Supreme Administrative Court Ruling on Transfer Pricing

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1. Introduction

The Supreme Administrative Court set groundbreaking rules for the burden of proof in its latest transfer pricing cases, in particular in Decision 7 Afs 74/2010-81 of 27 January 2011. This article summarizes two recent court cases that have a significant impact on how transfer pricing matters should be managed in companies located in the Czech Republic.

2. Transfer Pricing in the Czech Republic

Czech tax law historically has dealt with transfer pricing from its very beginning. The basic provision is Sec. 23(7) of the Income Tax Act, which requires the use of arm’s length prices in intercompany transactions and defines the conditions under which taxpayers are considered to be related parties. However, aside from this basic provision, tax law itself contains little guidance on how to apply transfer pricing rules in specific situations. Therefore, knowledge of the current interpretation is of utmost importance when assessing transfer prices. In addition to ongoing discussions with tax authorities during tax inspections and applications for advance pricing arrangements, case law represents an important interpretation source for transfer pricing matters.

The number of tax inspections focussed on transfer prices has significantly increased in recent years. This is partly caused by the fact that many companies with a limited risk profile reported losses during the economic downturn, and the tax authorities are challenging transfer prices at such companies.

The basic sanctions for using non-arm’s length prices are as follows:
- additional income tax assessment (19%);
- penalty of 20% of additionally assessed tax (1% of additionally reduced tax loss);
- additional withholding tax on tax base adjustment; and
- late payment interest on both additional income tax and withholding tax (approximately 15% per annum).

For companies obtaining tax relief under the investment incentive scheme, setting transfer pricing incorrectly may even lead to a total loss of the tax relief (tax holiday).

The latest experience of tax advisors indicates that Czech companies should actively manage their transfer pricing in order to reduce the above-mentioned transfer pricing risks.

Since 2006, taxpayers in the Czech Republic also have the possibility of obtaining advance pricing arrangements with regard to their transfer pricing. In many cases, this helps to manage transfer pricing risks and establish a good relationship with the tax authorities.

3. Legal Process for Tax Matters

The typical process of litigation in tax matters begins with an appeal against the decision of the local tax authority. The appeal is usually decided at the level of tax directors. If the taxpayer disagrees with the final decision of the tax administration, a court proceeding must be commenced. The Code of Administrative Justice creates a one-instance system of judicial review. There are regional courts that act as courts of first and last instance, with no appeal or other ordinary judicial remedy permissible. There is, however, the possibility to seek an extraordinary remedy – filing a constitutional complaint – before the Supreme Administrative Court (SAC). The admissibility criteria for a constitutional complaint are broadly defined so as in most instances to give taxpayers the possibility to seek this extraordinary remedy.

If a decision, measure or other intervention by a public authority that has entered into legal effect, in a proceeding in which the taxpayer was a party, violated the taxpayer’s fundamental rights or freedom as guaranteed by the Constitution, a constitutional complaint may be filed with the Constitutional Court of the Czech Republic.

The ultimate instance of appeal in tax matters would be to file a complaint before the European Court of Justice.

Currently, the SAC provides in its case law important interpretations of tax law, including transfer pricing provisions.

During its relatively short existence, the SAC has ruled on more than 20 noteworthy transfer pricing disputes.

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1. The homepage of the Supreme Administrative Court (www.nssoud.cz) provides detailed information about its competencies and case law.
between taxpayers and the tax authorities, thereby providing an important source of interpretation for the assessment of specific transfer pricing matters in the Czech Republic. The number of transfer pricing cases ruled upon by the SAC has increased significantly over the last five years. The experience of consultants reveals that the tax authorities are informed about the SAC decisions; however, their interpretation of individual cases may vary.

4. SAC Decision 7 Afs 74/2010-81 of 27 January 2011

The dispute between the taxpayer and the tax authorities focused on the determination of the arm’s length rent for real estate. The SAC decision summarizes the main approaches to the allocation of the burden of proof between the taxpayer and the tax authorities.

The SAC usually does not rule on the substance of transfer pricing issues (e.g. method selection, or markup percentage). First, the SAC decides whether the tax authorities proceeded in compliance with Czech law. This concerns in particular whether the tax authorities have considered all available information and evidence provided by the taxpayer, and whether the tax authorities have borne their part of the burden of proof as assigned under tax administration law. In fact, most transfer pricing disputes heard by the courts primarily deal with the burden of proof.

In practice, there are many cases in which the tax authorities have challenged the rental fees agreed between related parties. Because of available comparable data, the tax authorities may quickly identify potential deviations from the arm’s length principle. In some cases, the tax authorities use comparable information from lease agreements concluded by municipalities that lease their real estate, as detailed comparative data are readily available

SAC Decision 7 Afs 74/2010-81 of 27 January 2011 dealt with a situation in which a lessor rented real estate for a low price to related parties. The tax authorities claimed that the price was too low and required additional income to be taxed with the lessor. The lessor explained that the low rental fees were due to the poor condition of the real estate that was leased to related parties. The tax authorities rejected this explanation and concluded that the taxpayer had not proven the real condition of the real estate in the examined period. However, the SAC ruled that the tax authorities bore the burden of proof in this case and had to prove all significant parameters of the controlled transaction.

The main argumentation and conclusions of the SAC are presented below.

The SAC confirmed the general rule that the burden of proof in tax matters rests with the taxpayer. However, according to the SAC, in transfer pricing disputes the burden of proof primarily rests with the tax authorities which must:

- prove that the parties to the transaction are related parties under the definition provided by the Income Tax Act; and
- establish the arm’s length price (called the “reference price” in the decision) in order to be able to require that the taxpayer explain the difference between the arm’s length price and the intercompany price.

This means that the tax authorities may not challenge the transfer price used by the taxpayer before the tax authorities have first conducted relevant analyses and established the arm’s length price. At the same time, the tax authorities bear the burden of proof with respect to the arm’s length price established by the tax authorities.

The arm’s length price may be established by the tax authorities either by reference to real prices agreed between independent parties for the same or comparable goods or, if information about real comparable prices is not available, by using an estimate based on logical considerations and business experience. Furthermore, if real uncontrolled prices are used by the tax authorities, the tax authorities must analyse whether the conditions of the relevant uncontrolled transaction were comparable to those under which the examined controlled transaction was agreed. Any differences in transaction conditions must be taken into account by the tax authorities in adjusting the established arm’s length price.

Moreover, the SAC confirmed the application of the principle of in dubio mitius. Under this principle, in the case of doubts, the tax authorities must use the assessment that is favourable to the taxpayer. The SAC referred to the fact that transfer pricing analysis usually establishes a range of arm’s length prices. In such a case, within the range of values, the value which least encumbers the taxpayer should be used. The decision does not further explain the use of the statistical method.

Finally, the SAC ruled that even if the tax authorities establish the arm’s length price according to the above principles and define the difference to the challenged intercompany price, the tax authorities may not assess additional tax without giving the taxpayer adequate time to explain the difference. At this point, the burden of proof shifts to the taxpayer, which must prove economic reasons and justify the difference. This procedure results from the wording of the transfer pricing provision in Sec. 23(7) of the Income Tax Act, which provides that the tax authorities will assess additional tax if the difference is not satisfactorily explained or documented.

This SAC decision provided a more detailed interpretation of the allocation of the burden of proof in transfer pricing matters. In this regard, one should consider SAC Decision 8 Afs 19/2010-125 of 2 March 2011, which deals with the burden of proof in the context of a so-called “benefit test” for received services. As fees for services

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2. There are other SAC decisions which require that a range always be established and deny the use of one value for establishing the arm’s length price by the tax authorities.
5. Evidence Necessary for Received Services

The tax authorities traditionally focus on service fees paid by Czech companies to their foreign parents. The tax authorities often attempt to deny the tax deductibility of such fees, claiming that the services were actually not provided. Needless to say, this argument is possible as a result of missing documentation and limited information available locally. A similar situation is quite common in reality. It may significantly worsen the position of the taxpayer during a tax inspection focusing on services. In such a case, the tax inspection may last for several months and employ the time of local management.

For successful defence of the deductibility of service fees, the taxpayer must be able to prove that:
1. The services have actually been rendered;
2. The services represent a benefit for the taxpayer (i.e. are related to its taxable income); and
3. The agreed service fee is arm’s length

Points (1) and (2) represent the benefit test. If this test is not passed, the tax deductibility of the services will be denied by the tax authorities. In such a case, the tax authorities will not test the arm’s length character of the agreed price, as the entire expense is regarded as non-deductible.

The SAC summarized the approach to service fees in Decision 8 Afs 19/2010-125 of 2 March 2011. In this case, a Czech company (the lessor) owned real estate and rented it to independent parties. An Austrian company provided management and consulting services to the lessor. In particular, the Austrian company should have provided supervision; negotiations with tenants; revision of contracts; controlling; budgeting; financial management; and strategic and other consultancy. The service fees significantly increased each year, although the income of the Czech company was constant in the examined years and there was no significant change in the number of lease contracts.

The tax authorities required that the Czech company prove the actual provision of the services and their relationship to taxable income. The taxpayer provided a management and advisory contract, overview of rendered services confirmed by the service provider and other documentation. All documents, however, gave only a general description of the provided services.

The SAC ruled that the taxpayer was obliged to prove the relationship of the expensed service fees to its taxable income. As in other decisions on service fees, it referred to tangible evidence of the provided services, including reports, correspondence and confirmation of business trips. A list of provided services without primary documentation proving their actual provision may thus be regarded as insufficient.

This SAC decision further stresses the importance of primary documentation (e.g. reports, correspondence and meeting notes) and additionally requires the taxpayer to prove the relationship of the service fee to taxable income. This additional requirement should be covered in transfer pricing documentation, as employee turnover may render a company unable to retroactively identify the benefits.

6. Conclusion

The Supreme Administrative Court decisions considered in this article provide a significant interpretation of the allocation of the burden of proof in transfer pricing disputes. These decisions may be effectively used in transfer pricing disputes with tax authorities and should be taken into account when managing transfer pricing risks.

The SAC decisions should also be taken into account during the preparation of transfer pricing documentation. This is especially important for the documentation of services so as to provide taxpayers with sufficient comfort in the event of a tax inspection.