation that simulates the situation of independent enterprises. The basic profit could be for example determined if we take the lowest price that an independent would be willing to accept and the highest price that an independent buyer would in an uncontrolled transaction be willing to pay. The amount of profit that is above the settled price is the residual profit. The residual profit should be then divided in the second stage of the described model.

5.2.2 Transactional net margin method

This method analyzes and compares the net profit margin relatively to the costs, assets, sales and other factors. In general, the transactional net margin method is in a way similar to the cost plus and resale price method. The base of this method is setting the net margin of a controlled transaction on the same level that would have been realized between independent enterprises.

The advantage and strong side of this method is the fact, that the margin is not that easy to be affected by the differences between the transactions as for example the price that is used in the comparable uncontrolled price method. The net margin method is also less likely to be affected by the differences between the uncontrolled and controlled transactions than the gross profit margin method. The gross profit margins may vary due to different operating expenses, but the net margins tend to stay on similar levels.

In the transactional net margin method it is also not required to analyze all the participants and for example to allocate the costs or profit to all the participants. This could be the main advantage by using this method when one or more participants are hard or even impossible to analyze due to various reasons. The disadvantages of this method is again the required necessity of comparing the controlled situation to the uncontrolled one and, as already sad, it might be impossible to collect the comparable data related to the transaction between independent enterprises. The net margin is likely to be affected by factors as the strategy of the firm and the management, position of the enterprise among its competitors or the lifecycle of the product and whole business etc.

By applying the transactional net margin method and comparing the net margin to a net margin related to an uncontrolled transaction, this should not be done on the basis of the whole associated enterprise. The net margin related to the particular good should rather be taken into account, as the company should be oriented on more different strategies, sales, goods etc. The same rule should be followed also on the side of the independent enterprises, all transactions that are not similar or comparable, thus not useful in our case, should be taken out of our consideration and analyzes.

5.3 Conclusion to the methods

In general, the traditional transaction methods should be preferred and used rather than the transactional profit method or the net margin method. However, there are some cases and situations where the application of the transactional net profit methods is proper and the result reliable.

6 TRANSFER PRICING SURVEY

In December 2007 Ernst & Young, a worldwide performing audit and tax advisory company, published a global transfer pricing survey[7] (further "Survey") undertaken among 850 MNEs operating in all industry areas across 24 countries. The purpose of the following articles is to present the results and key findings of this survey as it uncovers valuable information about the actual situation within transfer pricing, the actual trends and practices, perceptions, audit experiences as well as the information about importance of transfer pricing for the companies from all over the world.

Author decided to adopt the results achieved by this study as it exceeds her resources to perform her own research to such enormous extent and as they are considered as reliable.

6.1 Summary of basic findings presented in the Survey[8]

40 % of all respondents identified transfer pricing as the most important tax issue facing their group, more than any other tax issue.

74 % of parent and 81 % of subsidiary respondents believe that that transfer pricing will be "absolutely critical" or "very important" to their organizations over the next two years

65 % of parent respondents believe that transfer pricing documentation is more important now than it was two years ago.

66 % of parent respondents have experienced and increased need for transfer pricing resources in the last three years, with 74 % meeting these needs through increased reliance on external advisors.

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[7] 2007-2008 Global transfer pricing survey, Ernst & Young, Tax & Transaction, s.r.o., December 2007

[8] Conclusions presented in this chapter adopt the authentic wording from 2007-2008 Global transfer pricing survey, Ernst & Young, Tax & Transaction, s.r.o., December 2007, p. 1-26, www.ey.cz.com

Over 52 % of all respondents have undergone a transfer pricing examination since 2003, with 27 % resulting in adjustments by tax authorities.

According to the survey, intercompany services transactions are the most susceptible to audit by tax authorities.

In audit cases resulting in adjustments, parent respondents indicated that tax authorities threatened to impose penalties in 31 % of cases, and penalties were actually imposed in 15 % of cases.

Parent respondents reported that tax authorities requested access to operational personnel in 36 % of examinations.

While 90 % of parent companies believe that intercompany agreements are important in supporting their transfer pricing positions, they reported that tax auditors requested them in only 7 % of examinations.

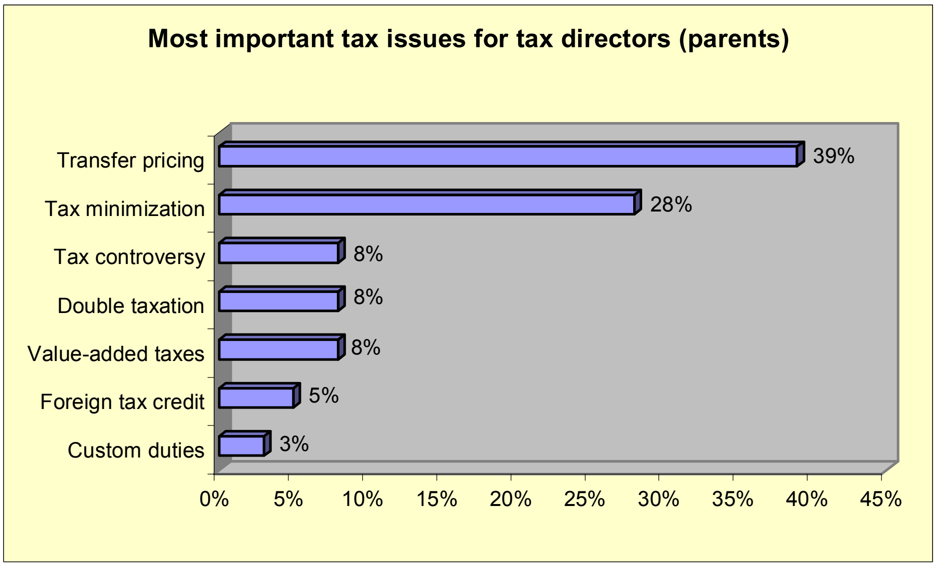
72 % of respondents believe the level of transfer pricing expertise within tax authorities is good to very good.

78 % of all respondents believe a transfer pricing audit is likely in the next two years.

6.2 Further facts presented in the Survey

The Ernst & Young Survey presents the importance that tax directors place on transfer pricing. According to the Survey, more parent companies identified transfer pricing as the most important tax issue they faced than any other issue. The following figure shows the importance of various issues to the companies comparing them to each other.

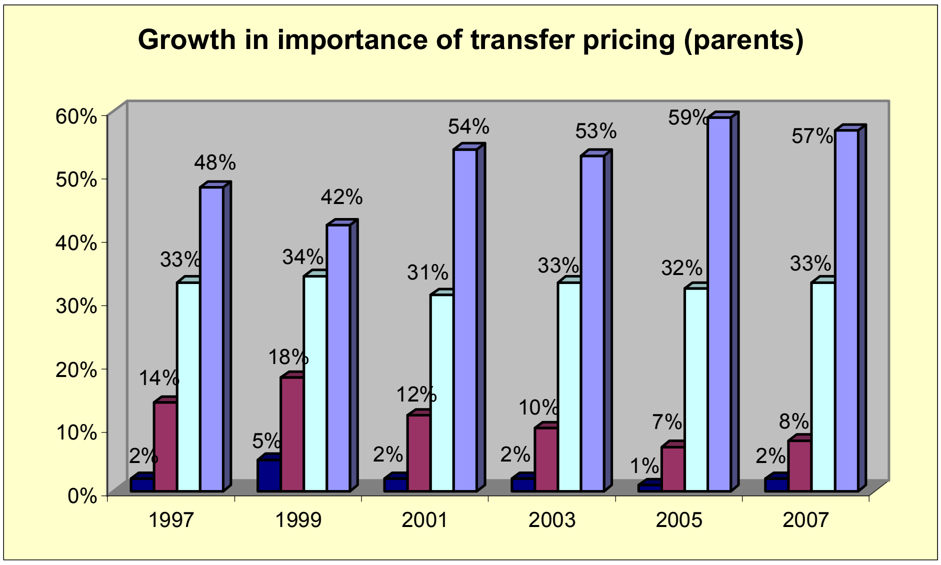
Figure 1: Most important tax issues for tax directors



As seen from the graph, transfer pricing became a most important tax issue for 39 % of companies, the Survey further states that in Europe 42 % of companies and 44 % of Asian-Pacific felt transfer pricing to be the leading issues. Among Europe, transfer pricing represents the main object of attention for companies in Germany and Switzerland with 76 % of votes for this issue.

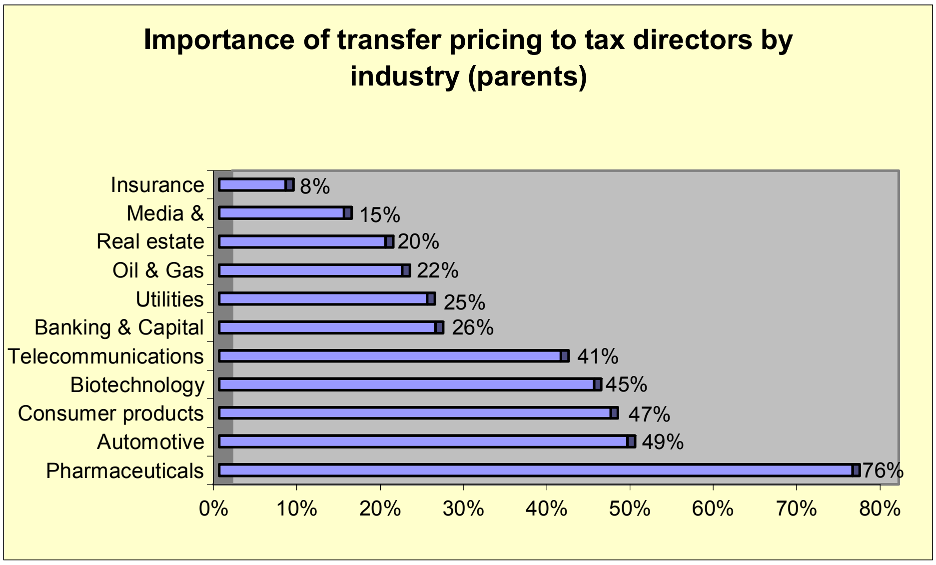
Next figure is a good demonstration of the growing importance of transfer pricing for the enterprises since 1997. In 1997, 2 % of enterprises stated that transfer pricing is not important for them at all, the number pf companies in 2007 with the same statement stays the same. For 14 % of enterprises in 1997 was transfer pricing not very important, whereas now there are only 8 % of companies declaring this. the number of companies seeing transfer pricing as fairly important stayed same on the level of 33 % and the number of companies placing extremely high value on transfer pricing taking it as very important has accelerated from 48 % to 57 % since 1997.

Figure 2: Growth in importance of transfer pricing (parents)



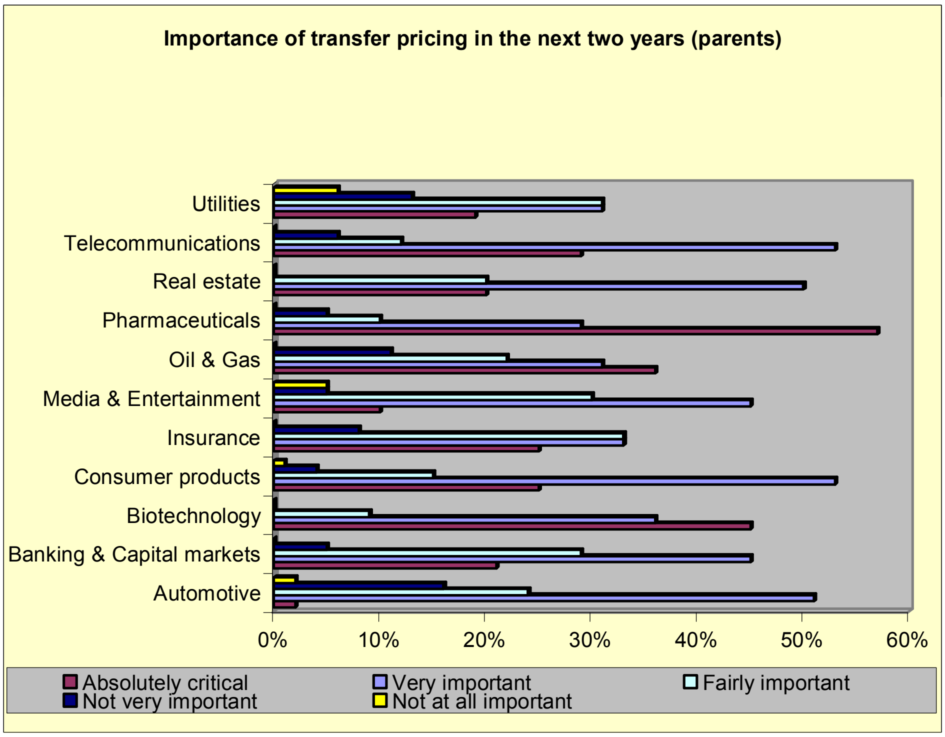
The next figure shows the growth in the level of importance that tax directors place on transfer pricing. According to the Survey, the importance of transfer pricing vary by industry, whereby is it the most important issue for enterprises in the pharmaceutical industry with 76 % and the minimum weight is placed on transfer pricing in insurance sector with 8 % respondents taking it as the most important issue. The reason for the importance in pharmaceutical sector might be the high probability of a value chain among the enterprises. And, on the other hand, the low number of companies transfer pricing that carefully might result from strong governmental regulatory policies and solvency rules already applied in this sector that determine and limit the prices and profits as such.

Figure 3: Importance of transfer pricing to tax directors by industry



In addition to the current state, the Survey also examined the opinions of the tax directors of the enterprises about the future development in the importance of transfer pricing to them. Next figure presents the expected development in the coming next two years.

Figure 4: Importance of transfer pricing in the next two years



As seen in the figure 4 a shift in expected importance according to industry could be detected. For example in Insurance industry the transfer pricing was the most important issue for 49 % in 2007, in next two years it is seen as a absolutely critical issue for 25 % of enterprises. This might also be connected with growing rate of ownership relationships between previous independent insurance companies and generally with the growing interest in transfer pricing on the side of tax authorities. In general, the number of companies presenting transfer pricing as absolutely critical or very important to them is growing within next two years.

Another interesting fact presented by the Survey is where the responsibility for transfer pricing in the company lies. From following two figures we can read that transfer pricing is dominantly the tax department responsibility followed by CFO/Financial directors and audit committees. However, according to the findings of the Survey, the responsibility has been shifted from the tax department towards the CFO/Financial directors since last years.

Figure 5: Responsibility for transfer pricing within the organization in 2005

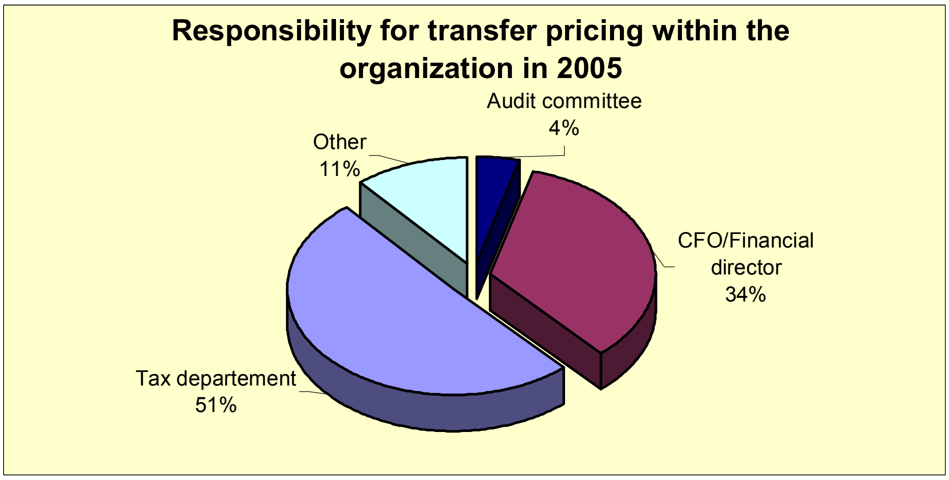
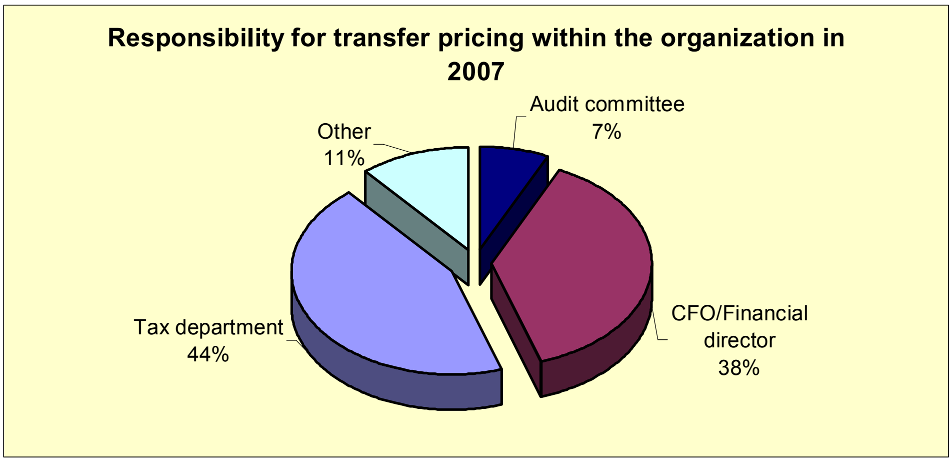
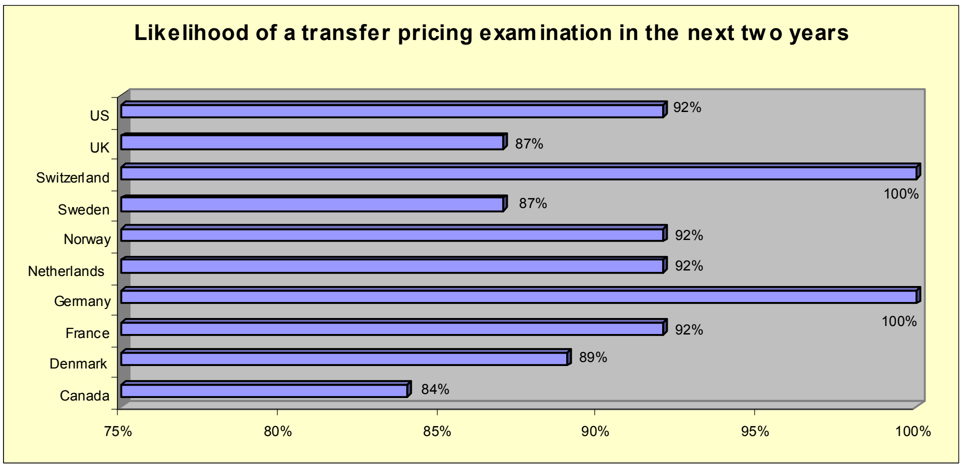


Figure 6: Responsibility for transfer pricing within the organization in 2007



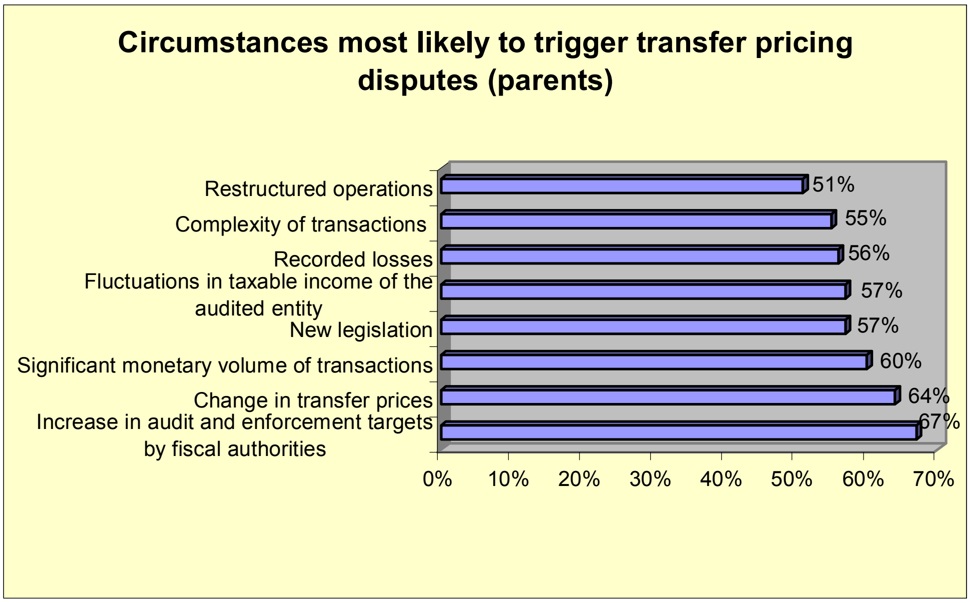
According to the findings of the Survey, more than half of examined enterprises declared, that they have experienced a transfer pricing examination by the tax authorities, whereby more than half of this examinations had adjustments as consequences. The countries with highest rates of companies being examined are the Netherlands with 84 %, followed by USA with 82 %, Canada with 81 %, France and Switzerland both with 76 % and United Kingdom with 75 %. Many of the enterprises expressed themselves that they believe their company to be audited with a very high level of probability within next two years. The next Figure shows the likelihood of a transfer pricing examination as seen by the tax directors in observed enterprises. As observable from the Figure 7, for example in Germany or Switzerland 100 % of companies believe they will experience the transfer pricing examination in next two years.

Figure 7: Likelihood of a transfer pricing examination in the next two years.



In the Survey the enterprises were also asked what they think the main reason for the expected examinations on the field of transfer pricing could be. Most of the companies see the increase in audit and enforcement targets by fiscal authorities as the main objective, followed by change in transfer prices or significant monetary volume of transactions. The Figure 8 presents the various reasons as stated by the observed companies, whereby multiple answers were taken into account.

Figure 8: Circumstances most likely to trigger transfer pricing disputes.



Further interesting findings of the Survey are connected to the transactions that have the most likelihood of being examined. It seems to be the administrative and managerial services to be the most vulnerable kind of transaction as far as the tax authorities challenges are concerned. It is obvious according to all about stated data that the transactions are in general seen as more likely to examined than it was in recent years, however, the most growth in this likelihood is observed exactly among the administrative and managerial services or intercompany financing. These results were gained by comparing the situation in 1997 and 2007, see Figure 9.

Figure 9: Comparison of transactions perceived by parents as susceptible to transfer pricing disputes with tax authorities in head office country in 1997 – 2007.

Comparison of transactions perceived by parents as particularly susceptible to transfer pricing disputes with tax authorities in head office country in 1997 - 2007			
	2007	**1997**	**Relative change**
Administrative or managerial services	54%	31%	74%
Intercompany financing	41%	25%	64%
Technical services	36%	24%	50%
transfer or sales of finished goods for resale	36%	33%	9%
License of intangible property	35%	24%	46%
Technology cost-sharing agreements	25%	21%	19%
Commission for sales/transfer of goods	25%	20%	25%
Sales of raw materials or components between group companies	21%	25%	-16%

The reality among different type of transactions expresses the following Figure 10 with numbers that present how many of undertaken transactions (in percentage) across various kinds of them have been reviewed by the tax administrators during 2007.

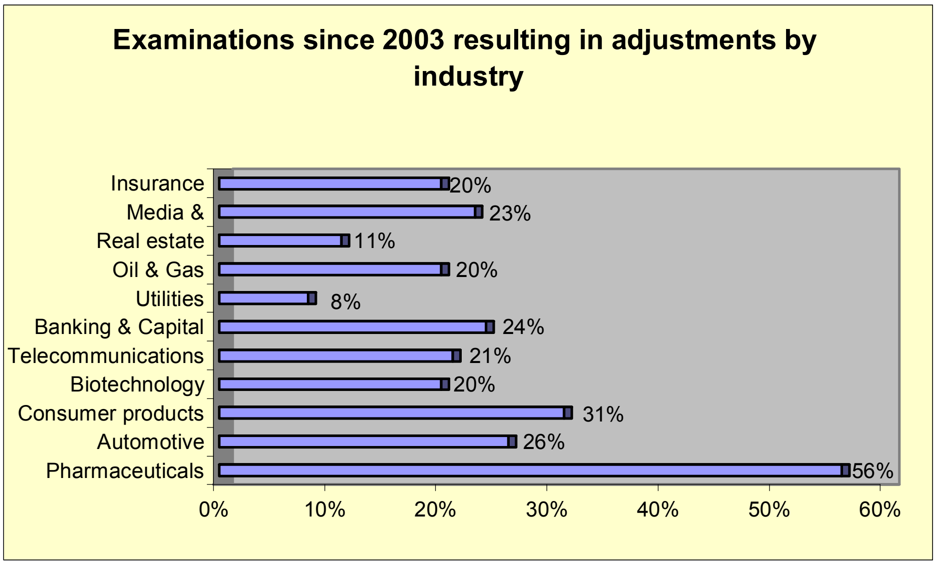
Figure 10: Types of transactions audited.

Types of transactions audited (parents)	
Intercompany services	55%
Transfer of sales of tangible goods	50%
License of tangible property	21%
Intercompany financing/Financial transactions	12%
Technology cost-sharing agreements	8%

By comparing the information about expected audits and collected data of reviewed transaction in reality, the most different kind of transaction which seem to be more susceptible than really are audited are the intercompany financing transactions. The tax directors expect them to be examined in 41 % in the next two years, whereas the data collected shows, that by now only 12 % of them were challenged by the tax administrators.

According to the Survey, among Europe the Nordic countries have the highest percentage of reviewed cases that were followed by an adjustment on the side of the taxpayers. On average, the transfer prices examinations lead to an adjustment in 23 % of all challenges. As far as the industries are concerned, in the Pharmaceutical industry the adjustments are most likely to be expected. The overview of examinations leading into adjustments presents the following Figure 11.

Figure 11: Examinations since 2003 resulting in adjustments by industry (parents)

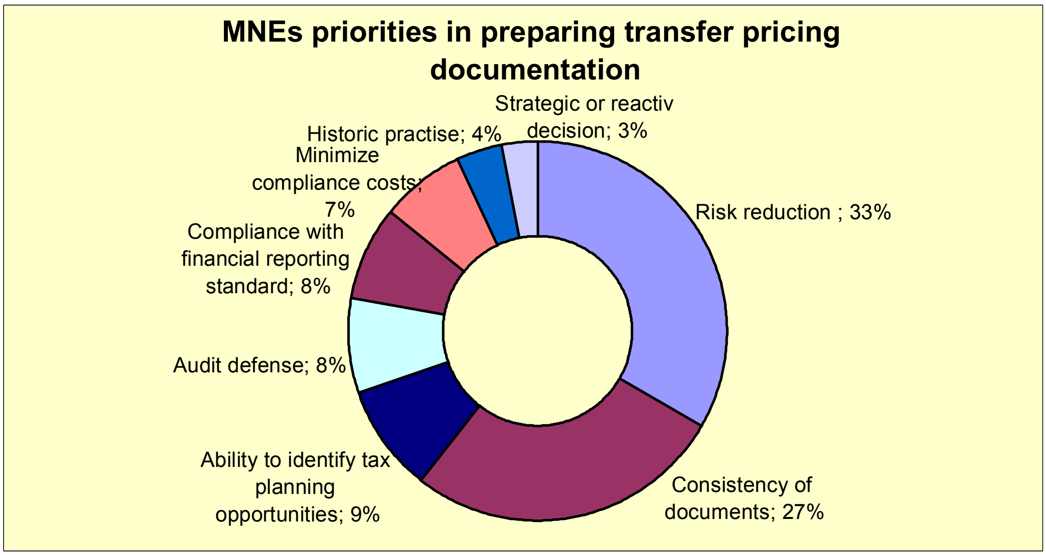


The most common method applied by the tax auditors was the cost-plus method, used in about 33 % of cases, followed by the profit split method in about 20 % of examinations.

The penalties were imposed in 15 % of challenges by the tax authorities. However, in more than 30 % the enterprises were threatened to have the penalties imposed. The Survey has shown that among Europe that France and Italy are the countries where the probability of imposing a penalty is the highest when about one half of all the respondents having received a transfer pricing adjustment suffered a transfer pricing penalty as well.

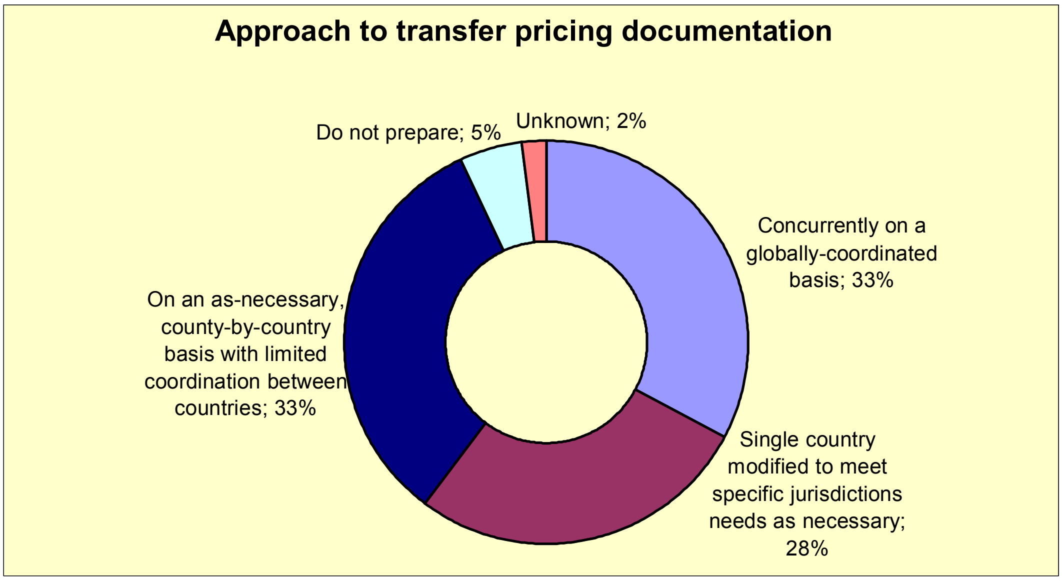
As the Survey shows, also the main objectives and goals of the transfer pricing documentation are shifting, when in 2005 the consistency of the documentation was the top priority, in 2007 it was displaced by risk reduction. Among the he other incentives we can find the ability to identify tax planning opportunities, the audit defense, compliance with financial reporting standards, minimizing compliance costs, company policy or strategic or reactive decision. In the next Figure the priorities in preparing transfer pricing documentation are presented.

Figure 12: MNEs priorities in preparing transfer pricing documentation.



As far as the approach to preparing the documentation is concerned, the Survey stated that more than one third of the respondents answered that they prepare the transfer pricing documentation currently on a globally/coordinated bases and around one third of the respondents on a country-by-country basis. Figure 13 uncovers the answers of observed enterprises in this respect.

Figure 13: Approach to transfer pricing documentation



Recently, the European Commission has called for a pan-European approach towards the documentation, as this approach could lead to potential cost savings on the site of tax administrators and the taxpayers as well. However, as the Survey shows, only about one quarter of the respondents stated that they rely on such pan-European comparables, while the other companies rather prefer local comparables. The reason for this might be the fact that such pan-European approach is based on uncovering tax information relating to all operations, those that stand inside the local jurisdiction and those that stand outside as well.

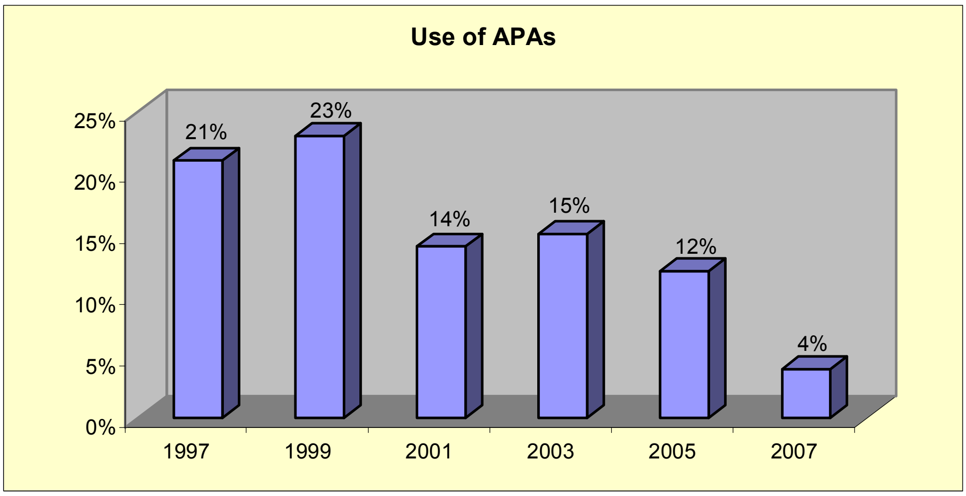
Selection of the transfer pricing method depends obviously on the subject being transferred. Among the respondents of the Survey the cost-plus method is the most frequently used method in transactions with intercompany services. However the comparable uncontrolled price method seems to be the most popular method for financing and intangible property transactions. This is perhaps because of the availibilty of comparable data in this respect as this is the main assumption of using the comparble uncontrolled transaction method. The popularity of various methods according to the kind of transaction is documented in following summary in Figure 14.

Figure 14: Methods Used by Transaction type

Methods Used by Transaction Type					
	Tangible goods	Services	Intangible property	Financing	Cost sharing
CUP/CUT	32%	19%	54%	56%	
Resale price	17%				
CPM	11%		14%	13%	
Cost		13%			29%
Cost-plus	29%	60%			49%
Profit-split	4%		10%	7%	
Other	6%	7%	22%	24%	22%

When the companies prepare their documentation and strategy how to avoid a being successfully challenged by the tax authority, the possibilities to use Advanced Pricing Agreement (Further APA). The APA works on the cooperation between the tax payer and the tax administrator, where the tax payer applies for the tax administrators judging about the correctness of the transfer prices being used in advance. The percentage of respondents seeking for APAs is stated below.

Figure 15: Use of APAs



7 CASE STUDY (CHENIMAL PRODUCT)

7.1 Introduction

This case study aims to describe and review the Czech and Slovak transfer pricing aspects of transactions defined below, whereby the practical usage of various transfer pricing methods and the whole procedure of setting the arm's length price will be demonstrated. The main objectives are to review the charged prices on selected transactions between further described entities in respect to Czech and Slovak transfer pricing rules.

This analysis is based on relevant Czech and Slovak tax law, OECD guidelines and a publicly available information database, namely Analyse Major Databases from European Source (further "AMADEUS")[9]. All information regarding the entities under review are due to the nature of the information adjusted and there should not be seen a real existing enterprise or group of enterprises behind the stated facts.

For the purposes of the case study a not existing entities joint in a not existing group named Chenimal group were taken. The main objectives of this study are to demonstrate the application of transfer pricing methods and especially the usage of the AMADEUS database rather than performing a transfer pricing analysis of an existing company for further usage.

The transactions partners are as follows:

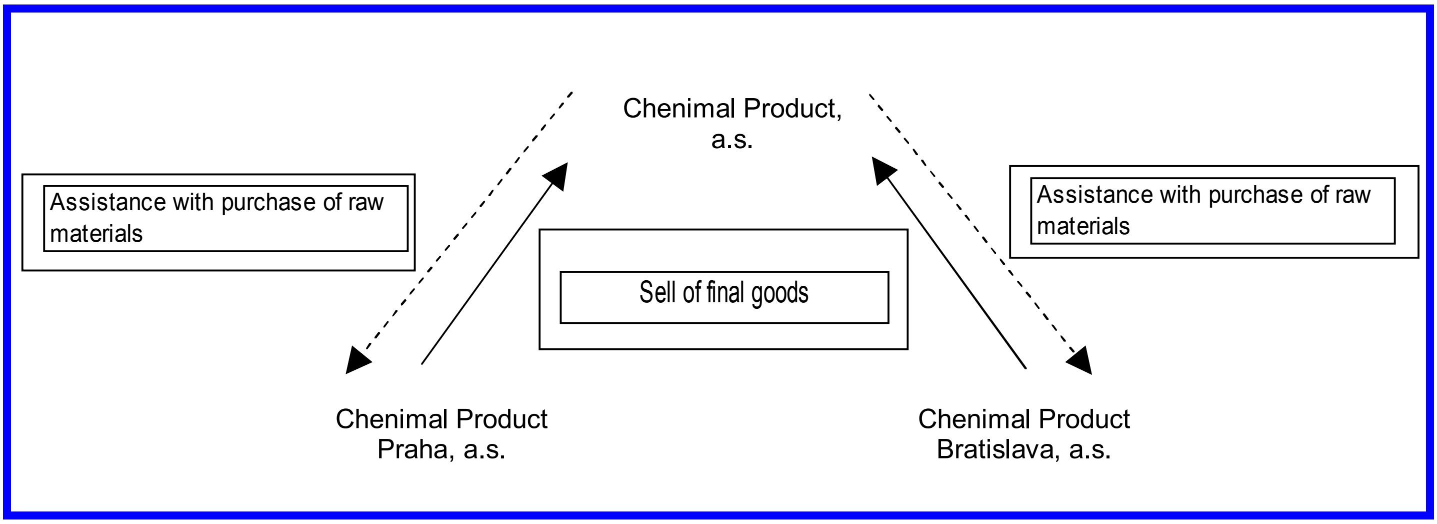
- Chenimal Product Praha a.s., Czech Republic, a company incorporated in the Czech Republic, with its seat in Praha, Czech tax resident (further "CHPP");
- Chenimal Product Bratislava a.s., Slovak Republic, a company incorporated in the Slovak Republic with its seat in Bratislava, Slovak tax resident (further "CHPB") and
- Chenimal Product a.s., Czech Republic, a company incorporated in the Czech Republic with its seat in Brno, Czech tax resident (further "CHP").

[9] The Bureau Van Dijk's AMADEUS database provides information on approximately 10 million European companies (database consists from company trade descriptions, industrial code classification and basic Profit and Loss items).

The transfer pricing study (further the "Study") should review the applied pricing methods within the group on following transactions:

- service provided by CHP to CHPP and CHPB, purchasing activities, whereby CHP purchases materials for CHPP and CHPB, a service fee is paid by CHP to CHPP and CHPB; and
- distribution service, purchase of final products by CHP from CHPP and CHPB and further resale, purchasing price is paid by CHPP and CHPB to CHP.

The Structure of the Chenimal group and the transaction undertaken is presented in the following picture.



In the Study, only the above described transactions are under review, the Study does not involve any other transactions being undertaken among the transaction partners within the group.

7.2 Functional analysis

When identifying the appropriate transfer pricing methods, the group structure, functions and risks of CHP, CHPP and CHPB must be taken into account and analyzed.

Functional analysis is the basis for establishing the transfer price methodology according to the Czech and Slovak tax law that would be consistent with the arm's length principle. It considers especially the functions, risks and intangibles of the involved parties in respect to the reviewed transactions. Furthermore, this analysis provides the initial basis for the further comparable search among the similar independent enterprises and their transactions.

It is obvious, that the function of a related party determines the amount of risk that the relevant party bears and uncovers the responsibilities of such party. The consequence of the specific division of functions among the companies is the influence on the price level. Thus, when searching for the comparable companies, the functions of them performed in the transactions should be taken into account.

7.2.1 Industry overview

The chemical-food processing industry is among the most rapidly developing industries in the Europe. Due to the extensive volume of research and development activities, chemical-food processing industry represents a very specialized form. The characteristic of it is further a huge portion of intangible assets employed and regulation of production procedures or the distribution processes.

As already sad, chemical-food production is based and dependent also on the results of research and development, which could be demonstrated by different substances mixtures development, production methods development etc. As these research activities are relatively investment-demanding and expensive for investing enterprises, the developed know-how is usually protected by patents and licenses. As consequence of the above described, having a license many producers in the chemical-food processing industry produce the products under brand of a different company following the prescribed manufacture procedure rather than producing and developing their own products.

As the quality of the manufactured products represents an important issue, the production of them must comply with the conditions of good manufacturing practice. In light of this, the knowledge of the industry together with technical and personal skills is essential. According to the regulations of the European Parliament all the producers of vitamins, minerals and animal food products have to be registered and there are strict rules as far as the hygienic rules are concerned. The production of animal food has got a specific position in the chemical-food processing industry, as the animal food represents the first step in the whole livestock production.

7.2.2 Group and Company overview

7.2.2.1 Chenimal Product Group

Among the companies operating in the chemical-food processing industry Chenimal Product group occurs as a newly created international group. Companies involved in the Chenimal Product group specialize in manufacturing, marketing and distribution of certain types of food, feeding mixtures, vitamins and minerals (further the "Product").

In order to make the whole production and related activities more effective, Chenimal Product divided the individual activities among the related enterprises and in general, we can talk about the areas of production, sale and distribution and marketing.

The companies concentrated in the Chenimal Product group perform all necessary activities for the business, manufacturing and sale of the Product, whereby the allocation of risks and functions of individual companies in the process is described in further sections. CHPP and CHPB are presented as fully-fledged manufacturers, except for special functions performed by CHP. CHP possesses special pricing policies towards CHPP and CHPB.

CHP contains marketing unit, distribution unit and purchasing unit. The purchasing unit of CHP specializes in purchasing raw material, whereby it bears the risk of short term price changes in respect to the budgeted price and the price of real purchase. The distribution unit bears the risk of a wholesaler. The marketing unit is oriented on the marketing activities for CHPP and CHPB.

7.2.2.2 Chenimal Product Praha a.s.

CHPP is a Czech company operating in the chemical-food processing industry and is oriented on manufacturing of the Product. It is a mother company of CHP in Brno and a potential strategic leader of the group. The most research and development activities are being performed in this company. This company is also prepared to store the goods and distribution and sale activities take place here. The associated CHP company cooperates with CHPP in purchasing the raw materials for CHPP.

When examining the functions of CHPP in the observed transaction, factors as production limits (break-even-point), pricing (trade-off between product margins and sales volumes), corporate strategy (organizational and operational structure, maximizing profit etc.), reputation (trade marks, trade names) and compliance with legal regulations were taken into account.

Before using the services of CHP by purchasing the raw materials, CHPP was responsible for the purchases on its own and performed all the necessary activities employing its own inputs. These activities related to the purchase of raw materials were for example market research and selection of a suitable supplier, communication with the suppliers, negotiating the terms and conditions of the contract concluded with the supplier etc. As these activities were enormously time and technically demanding, CHPP decided to cooperate with CHP and shift them into this entity.

CHPP still purchases the equipment necessary for the productions, as machines, furniture etc. It also performs research and development and testing of the quality of produced goods.

As far as the production of CHPP is concerned among the Product of CHPP we can mention around 20 different kinds of vitamin and mineral mixtures and around 100 different animal feeding mixtures. Products are oriented on feeding of small animals as dogs, cats, mice, hamsters, guinea-pigs etc., further for animals kept for livestock production as pigs, cows etc. Quite a dominant share of the production is dedicated to the products for horses, as there is huge variety of goods being demanded from the consumers and the popularity of these goods is growing rapidly. The mixtures or food additives are divided into groups according to the purpose of their consumption (different purpose of breeding – animal as a source of food, hobby, racing animals etc., different age of animals.)

CHPP faces the risk in the areas of production pricing, limits of production, corporate strategy or market risk. The risk of purchase price for raw materials has been among separate budget periods transferred to CHP. However, the overall purchase price fluctuation risk (changes across different budgeting periods) stays by CHPP. CHPP also bears the risk that the manufactured product will not be authorized or will not comply with the hygienic norms and rules.

Furthermore, CHPP faces the market risk in the sense that the product would be saleable at a price that would not generate a profit. The storage risk is not high as CHPP produces the volumes of Products actually ordered by CHP and it usually does not store the product for a long time period.

7.2.2.3 Chenimal Product Bratislava a.s.

CHPB is a Slovak company and it is oriented on the manufacturing of the same Product. Also part of the research and development activities is situated to this enterprise. Again, as by CHPP, CHP provides CHPB with purchasing services when assisting the CHPB with purchasing of raw material.

The basic functions and activities performed by CHPB are similar to those performed by CHPP. Again, as the basic activity of CHPB is the manufacturing of the Product, the break-even-point is being settled by CHPB as well as the pricing strategy and the organizational and operational structure.

As by CHPP, the purchasing activities of raw materials for the production were transferred to CHP, whereas the purchases of equipment or goods necessary for the operational business stays in the hands of CHPB.

As far as the Product production is concerned, among the Product of CHPB we can mention around 15 different kinds of vitamin and mineral mixtures and around 80 different animal feeding mixtures. Products are, as by CHPP, oriented on feeding of small animals as dogs, cats, mice, hamsters, guinea-pigs etc., further for animals kept for livestock production as pigs, cows etc and horses. Again, the mixtures or food additives are divided into groups according to the purpose of their consumption (different purpose of breeding – animal as a source of food, hobby, racing animals etc., different age of animals.) CHPB does not store the goods or distribute it in the area of Slovak Republic, all these activities are transferred to CHP and CHPB sells all its Products to CHP.

CHPB bears the similar risk as CHPP does as the functions and activities of CHPB are similar to those of CHPP as well (see description above).

7.2.2.4 Chenimal Product a.s.

CHP is a Czech company and it is a subsidiary of CHPP. CHP performs cooperating activities with CHPP and CHPB by providing them with distribution, marketing and promoting services and, furthermore, CHP assists CHPP and CHPB with buying the raw materials. The main functions of CHP are to promote the products of CHPP and CHPB and to sell them. The basic idea behind this structure is increasing effectiveness by collecting the purchasing, distribution and marketing activities into one company and the research, development and manufacture in two others situated one in the Czech Republic and one in the Slovak Republic. Strategic is also the geographical location of CHP, CHP is situated in Brno which is on the geographical connection between the two manufacturing enterprises. The flexibility and geographical location of the company helps the enterprise to cooperate with both entities, CHPP and CHPB, and to provide them with its services.

As already explained, CHP does not produce any own products, it trades the purchased Products form CHPP and CHPB. When purchasing the goods from CHPP or CHPB, CHP acts in the name of the two separate entities. The purchased goods are thereafter the delivery paid by CHPP and CHPB. CHP is oriented on marketing research, contacting and communicating with the suppliers, negotiating the best conditions etc.

Furthermore, after the Product is being manufactured by CHPP and CHPB, it is sold to CHP. These sells comply with the market demands as being observed by CHP. In this process, CHP is not obliged or forced to buy the manufactured goods, it acts independently when ordering the types or amounts of production according to its plans.

CHP bears different risks than its partners, as the functions and the activities of this entity differ from those that the others two perform in the whole process. CHP bears the marketing risk, that the promotion activities will not be successful in the demanded volume, further the risk that CHPP and CHPB will not be able to produce qualitative saleable product, as these suppliers are the only suppliers of CHP. CHP also bears the risk arising from the purchase assistance provided to CHPP and CHPB. CHP guarantees purchasing price for CHPP or CHPB in a respective budget period, the result is that CHP can make loss or profit on this transactions. As far as the distribution is concerned, CHP bears the risk that the product is not saleable or that the sold Product will not be paid by the customers. Actually, the risk borne by CHP is similar to the risk born by an independent wholesaler.

7.2.3 Summary of Functional Analysis

As already mentioned, CHPP and CHPB are fully-fledged manufacturers who decide about the strategy of production, about produced volumes etc. and thus bear the risk connected to the production and manufacture. CHPP and CHPB do not take the risks related to the distribution as they do not carry the wholesale functions. CHPP and CHPB also do not bear the purchase price fluctuation risk in the full amount as they let the CHP to assist them with the purchases and CHP guarantees them the purchase price for a specific time period. The risk of purchase price fluctuations is, thus, transferred to CHP.

CHP functions in the whole procedure are purchasing of raw materials, marketing and distribution functions. The risk born by this entity corresponds with these functions. It is the purchase price fluctuation risk, wholesaler risk and the marketing risk.

The transfer pricing study related to the Chenimal group is devoted to the analysis of purchasing of raw materials for CHPP and CHPB and the sale of goods to CHP by CHPP and CHPB whereby the levels of service fee and the purchasing prices are analyzed. In both transaction types, CHP is the tested party.

7.3 Analysis of Pricing Policies

7.3.1. Purchasing of raw materials by CHP for CHPP and CHPB

As already described above, CHP performs all the activities connected to the purchase of the raw materials as market research, contacting of the suppliers, choosing the best suppliers, negotiating the price of the supplied goods etc. CHP does not buy and own the raw materials, but it negotiates the price for the buyers who are CHPP and CHPB. However, even though CHP does not buy the raw materials, it bears part of the risk that the purchasing price will fluctuate, as it guarantees the purchase price for CHPP and CHPB for specific agreed period.

The basic question and the point of the analysis is to determine whether the price agreed as a purchase price (service fee) for CHPP or CHPB is arm's length. This price should correspond to the price that CHP would demand when cooperating with some independent entity. For the negotiating the price and for all other activities connected to the purchase assistance CHP charges a service fee. This fee is composed of two parts, the first is based on the actual incurred costs and is then increased by the mark-up whereas the second consists from the differences of the actual purchase price of the raw materials and the pre-agreed guaranteed price.

The mark-up should be added to the price in every case and as it is declared by CHP this mark-up amounts to 5 %, which corresponds with the usual mark-up level among other companies and as such is on the arm's length level. However, the second part of the service fee that CHP is charging is a variable fee which reflects the actual situation on the market. There is an arrangement between CHP and CHPP or CHPB that CHP takes 80 % of the potential profit/loss resulting from the price fluctuation and the rest should be born by CHPP/CHPB.

7.3.2. Purchase of goods by CHP from CHPP and CHPB

The agreement between CHP and CHPB or CHPP is based on the sales orders of CHP that comply with the market research and analysis of the market demands performed by CHP. The planning process that CHP is undergoing is similar to the planning process performed by a usual independent entity. CHPP and CHPB offer a discount to CPP for purchasing their products in big amounts. According to the arrangement CHP and CHPP or CHPB intend to achieve a margin of 4,5% by selling the product to the final customer. CHP is also remunerated for fulfilling the budget plan, if the sales are higher CHP achieves additional profit whereas if the sales are lower than planned CHP suffers loss.

7.4 Selection of transfer pricing method

As far as the proper transfer pricing method is concerned, in general, we can say that the traditional transaction methods are preferred to the others. When the obtained data or information are of insufficient quality or when no data available, the transactional profit methods should be applied. Thus, in the first step the comparable uncontrolled price method, cost plus method and resale price method will be considered.

7.4.1. Purchase of raw materials and selection of proper transfer pricing method

The arrangement agreed between CHP and CHPP or CHPB is in its nature unique, consequently there is no comparable transaction between independent enterprises that would offer reliable data for comparing it with our observed transaction. There is no such similar arrangement among independent enterprises found, where the individual entities would perform same functions and bear the same risks. Among independent enterprises it is not typical or usual that an enterprise does not have its own purchasing department and relies solely on the purchases of a separate entity. As a result, we can reject the comparable uncontrolled price method. We can also reject the cost plus method, as this is based on analyzing the cost incurred in connection to the provided services. The costs incurred by CHP relating to the provision of the assistance services could be determined, however, as the service is provided jointly for two enterprises, it is impossible to separate the costs and to determine the exact share on the costs of the relevant entities. Furthermore, we can also exclude the resale minus method, as there is actually no resale in this case.

When taking account the construction of the transaction, both entities CHPP and CHPB profit jointly from undertaking the transaction with CHP. Considering this, we can conclude, that the appropriate transfer pricing method to be chosen is the profit split method. This method could be applied in the following way:

- in the first step, basic return for CHP should be established by using the cost plus method
- in the second step the arm's length price is established by sharing the residual profit between CHP, CHPP and CHPB.

In the first step CHP uses the level of its costs and adds another 5 % to them as remuneration for their activity. The profit margin in the amount of 5 % is reasonable and could be seen as on arm's length level according to the activities performed in respect to the usual margins applied. However, analyzing the margin in this transaction is not the objective of this study, as it concentrates on the split of the additional profit that creates the final price for the buying entities.

The residual profit (or loss) is then in the second step split between the enterprises according to the risks and functions of the entities in the transaction. As CHP bears the risk of possible price change during the transaction, 80 % of the residual profit goes as a remuneration for CHP. The rest of the residual profit (or loss) in the amount of 20 % belongs to CHPP and CHPB. This allocation of the profit could be seen as reasonable, as it follows the risks and potential benefits of all entities, thus, no incorrectness in the applied procedure has been identified.

Obviously, the potential risk and thus also the potential profit or loss strongly depend on the level of agreed prices and budget over the relevant budgeting period. As a result, CHP is motivated to agree the possible highest prices and to achieve the possible large savings during the procedure of purchasing the raw materials. On the other hand, CHPP and CHPB have to follow realistic plans and agree on prices that could be expected on the market. However, as it is quite difficult to predict the price development of raw materials, CHP should expect both possible scenarios, profit and loss.

The Problem that might be connected to this arrangement is the possible argumentation of the Tax Authority, that the budgeting is adjusted in order to shift the profit to one or another entity. In case of arrangement between CHPP and CHP the problem seems to be less probable, as the level of the corporate income tax is the same for both entities being Czech tax residents. However, possible shifts of the profit could be seen as advantageous in the situation when one or another entity suffers an overall loss (also other factors as allowances, asset and amortization structure etc. that influence the final tax liability should be taken into account). Thus, the observation of this transaction is relevant for the Tax Authority also among the Czech Republic. Considering this, the enterprises should be based on a proper documentation able to declare, that the arrangement was agreed taking all the relevant factors and known information into account. Furthermore, as CHP and CHPP or CHPB are applying the same budgeting policy or methodology for a longer time, it is obvious whether the relevant factors and knowledge of the facts was appropriate considered or not, as it is really improbable that the management or responsible employees will not be able to predict the prices properly every period again and again.

Summarizing the above, the described arrangement and pricing policy could be seen as arm's length, as it reflects the functions performed and risks borne by individual entities being involved in the transactions. The most important aspect when protecting the entities from being challenged by the Tax Authority is an appropriate documentation and evidence of the budgeting policy.

7.4.2 Sales of goods and their distribution

Again, in this type of transaction, the basic principle that should be followed consists from considering the functions and risks of all involved entities. Also in this transaction, CHP is the tested entity.

By purchasing the final goods from CHPP and CHPB, CHP has been identified as a wholesaler of vitamins, minerals and animal feeding mixtures. According to the publicly shared information, no information about comparable uncontrolled prices in the same arrangement is available, thus the comparable uncontrolled price method has to be rejected. Usually, other independent entities performing the similar activities and producing similar products distribute their goods using their own resources and employees or they have contractual partners who buy the products directly from them.

For the calculation of an arm's length level of price the resale minus method could be used, as the CHP acts as a wholesaler and sells and distributes the purchased goods. The reselling price of these goods is established by market, thus, as such on the arm's length level. When deducting the margin of CHP from the reselling price, the final purchasing price can be calculated. Thus, the analysis will be based on two parts (combining the resale price method with the comparable search). In the comparable search all the comparable companies are reviewed with focusing on their profit margin as this the key information to determine whether the applied prices are arm's length.

As CHP does not bear any substantial risk in this kind of transaction, the margin should reflect this aspect and be rather low. For determining the reselling price of the goods a set of comparable enterprises should be identified taking all relevant factors of the distribution into account.

7.5 Comparable search for resale price method

The comparable search is oriented on companies acting as wholesalers of animal food products, vitamins, minerals and also other products that have the same characteristics (product characteristics, industry characteristics etc.). These could be for example some products from the food industry and others.

The companies that perform also other activities or distribute an incomparable product are excluded from the observation. An incomparable product is for example such product that can not be stored and distributed in the same way, as for example frozen meals, ready-to-serve meals or other fresh products etc. Also companies that were involved in intercompany transaction have to be excluded from our observation. The research is also limited on companies performing their activities in the area of Europe.

The basic data source that was used is the AMADEUS[10] database. The process of searching consists of two steps. In the first step a sample of such companies was identified, that could be potentially seen as comparable. This selection is based on AMADEUS search functions, as this database is able to eliminate all companies that do not match the entered criteria. The second step consists from a manual review of all previously selected companies and a further selection of appropriate companies.

7.5.1 Criteria involved in AMADES search

The criteria that were involved in the AMADEUS search were the following:

1. Industry Classification Codes Screening Criterion (Inclusion Criterion)

The first step in the search process was to examine the primary NACE[11] Rev 1.1 codes most likely to contain companies that would meet the comparability

[10] The companies' financial data is compiled into a standard format including 23 balance sheet items and 25 profit and loss account items from which ratios can be calculated.[10] AMADEUS also includes information on companies' legal forms, year of incorporation, addresses, directors, shareholder, participations, industry codes, and trade descriptions. The level of information provided for each company depends on availability.

[11] Nomenclature générale des activités économiques dans les communautés Européennes - the NACE Rev. 1 codes were derived from the revised International Standard Industrial Classification of All Economic Activities (ISIC Rev. 3), which were adopted by the United Nations Statistical Commission in 1989. The European Commission decided that NACE Rev. 1 should be introduced uniformly in all member states of the European Union. Upon approval of the European Council of Ministers in 1990, the use of NACE Rev. 1 has become obligatory for the classifications of economic activities in the European Union from 1 January 1993.

characteristics described above. In the AMADEUS search the NACE rev. 1.1 code 5121 – Wholesale of grain, seeds and animal feeds was used.

In this first step a large number of companies were selected, there were 21 269 potentially comparable companies found.

2. Excluding Keywords

Further, the following excluding keywords were implemented in the search in order to eliminate companies that were engaged in other activities: “assemb”, “equipment”,”instrument”,”manufactur”,”process”,”produci”,”producti”,”rent”.

After applying these criteria the set of potentially comparable companies was reduced to 17 242.

3. Availability of Financial Screening Criteria

The results of the search were further oriented on three basic financial criteria. After applying them, the automatic search mechanism rejected all companies that did not show the turnover for at least one of the latest financial years (sample reduced to 11 322). This was mainly because of the further necessary steps that are based on computation of financial ratios.

Furthermore, only such companies with the turnover exceeding EUR 500 000 and with a positive operating result were taken into account, whereby the rest of the sample was excluded. This limitation is in general because of eliminating small companies that usually face a different level of risks and usually have different operating profiles. It also excludes companies that are in the start-up phase or in a crisis. After applying the turnover criterion and the positive operating result criterion the sample was reduced to 6 083 companies and to 5391 respectively.

4. Automatic independence criteria

Through the research the independency of individual entities must be guaranteed. Using the AMADEUS "independence" criterion all the companies where one shareholder owns a stake of more than 25 percent (ownership by employee, management, family of individual allowed) and companies owning stakes bigger than 25 percent in other companies were excluded from further research.

The application of the independence criterion eliminated 4 783 companies, thus, the set of potentially comparable companies was reduced to 608.

5. Consolidation Criterion

Applying the consolidation criterion the AMADEUS database search exclude all companies that have consolidated and also unconsolidated statements. This is done basically as a protection against taking into account any duplicities and especially groups of associated companies. The size of the set was 579 after applying the consolidation criterion.

6. Activity Status Criterion

The purpose of applying the activity status criterion is to eliminate of all non-active companies. This criterion resulted in rejection of 7 companies.

After applying the different criteria in the automatic database search, the resulting set of potentially comparable companies consists of 572 entities.

7. Geographical Restriction

The examined sample was further restricted on 27 EU countries, whereby the resulting size of the set was 129. Appendix A shows the general overview of the selected countries with the information of geographical location. The following figure shows the geographical distribution of them.

Figure 16: Geographical distribution of the set of the potentially comparable companies.

Country	No. of Entities
Bulgaria	1
Denmark	2
Estonia	1
France	68
Germany	1
Greece	2
Hungary	1
Lithuania	1
Poland	1
Portugal	11
Romania	2
Spain	36
Sweden	2
United Kingdom	**129**

Appendix B shows the overall step by step results during the whole strategy of eliminating incomparable companies through AMADEUS.

7.5.2 Manual screening process

In the manual screening process the potentially comparable companies were further tested as far as the business description is concerned. The short description of the business activities is provided by AMADEUS, however, not in all cases. During this stage of the research process, additional criteria were established to focus the sample on those companies with characteristics most comparable to those of CHP.

Only those companies were taken that operate with the similar product and in the similar way (trade, wholesale distribution, supply). All the companies where there was insufficient description of their activities were rejected. Companies that were engaged in intercompany activities were also rejected.

Summarizing this, we could say that the reasons for further elimination during the manual screening process were: incomparable or unrelated products, unrelated business activity, inconsistent data or information, insufficient trade description or potentially intercompoany transactions.

Applying this procedure 100 companies were rejected and the set was reduced to 39. Appendix C provides further details regarding the companies eliminated from the analysis, including the company business descriptions and reasons for elimination.

7.5.3 Financial Analysis

The selected 39 companies and their financial results were used to establish the arm’s length range of the operation margin of those companies. The purpose of this further step is to compare the operating margin of independent companies generated by the similar transactions with the operating margin of CHP resulting from its activities. As we can use the resale prices and prices charged by CHPP and CHPB, we can also determine the operating margin. Should this operating margin of CHP (which is at the level of 4,5 %) be dramatically lower or exceed the operating margin typical for similar entities performing similar activities with the similar product, we can conclude, that the prices charged for the CHPP and CHPB products are not arm` s length. On the other hand, should the operating margin be in the range produced through our analysis of the financial data, we can conclude, that the prices being applied for the associated transaction are at the arm’s length level and no further adjustments are necessary from the transfer pricing point of view.

7.5.3.1 Multiple Years Data

According to the OECD Guidelines it might be generally useful to examine data from both the year under examination and prior years. Thus, the analysis attempted to obtain the most recent publicly available financial data for all the comparable companies. Using the multiple years of financial data we can evaluate the performance of the companies over time and eliminate or smooth all abnormalities that might appear when checking only the single year results. Our analysis on the comparable companies covers the financial years 2005 through 2007. Appendix D provides the relevant financial data of individual companies.

7.5.3.2 Profit Level Indicators

Considering the comparable companies we can calculate the profit level indicator (further "PLI") for each company. The PLI calculated was the operating profit margin defined as operating profit divided by turnover.

7.5.3.3 Interquartile Range

The interquartile range was used in order to increase the reliability of the results. The results for PLI should be according to statistical theories normally distributed around the median. For points that lie on either extreme of the curve, there is a risk that these observations are anomalous and unrepresentative of an arm's length return. Thus, only the interquartile range of the results was taken as an acceptable result.

In an interquartile range, the first quartile is the value below which 25 % of the observed values are located. The third quartile is the value above which 25 % of the observed values are located. The median is the value below and above which 50 % of the observed values are located. Therefore, the interquartile range indicates the most typical values of a tested variable.

7.5.3.4 Averaging Method

Using the financial data of the selected companies the average operating profit margin was calculated for each company. This average data of individual companies were then used for calculating the interquartile range.

7.5.3.5 Pooling Method

Pooled data was also used to calculate an interquartile range. Under the pooling method, each data point represents one observation from which to construct the interquartile range. If a company has more than one year of financial information available, then the PLI for each year represents a separate observation to be used in the construction of the interquartile range (i.e., the separate observations were used instead of one as in the case of the simple average method where the average PLI over the available years is taken).

The effect of the pooling method is to increase the number of observations and is particularly useful when data is not available for companies for all of the years under analysis.

7.5.3.6 Results of the Financial Analysis

As previously mentioned, the search for companies comparable to CHP performing wholesale of animal feed, vitamins and minerals resulted in the identification of 39 companies. The financial results of these companies were utilized to establish the arm's length ranges of the selected PLI. The results are presented in Figure 17 below.

Figure 17: Arm's length ranges of the selected PLI

Wholesale of grains, seeds and animal feeds		
Operating Margin Interquartile range		
	3-years Average	**3-Years Pooled**
Lower Quartile	1,09 %	1,04 %
Median	**2,10 %**	**1,89 %**
Upper Quartile	4,57 %	5,14 %

The analysis shows that independent comparable companies achieved the interquartile operating margin ranging from 1,09 % percent to 4,57 % percent, with a median of 2,10 % percent under the simple-average method. Calculating the pooled average of the operating margin as of the selected companies, it ranges from 1,04 % to 5,14 %, whereby the median equals to 1,89 %. As the operating margin of CHP generated by our examined transaction equals to 4,5 %, we can consider the prices to be on the arm's length level.

CONCLUSION

According to the transfer pricing regulation and legislative, the transaction among Chenimal group consisting of three associated entities were examined. The transfer pricing analysis focused on two transactions. First transaction was undertaken when Chenimal Product a.s. (“CHP”) assisted by purchase of raw materials for Chenimal Product Praha a.s. (“CPPP”) and Chenimal Product Bratislava a.s. (“CHPB”). For its services CHP charged a service fee. The second transaction was the distribution of final goods purchased by CHP from CHPP and CHPB.

In the transactions oriented on purchase of raw materials performed by CHP for CHPP and CHPB, CHP is the tested company, whereby it is the service provider and charges the service fee. In this case, no comparable uncontrolled price is available, as there is no information on similar transactions or arrangements between independent enterprises due to the uniqueness of the transaction. Hence, it is not possible to use the comparable uncontrolled price method. Also the cost plus method does not seem to be the appropriate method to determine the arm’s length price, as the exact cost resulting from performing the services are not easy to express. CHP can obviously calculate the costs relating to the provided service, however, the problem appears when identifying the proportion of costs that should be borne by CHPP or CHPB, as the service is being performed jointly for both entities. From our analysis we could also exclude the resale minus method, as no concrete goods for exact prices are being sold.

As a result, the profit split was applied. The residual profit (or loss) is split between the enterprises according to the risks and functions that the entities perform in the transaction. As CHP bears most of the risk connected to the price fluctuations, the share on the profit (loss) of CHP is 80 % and the rest belongs to CHPP and CHPB. We can consider this allocation as reasonable and arm’s length as it corresponds with the risks and potential benefits of all entities.

In the second examined type of transaction CHP has been identified as a wholesaler of vitamins, minerals and animal feeding mixtures. As there are no publicly available information about the similar comparable transaction between independent entities, the comparable uncontrolled price method had to be rejected. CHP acts as a wholesaler and sells and distributes the purchased goods, thus the resale minus method was applied. The reselling price of these goods is established by market, thus, as such on the arm's length level. By deducting the margin of CHP from the reselling price, the final purchasing price could be calculated. The margin as such was compared performing the comparable search among similar comparable companies.

The analysis showed that independent comparable companies achieve the interquartile operating margin ranging from 1,09 % percent to 4,57 % percent, with a median of 2,10 % percent under the simple-average method. Under the pooling method the operating margin ranges from 1,04 % to 5,14%, whereby the median equals to 1,89 %. As the operating margin of CHP generated by our examined transaction equals to 4,5 %, the conditions of the transactions were consider as arm's length.

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