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REVISED OECD TRANSFER PRICING GUIDELINES AND THE CZECH TAX POLICY

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Abstract

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In applying the international principles to the taxation of Multinational Enterprises, one of the most difficult issues that have arisen is the establishment for tax purposes of appropriate transfer prices. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. The Committee on Fiscal Affairs, which is the main tax policy body of the OECD, has issued a number of reports relating to the transfer pricing issues. The most important are the Transfer pricing Guidelines for multinational enterprises and tax authorities which was published in 1995. These Guidelines focus on the application of the arm's length principle to evaluate the transfer pricing of associated enterprises, the analysis of the methods for evaluating whether the conditions of commercial and financial relations within Multinational Enterprises satisfy the arm's length principle and discussion of the practical application of those methods. Simply, these Guidelines focus on the main issues of principle that arise in the transfer pricing area. The Committee on Fiscal Affairs continues its work in this area, on 22 July 2010 approved and released the proposed revisions to Chaps. I through III of these Guidelines and simultaneously published a new Chap. IX related to business restructuring. The revisions are the result of several years of work on comparability and the use of profit-based methods. The revised text will have a significant impact on the application of transfer pricing analysis and transfer pricing methods. The paper is focused on significant changes of newly approved Guidelines with aim to evaluate how the Czech Republic began applying the principles set out in the revised text of these Guidelines.

the OECD Transfer pricing Guidelines, the arm's length principle, Multinational Enterprises, transfer pricing methods, comparability

The role of multinational enterprises (MNEs) in world trade has increased dramatically over the last 20 years. The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context. These issues arise primarily from the practical difficulty, for both MNEs and tax administrations, of determining the income and expenses of a company or a permanent establishment that is part of an MNE group that should be taken into account within a jurisdiction, particularly where the MNE group's operations are highly integrated.

In applying the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in their transactions with each other. However, the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established if the group members had been acting as independent enterprises operating in open markets. To ensure the correct application of the separate entity approach, OECD[1] member countries[2] have adopted the arm's length principle, under which the effect of special conditions on the levels of profits should be eliminated.

These international taxation principles have been chosen by OECD member countries as serving the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimising conflict between tax administrations and promoting international trade and investment.

The foregoing principles concerning the taxation of MNEs are incorporated in the *OECD Model Tax Convention on Income and on Capital* (OECD Model Tax Convention), which forms the basis of the extensive network of bilateral income tax treaties between OECD member countries and between OECD member and non-member countries. These principles also are incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Nations. The main mechanisms for resolving issues that arise in the application of international tax principles to MNEs are contained in these bilateral treaties.

In applying the foregoing principles to the taxation of MNEs, one of the most difficult issues that has arisen is the establishment for tax purposes of appropriate transfer prices[3]. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises[4] in different tax jurisdictions. The Committee on Fiscal Affairs has issued a number of reports relating to transfer pricing issues of MNEs. The most important report is the *Transfer pricing Guidelines for multinational enterprises and tax authorities* which was published in 1995. These Guidelines focus on the application of the arm's length principle to evaluate the transfer pricing of associated enterprises. The Guidelines are intended to help tax administrations and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimising conflict among tax administrations and between tax administrations and MNEs and avoiding costly litigation. The Guidelines analyse the methods for evaluating whether the conditions of commercial and financial relations within an MNE satisfy the arm's length principle and discuss the practical application of those methods. These Guidelines are also intended primarily to govern the resolution of transfer pricing cases in mutual agreement proceedings between OECD member countries and, where appropriate, arbitration proceedings. So, these Guidelines generally focus on the main issues of principle that arise in the transfer pricing area.

The last revision of Chapters I–III and a new Chapter IX of these Guidelines were approved on 22 July 2010, reflecting several years of work undertaken by the Committee on Fiscal Affairs on comparability, on transactional profit methods and on the transfer pricing aspects of business restructurings. The revised text will have a significant impact on the application of transfer pricing analysis and transfer pricing methods. The Committee on Fiscal Affairs intends to continue its work in this area. These Guidelines will continue to be supplemented with additional guidance addressing other aspects of transfer pricing and will be periodically reviewed and revised on an ongoing basis.

The paper is focused on significant changes of newly approved Guidelines (2010) with aim to evaluate how the Czech Republic began applying the principles set out in the revised text of these Guidelines.

MATERIALS AND METHODS

The basic source of our research was the OECD Transfer pricing Guidelines which was issued by the OECD in 1995 and its approved revision of the chapter I–III and new chapter IX on July 2010. The next sources were the decrees related to transfer pricing *D-258 Communication by the Ministry of Finance in respect of international standards application in taxation of transactions between associated enterprises – transfer pricing* issued by Czech Ministry of Finance in 2004, D-292 *Communication by the Ministry of Finance in respect of s.38nc of Act no. 586/1992 Coll., on income taxes – binding consideration over the transfer pricing policy used in related party transactions* and D-293 *Communication by the Ministry of Finance in respect of the scope of transfer pricing documentation* issued by Ministry of Finance

1 The organisation for econimic co-operation and development is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation.

2 The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

3 Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises.

4 Associated enterprise is an enterprise that satisfies the conditions set forth in Article 9, sub-paragraphs 1a) and 1b) of the OECD Model Tax Convention. Under these conditions, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if "the same persons participate directly or indirectly in the management, control, or capital" of both enterprises.

in 2006. In addition, the last sources were updated decrees D-332, D-333 and D-334 which replaced above mentioned decrees of Ministry of Finance and became effective on 1 January 2010.

Within the paper, the analysis and synthesis as scientific methods were used to introduction of the main changes in OECD Transfer pricing Guidelines and in above mentioned decrees of Ministry of Finance and consequently summarized into the final results. Furthermore logical-systematic method was applied for elucidation of actual situation of associated entities in the Czech Republic, creation of the partial outcomes and final results.

RESULTS AND DISCUSSION

Changes to chapters I through III

The Guidelines has reaffirmed the position of **the arm's length principle** as the international standard and the fairest and more reliable basis for determining taxable profits.

The old Guidelines suggested that the traditional transaction methods were to be preferred over transactional profit methods. In exceptional cases where traditional transaction methods could not be reliably applied alone or exceptionally could not be applied at all - these would be considered cases of last resort, in such cases of last resort, was suggested application of a transactional profit method. The transactional profit methods were discribed as methods of last resort.

The most significant change is the **removal of the distinction between traditional methods and profit-based methods**. In principle, the traditional transaction method and a transactional profit method can be applied in an equally reliable manner. Paragraphs 2.1–2.11 provide guidance on the selection of the most appropriate transfer pricing method to the circumstances of the case. For this purpose, the selection process should take account of the respective strengths and weaknesses of the OECD recognised methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them. However, where the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred. Since the CUP method is the most direct and reliable way to apply the arm's length principle is the CUP method preferable over all other methods. So, if it is an even choice between the CUP method and other methods, the CUP should still prevail.

Another major change is **higher standards of comparability** when using the profit-based methods. It means that a comparability analysis must be performed in all cases in order to select and apply the most appropriate transfer pricing method, and the process for selecting and applying a transactional net margin method should not be less reliable than for other methods. So, the comparability analysis still plays central role in applying the arm's length principle and is detail described in Chapter III. In addition to the five comparability factors which have been present in the Guidelines since 1995, a **nine-step process** has been added as an accepted good practice of applying the recommendations of the revised Guidelines. Below is a description of a typical nine-step process:

- Step 1: Determination of years to be covered.
- Step 2: Broad-based analysis of the taxpayer's circumstances.
- Step 3: Understanding the controlled transaction(s) under examination, based in particular on a functional analysis.
- Step 4: Review of existing internal comparables, if any.
- Step 5: Determination of available sources of information on external comparables.
- Step 6: Selection of the most appropriate transfer pricing method.
- Step 7: Identification of potential comparables.
- Step 8: Determination of and making comparability adjustments where appropriate.
- Step 9: Interpretation and use of data collected, determination of the arm's length remuneration.

The "broad-based analysis" is an essential step in the comparability analysis since helps understand the conditions in the taxpayer's controlled transaction as well as those in the uncontrolled transactions to be compared, in particular the economic circumstances of the transaction. A common source of information for the comparability analysis is commercial databases, which can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case. However, use of commercial databases should not encourage quantity over quality.

The identification of potential comparables has to be made with the objective of finding the most reliable data, recognising that they will not always be perfect. However, even in cases where comparable data are scarce and imperfect, the selection of the most appropriate transfer pricing method should be consistent with the functional analysis of the parties. The process of identifying potential comparables is one of the most critical aspects of the comparability analysis and it should be transparent, systematic and verifiable.

For the first time Guidelines endorses **the use of statistical tools** that (*e.g.* the interquartile range[5] or other percentiles) might help to enhance the reliability of the analysis to draw conclusions from the data that have been found. Measures of central tendency may be used to determine the most appropriate point in the range (for instance the median, the mean or weighted averages, etc.), in order to minimise the risk of error due to unknown or unquantifiable remaining comparability defects. Currently, many tax administrations require a narrowed range of results, so-called interquartile range, to eliminate extreme results. Next important change is **using of multiple-year data**. As recommend Guidelines, it may also be necessary to use multiple-year data in order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction and to take into consideration effects resulting from temporary accounting differences, varying business and product life cycles and discrepancies in short-term economic conditions which have an impact on net profitability of controlled and/or uncontrolled transactions. Such an analysis may be particularly useful where a transactional profit method is applied. It is possible so that the net margins of more than one year may be looked at on an average basis, however, a number of OECD member countries have the rule of examining the fiscal years separately. The determination of the interquartile range and using of multiple-year data are stated in the Tab. I.

Generally, it is a good practice for taxpayers to set up a process to establish, monitor and review their transfer prices, and they should also expect to provide documentation demonstrating the conduct of a detailed comparability analysis.

The revised Guidelines are now more concerned on **the selection of financial ratios or profit level indicators**. There are a number of different profit level indicators available for an arm's length test under TNMM. The choice of a profit level indicator and the appropriateness of its application depend on, for instance, whether the tested party is a service provider, production facility or sales organization.

I: *The interquartile range*[6]

Results	2009	2008	2007	Average
		Operating margin (%)		
Median (50th percentile)	4.87	10.10	9.92	8.30
First quartile (25th percentile)	**2.59**	**6.76**	**7.72**	**5.69**
Second quartile (50th percentile)	4.87	10.10	9.92	8.30
Third quartile (75the percentile)	**11.38**	**18.97**	**35.26**	**21.87**
Lower Limit	–25.28	–2.66	4.83	–7.70
Upper Limit	12.62	26.20	44.17	27.66
Tested party	9.76	7.89	15.54	11.06

Source: own calculation and processing

II: *Denominators of net profit level indicators*

<table>
<tr><th rowspan="5">Denominators of net profit level indicators</th><th colspan="3">Different activities</th></tr>
<tr><th>distribution activity</th><th>manufacturing activity or service providers</th><th>capital-intensive activity</th></tr>
<tr><td>$\frac{\textit{Operating profit}}{\textbf{Sales}}$</td><td>$\frac{\textit{Operating profit}}{\textbf{(cost of goods sold + operating expenses)*}}$</td><td rowspan="3">$\frac{\textit{Operating profit}}{\textbf{(total assets – non-operating assets inc. cash)**}}$</td></tr>
<tr><td>$\frac{\textit{Operating profit}}{\textbf{Distribution operating expenses}}$</td><td>$\frac{\textit{Operating profit}}{\textbf{Operating expenses}}$</td></tr>
<tr><td colspan="2">$\frac{\textit{Gross operating profit}}{\textbf{Operating expenses}}$</td></tr>
</table>

* Cost of goods sold + operating expenses define Total costs.
** Non-operating assets covers cash and equivalents, financial assets and other financial investments, tax receivables and deferred tax assets.
Note: Denominators are highlighted.
Source: OECD Transfer pricing Guidelines, own processing

5 The interquartile range is the range from the 25th to the 75th percentile of the results derived from uncontrolled transactions. Only those 50 percent of observations which are closest to the median are considered as a reliable range of arm's length results.

6 The interquartile range is highlighted, for example 2.59 percent to 11.38 percent for year 2009 or 5.69 percent to 21.87 percent for the period 2007 to 2009 as average of results. Because the profit margin of the tested party falls within this interquartile range, even in all three years when the multiple-year data were used, the taxpayer concludes that the arm's length test is met.

The selection of the denominator should be consistent with the comparability (including functional) analysis of the controlled transaction, and in particular it should reflect the allocation of risks between the parties. The denominator should be focused on the relevant indicator(s) of the value of the functions performed by the tested party in the transaction under review, taking account of its assets used and risks assumed. Typically, and subject to a review of the facts and circumstances of the case, sales or distribution operating expenses may be an appropriate base for distribution activities, total costs or operating expenses may be an appropriate base for a service or manufacturing activity, and operating assets may be an appropriate base for capital-intensive activities such as certain manufacturing activities or utilities (see tab. II).

Other bases can also be appropriate depending on the circumstances of the case. For instance, depending on the industry and on the controlled transaction under review, it may be useful to look at other denominators where independent data may exist, such as: floor area of retail points, weight of products transported, number of employees, time, distance, etc. The Guidelines also endorses applying Berry ratios[7] in situations where a taxpayer as a sales agent purchases goods from an associated enterprise and sells them to other associated enterprises. In such cases, the resale price method and cost plus method may not be applicable. Furthermore, the Berry ratio may be suitable for service providers, contract or toll manufacturers with low capital intensity. So that, depending on the facts and circumstances of the case, a Berry ratio may be an appropriate indicator.

Generally, the Guidelines now provide the profit level indicators on the most common base – including return on sales, return on cost and return on capital/assets.

Last major change is **detailed analysis of when the profit split method is likely to be the most appropriate method** and what its limitations and disadvantages are in practice and importantly how it should be applied. A transactional profit split method may also be found to be the most appropriate method in cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique intangibles) to the transaction, because in such a case independent parties might wish to share the profits of the transaction in proportion to their respective contributions and a two-sided method might be more appropriate in these circumstances than a one-sided method. The revised Guidelines address this point explicitly and approve the preference for two-sided methods. This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations.

Transfer pricing aspects of business restructuring

A brand new Chap. IX combines the four issues into a single, four-part chapter of the Guidelines:

1. Special considerations for risks.
2. Arm's length compensation for the restructuring itself.
3. Remuneration of post-restructuring controlled transactions.
4. Recognition of the actual transactions undertaken.

All sub-chapters contain a discussion of the transfer pricing aspects of business restructurings, i.e. of the application of Article 9 (Associated enterprises) of the OECD Model Tax Convention and of these Guidelines to business restructurings. Since business restructurings are typically accompanied by a reallocation of profits among the members of the MNE group, either immediately after the restructuring or over a few years is one major objective of this new chapter in relation to Article 9 to discuss the extent to which such a reallocation of profits is consistent with the arm's length principle and more generally how the arm's length principle applies to business restructurings. This chapter IX only covers transactions between associated enterprises in the context of Article 9 of the OECD Model Tax Convention and does not address domestic anti-abuse rules and CFC legislation.

Due to exceeding the allowable scope of the paper will not be this issue detail elaborated.

The Czech Tax Policy and Revised Guidelines

After the revised OECD Transfer pricing Guidelines was published on 22 July 2010, the Czech Ministry of Finance only issued report "*The amendment to the OECD Transfer pricing Guidelines*" on 6th September 2010 on its Web site, where also informed that the Czech Tax Administration will gradually publish a translation of the revised Guidelines.

Consequently, in the December 2010 the Czech Ministy of Finance published new decrees, in particular decree D-332 *Communication by the Ministry of Finance in respect of international standards application in taxation of transactions between associated enterprises – transfer pricing*, D-333 *Communication by the Ministry of Finance in respect of s.38nc of Act no. 586/1992 Coll., on income taxes – binding consideration over the transfer pricing policy used in related party transactions* and D-334 *Communication by the Ministry of Finance in respect of the scope of transfer pricing documentation*, relating to

7 Berry ratios are defined as ratios of gross profit to operating expenses.

transfer prices between associated entities. All decrees became effective on 1 January 2011.

Decree D-332 replaces cancelled decree D-258 and has been published to ensure a uniform procedure for taxing trasfers of goods, intangible assets and services within a group of associated entities, considering both tax administrations and taxpayers. New decree reflects the revision of Guidelines and recommends the selection of the most appropriate transfer pricing method to the circumstances of the case. It means that it is not necessary to follow the pre-set order of transfer pricing methods but the most suitable method should be selected without explanation of why other methods have not been used. Furthermore, detailed information about transfer pricing documentation is omitted because is explained in detail in another decree D-334. The last change of decree is in an appendix which contains explanation of different relationships between associated entities, examples of determination of transfer prices using different transfer pricing methods, appropriate comparability adjustments together with performance of functional analysis and determination of the arm's length range.

Decree D-333 replaces cancelled decree D-292 and provides the procedure that should be followed during the application of the binding consideration in respect of s.38nc of Income tax Act. The administration fee paid for the binding consideration performed by tax administration remains CZK 10.000. Nevertheless, the concept of the binding consideration in this new decree has not changed significantly.

Decree D-334 replaces cancelled decree D-293 and includes recommendations of the Czech Ministry of Finance in respect of the scope of documentation that should be provided when setting transfer prices between associated entities. The new decree has not changed significantly.

To sum up, the new decrees are almost identical to the previous ones. However, some important changes can be found, in particular in decree D-332. The main reasons for their modification were the need follow up the appropriate provisions of the new Tax Code (Act No. 208/2009 Coll.) which became effective on 1 January 2011 and furthermore the addition of information about the revised OECD Transfer pricing Guidelines. Unfortunately, the Czech Ministy of Finance has not yet released any decree relating to transfer pricing aspects of business restructurings.

III: *Summarization of changes in OECD Transfer pricing Guidelines*

TP Guidelines 1995	**TP Guidelines 2010**
There are differences in preferences between traditional and profit transaction methods. Traditional transactional methods are preferred, in particular CUP method. The transactional profit methods are considered as the last resort methods.	Differences in preferences between traditional and profit transactional methods have been removal. Now the traditional transaction method and a transactional profit method can be applied in an equally reliable manner. However, the CUP method is still preferred.
The arm's length principle as the most accepted international transfer pricing rule.	Without changes, the arm's length principle is still the fairest and more reliable basis for determining taxable profits.
The comparability analysis contains the five comparability factors.	To five comparability factors has been added nine-step process as an accepted good practice of application of the comparability analysis. Furthermore the higher standards of comparability have been required when using the profit-based methods.
Applying statistical tools, in particular interquartile range and multiple-year data are not recommended when the arm's length range is determined.	For the first time Guidelines endorses the use of statistical tools (*e.g.* the interquartile range or other percentiles) and multiple-year data when the arm's length range is determined.
Profit level indicators are mentioned in Guidelines however, without any detail. The Berry ratio is not recommended.	The revised Guidelines are now more concerned on the selection of profit level indicators. Generally, the Guidelines now provide the profit level indicators on the most common base – including return on sales, return on cost and return on capital/assets. The Berry ratio is recommended now with respect of the facts and circumstances of the case.
Guidelines do not address in detail the practical application of the profit split method.	The revised Guidelines contain detailed analysis of when the profit split method may be the most suitable method, and limits and disadvantages of this method. Guidelines also contain annex with application of this method.
Transfer pricing aspects of business restructurings are not included in Guidelines. Draft relating to this issue was published in 2008 separately.	The revised Guidelines contain new chapter IX. of business restructuring based on issued draft in 2008.

Source: OECD Transfer pricing Guidelines, own processing

SUMMARY

The OECD Transfer pricing Guidelines is revised on an ongoing basis, so the revision of these Guidelines in 2010 was not the last one. The most significant changes are the removal of the distinction between traditional methods and profit-based methods, application of higher standards of comparability when using the profit-based methods, setting a nine-step process of comparability analysis, using statistical tools and multiple-year data, selection of profit level indicators, detailed analysis of when the profit split method is likely to be the most appropriate method and brand new chapter of business restructuring (see Tab. III). The most accepted international transfer pricing rule is still the arm's length principle as the fairest and more reliable basis for determining taxable profits.

After the revised OECD Transfer pricing Guidelines was published on 22 July 2010, the Czech Ministry of Finance published new decrees in the December 2010, in particular decree D-332, D-333 and D-334 relating to transfer prices between associated entities. All decrees became effective on 1 January 2011. The new decrees are almost identical to the previous cancelled ones. However, some important changes which reflect the revision of Guidelines can be found, in particular in decree D-332. The main reasons for their modification were the need follow up the appropriate provisions of the new Tax Code (Act No. 208/2009 Coll.) which became effective on 1 January 2011 and furthermore the addition of information about the revised OECD Transfer pricing Guidelines. Unfortunately, the Czech Ministry of Finance has not yet released any decree relating to transfer pricing aspects of business restructurings.

However, the Guidelines will continue to be supplemented with additional guidance addressing other aspects of transfer pricing and will be periodically reviewed and revised on an ongoing basis. Future work will address such issues as the application of the arm's length principle to transactions involving intangible property, services, cost contribution arrangements, permanent establishments, and thin capitalization.

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