Specifics in area of transfer pricing

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Abstract:

Importantgoal of every business activity is mainly profit achievment. Created profit is subject of tax in every country. Everyone is naturally trying to maximaze net income, tax subjects are interested to use taxation of profit where its more preferable for them. We cannot blame tax subjects for this behaviour, because tax savings mean aswell an investment and further business development. Tax benefits can be achieved mainly by transfering the profit between connected people within jurisdiction of the same country or by transfering between cross - border connected people, therefore from country to different country. In first case for instance domestic company A, which has high risk rate, transfers part of profit to domestic company B, which is loss-making. The B company wont be reporting loss of profits and the A company will legaly lower its tax base. In second case connected companies A and B, which have base of operation located in different countries, will try to report profit in country with the lower tax. Both companies A and B share common goal. Transfer of profit is generaly realized through targeted pricing of products, servises and other payments, for instance interests. Here lies the foundation for working title – transfer pricing.

Keywords: transfer, transfer pricing, transactional profit methods, traditional transactional methods

1 Introduction

Interest of each country is to collect the maximum possible amount of taxes, meaning acquiring the right for taxation of the highest possible number of subjects (entrepreneurs). The tax system based on the principle of taxation according to the residence are included in the tax base with every income or any part of the income, including income from the sources abroad of each person (legal or natural), which under the given jurisdiction is considered as resident. The tax system based on the principle according to the source is included in the taxable income generated within the tax jurisdiction of the country irrespective of the residence of the taxpayer.

2 Basic concepts of transfer pricing

Transfer pricing means setting the price at which the transactions are carried out between companies of multinational groups, including the transfer of goods, property, services, loans and leases.

The aim of transfer pricing is to eliminate the effects of „non-market factors,, affecting the price for tax purposes.

The most important concept in the context of transfer pricing is the notion of transaction.

<u>The transaction</u> is commercial or financial relationship between two or several persons. In transfer pricing we have focused on foreign related party transactions - ie transactions carried out by a person established or resident in the Slovak Republic with economically or personnally established person or person residing abroad. These transactions are called controlled transactions.

<u>Controlled transactions</u> compared with the <u>uncontrolled transactions</u> – ie transactions carried out between independent parties. We can only compare the transactions that are having each comparable

economically important characteristics. If the foreign related party transaction performs comparable with the dependent and the independent person, then we can use this to compare the internal uncontrolled transaction. If the foreign related party does not perform comparable transaction with an independent person, then the comparison we need to use comparable transactions carried out between independent parties, ie. external uncontrolled transaction.

People within the transfer pricing - the economically connected persons, in which the tax subject has more than 25% direct or indirect interest or indirectly derived of the share capital or voting rights or personnel linked persons (eg., Through statutory or supervisory authorities) or with whom the tax subject has established relationship with the sole purpose of reducing the tax base and increase tax loss.

3 Methods of transfer pricing

The transfer pricing method are being used for examination - testing of a particular transaction. Sometimes it is useful to test the aggregated transactions, but only in respect of transactions which are of the same species or are linked, closely related and implemented in similar conditions that affects their valuation.

With the help of aplication of the transfer pricing method, the relevant foreign party modifies the related transaction in the way, as if it was performed by an independent person under comparable conditions. Using different transfer pricing method there are no special rules that could be applicable for each case. Therefore, the tax authorities should consider adjustments using the appropriate method for a particular situation. In general, the tax authorities and the tax subject should come to a reasonable compromise, and they should take into account the uncertainty of the methods, giving priority to a higher degree of comparability and a more direct and closer relationship to the transaction. The use of the certain method, the tax subject is required to provide and submit the tax authorities with relevant documentation, which contains a justification as to why the appropriate transfer pricing method was chosen.

We distinguish between direct and indirect methods of transfer pricing. Under the direct method the direct price of controlled transaction price and the price of uncontrolled transactions is compared. With indirect transfer pricing method the change of price of the controlled transacton occurs indirectly, with the use of other indicators, for example. gross margin or net profit.

We divide the transfer pricing methods into unilateral and bilateral. Unilateral method examines only one of the contracted parties of the transaction, usually one that carries less complex functions and is undertaking lower risks. For examination - tests we can choose domestic or foreign subject. If the tested side is domestic subject, we have to know the information necessary to perform functional and risk analysis about the other contracted party. If we choose to test foreign subject, we all the necessary relevant documents and financial indicators needed for the analysis and investigation. Bilateral method examines both contracted parties of the transaction and their contribution to the expected profit earned in future. Aggregate profits is then divided among the dependent parties in accordance with the independent relationship principle.

The use of appropriate methods

When choosing the appropriate transfer pricing method it is necessary to focus on finding the most appropriate method for a particular case, especially considering the specifics of the relevant transaction. For the purpose of selecting the most appropriate transfer pricing method we consider the 2.2 Directive in mind the following criteria:

- Strengths and weaknesses of the chosen method
- The appropriateness of the chosen method within the context nature of the controlled transaction, which we find by performing functional and risk analysis
- The availability of comparable independent information necessary for comparability analysis
- The degree of comparability between controlled and uncontrolled transactions, including the level of adjustment needed to eliminate the differences between these transactions.

None of the transfer pricing methods is suitable nor applicable in every situation. It is not necessary to prove that the use of the appropriate method is not appropriate in the given circumstances and conditions, and it is not necessary aswell to analyze and test other methods of transfer pricing. It is sufficient if it is based on an analysis of comparability factors which exclude methods that are not appropriate.

The Tax Income Law, applicable from 1.1.2014 removes the preferred preference for the use of traditional transaction methods before transaction profit methods. The original text of the Directive also favored hierarchy in the application of transfer pricing methods. Updated version of the directive removed that fact. Traditional transaction methods are still considered the most direct approach to determine whether the conditions in the commercial and financial relations between related parties are in accordance with the independent relationship principle. If in a particular case the use of traditional transaction methods and transactional profit methods is reliable aswell, we still prioritize the traditional transaction methods. On the other hand, there are situations where it is preferable to use one of the transactional profit methods. Such cases arise for example. if both parties have a unique and valuable contribution within the controlled transaction (eg. possession of unique intangible assets) or when to implement highly interconnected activities. Use any of the transactional profit methods is solution even in the case where there are no comparable data from internal or external sources. However, it is not appropriate to use transactional profit methods just because it is difficult to obtain data on the independent transaction. Provisions of the Income Tax law allows to select a different method to determine the difference in the tax base of foreign dependents, such as those defined in § 18 section 2 and paragraph 3 of Tax Income Law. Also according to Directive it is possible to use another method, which is described in the Directive. Using methods must be consistent with the independent trade relationship. If another method, which is not defined in the Law on Income Tax or the Directive is being used, it is necessary that the tax subject justifies this choice on the basis of assessment of the facts and arguments.

3.1 Traditional transactional methods

Traditional transaction methods are based on a comparison of prices of products or services that are subject to controlled transactions between related parties. It is a method of independent market price method and the method of subsequent sales increased costs

- ***Method independent market price*** is defined in § 18 section 2 point. a) Tax Income Law. Method of independent market price is based on a comparison of prices and services between related parties that agreed to the price of a comparable product or service that was agreed between independent parties. If the difference between the compared prices, adjusted the price depends on the way that will be replaced by an independent price that would use an independent person in comparable transactions under comparable conditions. This sets that it is a direct method. The independent market price method is one-sided method. Using this method requires a high degree of comparability – for the application of the method it is essential to have comparable product or service, and then using a comparability analysis that examines the comparability of contractual terms, market and economic environment in the controlled and uncontrolled transactions. Method is applicable for transactions with tangible property (eg. Involving raw materials), intangible assets (eg. During Royalties) and also in financial transactions (eg. At interest rates). With application of the method is useful to have internal comparable uncontrolled transactions and the external comparable uncontrolled transaction, if it is possible to make reasonable adjustments to remove the fundamental differences that affect the price of the transfer. If we have an internal comparable uncontrolled transaction within the method of comparability analysis, the use of independent market price rather simple and accurate.

- ***The method of subsequent sales*** –

defined in § 18 section 2 point. b) of the

Tax Income Law. With application of this method, the transfer price of assets purchased by foreign related party is converted to an independent market price at which the foreign person sells the property in an independent person and the price is reduced by the amount of the usual trade margin (ie margin, ie the percentual difference between the selling and the purchasing price of property) of comparable independent dealers. Method of subsequent sale is an indirect one-sided method and is used in cases where the dependent person established or resident in the territory of the Slovak Republic buys goods from the dependent person established or resident abroad and also sells independent person (tested party is the domestic subject) or when dependent person established or residing abroad sells the goods bought from foreign related persons established or resident in the territory of the Slovak Republic and also sells to independent persons (tested party is a foreign subject). Condition for the application of the method is carried out in compliance with the functions and risks of compared subjects. If the dealer will affect the transaction, so that adds significant value to it (eg. Further processed of purchased goods), the method can not be used. The method can also be used if there are differences in the subject transaction because commodity differences have lower impact on the level of trade margins than on the price. Subsequent sale method can be used mainly in product distributors. When applying this method that is based on the fact that we know independent sales price and the comparable profit margin applied in comparable uncontrolled transactions.

- **Method of increased costs** is adjusted in law on income tax provisions in § 18 sec. 2 point. c). In this method, an independent market price is calculated from the actual direct and indirect costs incurred to produce the product (property or services), which is subject to controlled transactions between related parties. These costs are increased by the amount of mark-up, which the supplier applies in relation to independent customers or the amount of mark-up, which would apply to a comparable independent trade under comparable conditions. Put simply, we can define price surcharge as the difference between the costs incurred in producing the product or service and its selling price by the manufacturer or service provider. Increased cost method is also indirect and unilateral method and object comparison in its application of the mark-up amount claimed by the foreign related party for its costs. To the cost base to include direct and indirect costs and those directly related to the controlled transaction. When applying the method is necessary to pay attention to the comparability of costs, for example. the adjustments to ensure comparability into account differences in the ownership of the property used. Method is mainly used for transactions in the production and sale of semi-finished or finished products (goods or services) that do not contain high added value eg. in the form of unique intangible assets. It is usually used for the valuation of long-term contracts for example. in contract manufacturing. The amount of mark-up depends on the functions performed and risks borne a share of tangible and intangible assets in the transaction.

3.2 Transactional profit methods

These methods are based on the comparison of profits accruing from particular controlled transactions. Such methods include the profit split method and net margins method.

Profit split method is defined in § 18 par. 3 point. a) Law on Income Tax. The method is based on such divisions of expected profit from controlled transactions between related parties, as would be expected by independent persons in the joint venture subject to the arm's length principle. Profit split method is a two-sided method. Dividing the aggregate profits may be done either on the basis of the allocation key, which may be a specific number (eg. Ratio of 30/70, which is used by independent persons in comparable transactions) or on the basis of variable (eg. Proportion of expenditure incurred by one of the parties to the transaction to exercise particular function, for example. marketing). The method is useful in situations where the transactions are highly integrated and the parties contribute to the transaction in a unique manner or are in possession of a valuable intangible assets. There are two approaches to profit split - on the basis of contributing or residual analysis.

The net margin method is defined in § 18 par. 3 point. b) Law on Income Tax. The method determines the amount of the profit margin of the business or financial relationship between the related parties in relation with fixed base (eg. Expenses, revenues) and compares it with a profit mark-up used in relation to unrelated third parties. The method is one-sided and can be used only for individual transactions or more of the same transactions. If the taxpayer performs more different types of transactions, it is necessary to examine each transaction and related functions separately. Method can therefore only be applied after the functional and risk analysis. When applying the net margin method it is possible to use various indicators of profitability, for example. net profit for sales, net profit for the cost, net profit for assets. In doing so it is necessary to verify whether the selected indicator provides a reliable expression of the profitability of the taxpayer, and if there are reliable data on comparable entities. In practice, various commercial databases are used for the comparable indicators and data search to avoid distortion of the final result. Use of the method is limited even if the parties to the transaction own valuable intangible assets or their contribution to the transaction has a unique character.

A taxpayer may in writing request the tax authority for the issuance of the decision for a specific transfer pricing method no later than 60 days before the beginning of the tax period during which the agreed method is to be applied. At the request of the taxpayer filed at least 60 days (30 days according to the law in force until 31 December 2013) before the expiry of the period specified in the decision on the approval of the valuation method the tax authorities may issue an approval for no more than five additional tax years if the taxpayer proves that there was no change in the conditions under which the earlier decision was made. The decision on approval of the valuation methods can not be appealed. The taxpayer pays a payment under a special regulation together with a request for a decision on approval of the valuation method:

- 1% of the amount of expected business case, but at least 4 000 EUR and not more than 30 000 EUR when applying for a definite decision on the application of one tax provision (ie, unilateral approval by the tax),
- 2% of the amount expected business case, but at least 5 000 EUR and not more than 30 000 EUR when applying for a definite decision on the application of two or more tax rules (ie, agreeing on the application of international treaties).

4 Transfer pricing documentation

Under current legislation, companies, which are using transfer pricing are required to document the use of transfer prices. This is what transfer pricing documentation is used for.

Since the year 2014 it is important to ensure timely documentation because the time for the submission to tax administrator was reduced from 60 days to 15 days after the notice delivery. The tax administrator may request the submission of documentation for transfer pricing at any time, not just during tax audits.

Taxpayers who according to Slovak accounting legislation need to prepare statements under IFRS must keep complete documentation, which will include information regarding the whole group of dependent persons ("general documentation"), as well as the specific taxpayer ("specific documentation").

General documentation contains a set of information providing an overview of the group of dependent persons. Specific documentation in addition to information about the business and business strategy of taxpayer describes transactions with related parties, internal and / or external comparable data of independent persons and comparability analysis (information on the factors determining the comparability of controlled transactions with uncontrolled transactions: Characteristics of property or services, function analysis, contractual conditions, the economic environment, specific business strategies), a description of the taxpayer's transfer pricing and information regarding the selection and method of application of the method (s) of transfer pricing and the determination of prices of controlled transactions.

Companies that do not have to prepare financial statements under IFRS can use simplified documentation, which must include information demonstrating compliance with the arm's length principle regarding undertaken major controlled transactions. Simple documentation must contain the following information:

- description of significant transactions, their amount or proportion of total transactions,
- information on pending / ongoing transactions,

- information on prices used in these transactions

In reality though, it pays off if these companies also have transfer pricing method, including comparability analysis in their documentation. If the tax administrator questions the accuracy of transfer prices, analysis used to justify the method used for transfer pricing and compliance with arm's length principle can be pre-prepared, whereby the burden of proof moves to the tax authority.

Slovak legislation does not require the preparation of documentation to abide by the provisions of Chapter 5 of the OECD Transfer Pricing. Its content is based on the Decision of the Council of the EU Code of Conduct for transfer pricing documentation. However, this is similar to OECD guidelines.

Documentation must be presented in the Slovak language, but at the taxpayer's request the tax administrator may also accept documentation in another language. If the company did not make any significant controlled transactions with foreign related parties, the documentation does not have to be prepared.

5 Conclusion

Based on various studies, transfer pricing is the most important international tax issue, which the multinational companies are currently facing.

Eighty-six percent of parent respondents and 93% of the subsidiaries of multinational corporations identified transfer pricing as the most important international tax issue, with which they are currently engaged and indicated that control of tax authorities is becoming the rule rather than the exception. Study of Global Transfer Pricing Survey 2003 showed that 59% of all multinational companies with revenues over 5 billion USD and 71% of all multinational companies based in the USA, were in some part of their structure scrutinized for transfer pricing since the year 1999 regardless of the revenues amount. Out of all respondents 76% said that they believe that over the next two years transfer pricing will be scrutinized in their group.

Multinational companies are convinced of the increasing likelihood of transfer pricing controls, as more and more countries adopt laws on transfer pricing and those countries that already have such rules are increasing efforts in the area of enforcement of these laws. In addition, audits will become increasingly difficult, as the financial authorities, according to survey participants are now better prepared. Feedback from the tax authorities supported these findings. Many countries are showing that they are investing more in training and support for their staff to be able to use all available resources.

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