http://dx.doi.org/10.15414/isd2016.s6.05

Transfer pricing of transactions between related parties in the Slovak Republic

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Abstract
Transfer pricing is the setting of prices for transactions between related parties for tax purposes in order to meet the arm´s length principle. Unrelated relationship is characterized by the fact that parties participated in the mutual transactions pursue their own interests and their aim is to achieve the highest profit. Related parties often pursue the mutual aim and they try to obtain the highest profit for a group. If prices applied in business relationships between related parties differ from comparable business relationships between unrelated parties, the related party is obliged to adjust the tax base to a difference. In order to determine a difference, several methods of transfer pricing or their combinations are used. The Slovak Republic adopts the methods of transfer pricing pursuant to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations which are based on the comparison of prices and the comparison of profit. Since 2015 the rules of transfer pricing has been enlarged to the obligation to keep the documentation on used methods of transfer pricing except for foreign related parties to domestic related parties as well in order to minimize the tax evasion. The article aim is to assess the transfer pricing in the Slovak Republic and to review the strengths and weaknesses of individual methods of transfer pricing.

Keywords: *arm´s length principle, documentation, method, related parties, transfer pricing*

JEL Classification: *H25, H71, M41*

1. Introduction

Measurement belongs to the most complicated problem in the theory and accounting practice as well as in the tax area. The issue of transaction measurement between related parties for purposes of income tax is currently growing by both taxpayers and tax administrators. Globalization as an economic process progresses further and its negative effects are manifested in excessive profit shifting from their countries of origin do tax havens. Transfer pricing appear to be an appropriate solution to this global economic problem (Rajnoha, Slivková & Dobrovič, 2014). Transfer pricing is the phenomenon by which related corporate entities in different jurisdictions determine the price at which a transfer of goods or services between those two entities should be deemed to have occurred. This phenomenon is an inherent and endemic part of the international trading system (Bastin, 2014).

Taxpayers are focused on decreasing of their taxable business income so they are interested in the profit creation in place where it is the most tax advantageous (Solilova & Nerudova, 2013). This advantage can be achieved by the profit transfer between foreign related parties to countries with the lowest income tax rate. High transfer prices for sales of goods to affiliates in high-tax countries are used to repatriate profits to low-tax countries, thereby reducing the overall tax burden (Behrens, Peralt & Picard, 2014; Usmen, 2012). From a political perspective, concern about profit shifting to low-tax jurisdictions is growing due to increasing international tax rate differentials (Martini, Niemann & Simons, 2012). Transfer price taxation is a system that tries to protect the domestic tax authority and to prevent international tax evasion (Cho & Park, 2015). However, tax advantage might be gained as well by the profit transfer between

domestic related parties with the aim to decrease the income tax base of profitable company and tax loss carry forward in loss-making company (Kočiš, 2015).

Transfer pricing might be characterized as a manner for price determination of transactions performed by related parties so they equal to those in conditions of unrelated relationship. Unrelated parties under the influence of market commercial conditions act so that they naturally defend their own interest. A seller is interested in maximizing of his selling price (income) and a buyer is interested in minimizing his buying price (cost). In case of related parties the natural market regulator is not working. A buyer and a seller act in concert and follow the same economic interest. Therefore business relationships of related parties are individually reviewed in accounting and tax practice (Pastierik, 2015).

If prices in business relationships of related parties differentiate from prices used between unrelated parties in comparable business relationships, the related parties are obliged to adjust income tax base to a difference. Several methods of transfer pricing and their combinations are used for a difference determination while it is allowed to use only such a method which a use pursues the arm's length principle. The used method is declared by a related party by means of transfer pricing documentation (Karelová, 2015).

All the obligations as regards the transfer pricing were binding only to foreign related parties in the Slovak Republic till the end of financial year 2014. The amendment of the Act No. 595/2003 Coll. on Income Tax with the latest amendments has come into force since 1 January 2015. The amendment has brought the extension of transfer pricing rules to domestic related parties.

2. Data and Methods

The paper's aim is to assess the issue of transfer pricing in the Slovak Republic and to review the strengths and weaknesses of individual transfer pricing methods. The theoretical research has been applied for reaching the paper's aim.

Basic input materials are following legal norms except for professional literature:

- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,
- Act No. 595/2003 Coll. on Income Tax with the latest amendments (hereinafter referred to as “Income Tax Act”),
- Regulation of the Ministry of Finance of the Slovak Republic No. MF/011491/2015-724 on determination of documentation content pursuant to the Article 18 par. 1 of the Income Tax Act,
- Methodical instruction of Financial Directorate of the Slovak Republic to the application of transfer pricing methods.

Generally accepted basic research methods have been applied in the paper's processing which lead to the achievement of scientific knowledge in relation to the before mentioned issue.

3. Results and Discussion

3.1 Transfer pricing: Economic substance and legal arrangement

The arm's length principle has been anchored in legal norms of the Slovak Republic since its formation since the year 1993. However, the practical application of transfer pricing rules has been substantially limited by the tax authorities and taxpayers for a long time. The increased attention has been paid to transfer pricing since the year 2009, when the obligation of taxpayers to maintain a documentation of used transfer pricing method has been anchored. For the taxable

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period beginning 1 January 2009 the amended measure of Article 18 of the Income Tax Act was applied for the first time, as well as the first measure of the Ministry of Finance of the Slovak Republic No. MF/8288/2009-72 on documentation content of pricing method used by a taxpayer pursuant to the Article 18 par. 1 of the Income Tax Act. This has determined the basic legal range of transfer pricing regime in the Slovak Republic and therefore the presumptions for a practical application of internationally accepted principle of unrelated relationship have been created.

The first measure of the Ministry of finance of the Slovak Republic on documentation content of transfer pricing method has been substituted by the new measure of the Ministry of finance of the Slovak Republic No. MF/8120/2014-721 on determination of documentation content of pricing method used by a taxpayer pursuant to the Article 18 par. 1 of the Income Tax Act. The previously existed legal arrangement on documentation content of transfer pricing differentiated two basic forms of documentation, namely basic documentation for taxpayers reported profit or loss in individual financial statements pursuant to IFRS and simplified documentation for all other taxpayers. The basic change brought by a new measure is the classification of taxpayers to three groups according to predefined criteria and depending on it is the distinction of three documentation forms (basic, reduced and full documentation).

The further substantial change has been marked in the legal arrangements of transfer pricing since 1 January 2015 when the application of transfer pricing except for foreign related parties has been set up also to domestic related parties. In connection with the before mentioned the current rules on documentation content of transfer pricing have been adjusted by the new measure of the Ministry of Finance of the Slovak Republic No. MF/011491/2015-724 on determination of documentation content of pricing method used by a taxpayer pursuant to the Article 18 par. 1 of the Income Tax Act.

The new measure as well as the previous measure conceptually derives from the principles and fundamentals set up in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The directive on transfer pricing deals with the issue of transfer pricing from the international context. It is considered as the generally accepted additional expository means to the Article 9 of double taxation avoidance treaties pursuant to which the Slovak Republic is bound in accordance with the Vienna Convention on the Law of Treaties. The directive on transfer pricing deals with the definition of the arm's length principle and individual used methods of transfer pricing.

The arm's length principle presents the base of transfer pricing. It is defined in the Article 18 par. 1 of the Income Tax Act. It is based on the comparison of conditions set in business or financial relationships between related parties with the conditions which would be agreed between unrelated parties in comparable business or financial relationships under comparable circumstances. When comparing, mainly the activities are taken into account which are performed by comparable parties, i.e. production, installation works, research and development, purchase and sale, and the others. The subject of comparison is also the content of their business risks, the features of comparable property or service, agreed agreement conditions, economic environment of market, business strategy. Conditions are comparable if there is not the substantial difference between them or when the influence of such differences might be eliminated. The arm's length principle allows tax administrator to adjust the tax base of related party to a difference which occurs when the prices in transactions differentiate from the prices in comparable transactions between unrelated parties under comparable circumstances.

Related party is defined quite extensively by the Income Tax Act. Related party is a close person pursuant to the Civil Code, or economically, personally or another affiliated party. Economical or personal relationship means:

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1. a person's share in property, control or management of another person. The share in property or control means more than 25 % of direct or indirect share or indirect derived share in share capital or voting rights. If the amount of indirect derived share exceeds 50 %, all parties by means which the amount is calculated, are economically related regardless their real amount of share. The participation in management means the relationship of statutory members or members of supervisory board of commercial companies or cooperatives to this commercial company or cooperative.
2. the mutual relationship between parties which are under control or management of the same party or in which this party has direct or indirect share in property.

Pursuant to the Income Tax Act another relationship is defined as a business relationship created mainly for the purpose of tax base decrease or increase of tax loss.

The term “transaction” might be defined as a business or financial relationship between two or more parties. The subject of transfer pricing are transactions of related parties, marked as controlled transactions. The price is the subject of a controlled transaction, is marked as a transfer price. Transactions realized between unrelated/independent parties present unrelated transactions. Controlled transactions are compared with uncontrolled transactions while only those transactions might be compared which have all economically crucial comparable features. If a related party performs a comparable transaction with a related party as well as an unrelated party, an internal uncontrolled transaction shall be used for the comparison, i.e. transaction between related and unrelated party. If a related party performs a comparable transaction only with a related party, an external uncontrolled transaction shall be used for the comparison, i.e. transaction between unrelated parties.

3.2 Methods of transfer pricing

Methods of transfer pricing present the manner how to calculate a difference to which prices differentiate in the mutual business relationships between related parties from prices used between unrelated parties in comparable business relationships.

The Slovak Republic has adopted the methods of transfer pricing pursuant to the Directive on transfer pricing which are based on the comparison of price (traditional transaction methods) and the comparison of profit (transactional profit methods). The Income Tax Act allows the mutual combination of before mentioned methods, respectively allows the selection of another method which is not defined in the Income Tax Act and the Directive on transfer pricing. The condition is to use another method which shall be in conformity with the arm's length principle.

Such a method should be used in a particular case which is the most appropriate taking into account the particular transaction specifics. For the purpose of the most appropriate selection of transfer pricing the following criteria are taken into account:

- strengths and weaknesses of a selected method,
- appropriateness of a selected method in the context of the controlled transaction nature,
- availability of comparable independent information,
- comparison level between controlled and uncontrolled transactions including the adjustments levels indispensable for the elimination of differences between these transactions.

3.2.1 Traditional transaction methods

Traditional transaction methods derive from the price comparison of goods or services which are the subject of controlled transaction between related parties. The comparable uncontrolled price method, resale price method and cost plus method belong to these methods.

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a) The comparable uncontrolled price method derives from the price comparison of property or service agreed between related parties with the price of comparable property or service agreed between unrelated parties. For the application of this method the compliance of assessed property or service is inevitable and as well as a high level of comparability of agreement conditions, market and economic environment. This fact might be considered as a disadvantage of the method while in practice it is rather difficult to find a comparable uncontrolled transaction performed in comparable circumstances. The method advantage is its relative independence on the internal information system of an enterprise because transfer price is compared with a price which shall be confirmed in the market. The comparable uncontrolled price method is suitable to apply in transactions with tangible assets (e.g. raw materials), intangible assets (e.g. licence fees) and with financial transactions (e.g. interest rates).

b) The resale price method derives from the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the "resale price margin") applied by other independent enterprises in comparable transactions. The condition of this method application is the conformity in performed functions and taken into accounts risks assumed of compared subjects. The method can be used in case that the reseller does not add any other margin to an asset, i.e. he resells the purchased products with any adjustment. Differences in products do not eliminate the application of this method because the product differences have a lower influence in margin than in price. The resale price method is used mainly in case of distributors.

c) The cost plus method derives from the real direct and indirect costs needed for property or rendering of services increased by a sum of price margin. Costs are increased by a price margin applied by the same supplier in transactions with independent enterprises or by a price margin which should be applied by an unrelated party in a comparable transaction under comparable circumstances. When applying this method it is necessary to pay attention to the costs comparability. The cost plus method is appropriate in transactions with subjects like production and sale of semi-finished products or finished products which do not include any added value.

3.2.2 Transactional profit methods

The transactional profit methods derive from the profit comparability arising from a controlled transaction. They comprise of transactional profit split method and transactional net margin method. The application of transactional profit methods is appropriate in case there is not a sufficiency of reliable data at disposal for the analysis of comparability in traditional transaction methods. The before mentioned methods are used in transactions where the subjects are unique products, services or intangible assets of high values (e.g. trademarks, business name).

a) The transactional profit split method derives from the split of assumed profit from controlled transactions expected by unrelated parties in an associated business and taking into account the arm's length principle. When applying this method it is indispensable to have at disposal the information on both contractual transaction parties. The condition of the transaction profit split method usage is the achievement of combined profit which shall be the subject of split. The distribution of combined profit can be realized on the base of allocation key (e.g. ration 20/80) or on the base of variable (e.g. the proportional part of incurred costs by one contractual transaction party to perform certain function, e.g. research and development, marketing, distribution). The usage of transaction profit split method is

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appropriate in highly integrated operations when contractual parties own valuable intangible assets or their contribution to transactions has a unique character.

b) The transactional net margin method determines the amount of profit margin in transactions between related parties in connection to set basis (e.g. costs, income) and compare it with the profit margin used in relation to unrelated parties. The method can be used only in individual transactions or several same transactions. If a related party performs more various types of transactions, it is essential to treat each transaction separately. The method usage is limited when the contractual parties own valuable intangible assets or contribute to transactions by a unique manner. Various indicators of profitability can be used in this method. It is crucial to confirm whether selected indicators provide reliable determination of taxpayer profitability and whether reliable data on comparable subjects are at disposal. The method advantage is that transactions are not compared on the base of absolute terms but on the base of relative characteristics.

Uniform rules do not exist when applying individual methods of transfer pricing which would be appropriate and applicable in each situation. The selection of particular method is the result of compromise while it is necessary to take into account a possible method inaccuracy, prioritize a higher level of comparability and a tighter relation to a transaction. The application of selected transfer pricing method shall be announced to a tax administrator by a taxpayer, while a taxpayer is obliged to demonstrate and justify the submission of transfer pricing documentation.

A taxpayer might ask a tax administrator for a decision on approval of a particular transfer pricing method before performing a transaction with a related party. Therefore a taxpayer can confirm whether his proposed procedure of transaction pricing is in accordance with the arm's length principle. The written request shall be filed at least 60 days before the beginning of a tax period in which the proposed transfer pricing method will be applied. Transfer pricing documentation shall be included in the request. The decision on approval of the transfer pricing method may be issued for up to five tax years.

3.3 Documentation on transfer pricing

In case of controlled transactions each related party is obliged to keep the documentation on used method of transfer pricing. The documentation presents the file of information, data and facts presenting and explaining the procedure of price creation in controlled transactions. The minimal range of documentation is limited by the Measure of the Ministry of Finance of the Slovak Republic No. MF/011491/2015-724 on determination of documentation content of pricing method used by a taxpayer pursuant to the Article 18 par. 1 of the Income Tax Act. From the point of required data range the following types of documentation is recognized: reduced, basic and full documentation. Each of the before mentioned documentation is fully determined for a precise group of taxpayers who are obliged to keep a particular documentation.

The obligation to keep the documentation on transfer pricing in range of full documentation relates to taxpayers who:

a) report the profit or loss in individual financial statements in accordance with the International Financial Reporting Standards (with some exceptions)
b) perform transactions with related parties who are taxpayers of non-contractual state (with exception of natural persons and taxpayers who are micro-accounting entities pursuant to the Act No. 431/2002 Coll. on Accounting with the latest amendments),
c) require the approval of transfer pricing method by a tax administrator,
d) deduct the tax loss exceeding the sum of 300 000 € from the tax base in a tax period,
e) deduct the tax loss exceeding 400 000 € from the tax base at least for two following tax periods (with some exceptions),

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f) apply the tax allowance in a tax period,
g) request the secondary adjustment of tax base in accordance with the international agreements.

Taxpayers natural persons and taxpayers who are micro-accounting entities pursuant to the Act No. 431/2002 Coll. on Accounting with the latest amendments (hereinafter referred to as "Accounting Act") keep the documentation minimally in range of reduced documentation. The possibility to keep the reduced documentation relates as well as to the selected subjects of public administration but only for some controlled transactions. The same is applied in case of transactions between domestic related parties, it is sufficient to keep the reduced documentation as regards domestic controlled transactions. The possibility to keep the documentation on domestic controlled transactions in reduced range is not provided to taxpayers who in accordance with the before mentioned points from c) to g) are obliged to keep the full documentation on transfer pricing. The possibility to keep the reduced documentation is assessed positively as regards the Articles of OECD Guideline on transfer pricing pursuant to which the interstate requirements on documentation content should not cause inappropriate burden to taxpayers.

The keeping of documentation in minimal range of basic documentation shall be for all other taxpayers who have not been mentioned before.

The documentation in the range of basic or full documentation is kept for transactions or groups of uniform transactions with the value over 1 000 000 € in a particular tax period or transactions which are crucial for a taxpayer. Pursuant to the Accounting act the crucial information is such for which a non-disclosure could affect the judgment or decision making of information users from the financial statements. The level of significance is individual for each taxpayer therefore in practice it is usually determined in the internal accounting directive. For other controlled transactions it is sufficient to keep the documentation in the reduced range.

The documentation is conducted for each controlled transaction separately or together for a group of uniform transactions. The documentation is kept for a particular tax period. If any essential changes have arisen, a taxpayer might refer to information determined in the documentation of the previous tax period.

4. Conclusion

The issue of transfer pricing presents the crucial area of legal arrangements of income tax and is the subject of dynamic development in the global but as well as in the national scale. Recently the transfer pricing has become the central theme for both tax administrators and taxpayers in the Slovak Republic. It relates to the fact that as at 1 January 2015 the principle of unrelated relationship has been applied not only to transactions between foreign related parties but also between domestic related parties.

The obligation of related parties is the adjustment of income tax base to a difference for which the price in the mutual transactions of related parties differentiate from prices used between unrelated parties in comparable transactions and under comparable circumstances. In order to determine the before mentioned difference various transfer pricing methods are used, which shall be kept in the documentation by taxpayers since the year 2009. Until the year 2009 the comparability analysis between related parties was problematic for taxpayers as well as for tax administrators performing a tax control. The obligation to keep the documentation on transfer pricing has simplified the work of tax administrators and has transferred the burden of transfer pricing proof to taxpayers.

During the last years the number of tax controls focused on the transfer pricing has been increased and therefore the professional skills of employees of financial administration have been increased as well. In the future the intensification of transfer pricing controls between domestic related parties can be expected, focusing particularly on those related parties that disclose the tax loss. We recommend taxpayers to report the widest possible range of information in transfer pricing documentation to demonstrate compliance with the arm's length principle to transactions between related parties despite the minimal range of information provided in the measure of the Ministry of Finance of the Slovak Republic on formalities of transfer pricing documentation.

Tax payers transfer their profit between related parties within the country or transfer the profit between related parties across borders to countries with more favourable tax regulations, in the economic literature marked as the so-called "stowaways". These subjects participate in the social consumption financed by collected taxes but they themselves do not contribute to them. Therefore the economic and tax policy of a state should ensure that taxpayers obtain legal and moral barriers to transfer the profit between related parties in order to acquire a tax advantage.

In several countries of CEE (the Slovak Republic, the Czech Republic, Poland, Hungary, Romania) the issue of transfer pricing is amended by particular legal arrangements related to the income tax. The rules of transfer pricing relate to foreign as well as domestic related parties in all before mentioned countries. In the Slovak Republic the obligation to evaluate transaction on the arm’s length principle referred only to foreign related parties till the end of 2014. Effective since 1 January 2015 the rules of transfer pricing has been spread also to domestic related parties. In the before mentioned countries including the Slovak Republic all taxpayers keep the transfer documentation as they perform transactions with domestic or foreign related parties. In Poland except for these subjects it relates to those taxpayers who perform transactions with so called tax havens.

In the selected countries of CEE the acceptable methods of transfer pricing are those pursuant to the OECD Guidelines. In the Slovak Republic and the Czech Republic the traditional transaction methods can be used as well as transactional profit methods of transfer pricing while the principle of the most advantageous method is applied. In Hungary and Poland the traditional transaction methods are preferred before the transactional profit methods. In Romania the uncontrolled price method is preferred and the selection of another method is required to be reasoned. Even in the Slovak Republic recently the usage of traditional transaction methods has been preferred before the transactional profit methods. This hierarchy in the application of transfer pricing methods has been eliminated by the amendment of the Income Tax Act effective since 1 January in accordance with the current version of the OECD Guidelines. In conclusion it can be stated that the Slovak Republic altogether with other selected countries of CEE respects the rules arising from the OECD Guidelines in the area of transfer pricing between related parties, while the concrete methods of application of the arm’s length principle and the obligation of keeping the documentation on transfer pricing are anchored in the particular legal arrangements as regard the income tax.

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* Online full-text paper availability: doi:http://dx.doi.org/10.15414/isd2016.s6.05