

Ministry of Finance
Direct Taxes Department

Ref.no.: 39/86 829/2009-393

Guidance D - 332

Communication by the Ministry of Finance in respect of international standards application in taxation of transactions between associated enterprises – transfer pricing

For the purposes of unification and simplification of the mentioned transfer valuation, there are principles and procedures stipulated in the Transfer Pricing Guidelines for Multinational enterprises and Tax Administrations processed in the form of the Report by Fiscal Issues Committee of the Organization for Economic Cooperation and Development (hereinafter just „Directive“ or „TPG“) applied internationally.

These principles and procedures must be applied in accordance with the valid international Double Taxation Avoidance Treaties entered into by the Czech Republic and other states, as well as in accordance with the applicable laws of the Czech Republic.

The issuance of this methodology guidance aims at assuring unified approach to taxation of the mentioned transfers within multinational enterprises both by the tax administration and taxpayers.

This methodology guidance has been processed with respect to the existing Czech legislation and relevant applicable international conventions, and deals namely with the implementation of the basic principles in administration of taxes regarding transfer pricing under the conditions of the Czech Republic.

1. TRANSFER PRICING, ARM'S LENGTH PRINCIPLE

In a simplified way, it may be stated that transfer pricing (usual prices) means the “prices” applied in transactions between two taxpayers associated in economic or personnel sense, in the terminology of Double Taxation Treaties the term “associated enterprises” is used. These prices must be set up in the same way as would be applied by the enterprises not associated in economic or personnel sense (independent enterprises). The prices determined in such a way are the prices determined on the basis of an arm's length principle. In the Czech conditions we can say that this means application of “usual prices” used for income tax base definition pursuant to provisions stipulated in our tax laws.

The arm's length principle is regulated:

- A. In Double Taxation Treaties (hereinafter just “Treaties” or “DTA”);
- B. In the national Act no. 586/1992 Coll., on Income Taxes, as amended (hereinafter just “AIT”).

1.1. Bilateral Double Taxation Treaties

This concerns mostly the Article 9 under most of the bilateral DTA as well Model Convention on Avoidance of Double Taxation issued by OECD.

When regulating prices for taxation purposes in respect of transactions between associated enterprises, it is necessary to respect primarily relevant provisions of the Treaties. This obligation arises from the provision of s. 37 of AIT:

“The provisions of this Act are to be used only if the international Treaty, the Czech Republic is bound by, does not provide for otherwise”.

In this case, Double Taxation Treaties are considered as such binding treaties. For the purposes of entering into such treaties OECD has produced the Model Convention on Avoidance of Double Taxation, including its explanatory Commentary.

The issues as regards administration of taxes are regulated accordingly pursuant to section 5 of Act no. 280/2009 Coll., on Administration of Taxes, as amended (hereinafter “AAT”).

The obligation to prefer international treaties in general (it means also for the tax purposes) arises from the wording of the Article 10 of Act no. 1/1993 Coll., Constitution of the Czech Republic, as amended:

“Promulgated international treaties ratified by the Parliament and binding the Czech Republic are part of the Czech legal order; unless the international treaties provide for otherwise, the international treaties shall be applied.”

The possibility to adjust tax base in transfers between associated enterprises arises from the Article 9 par. 1 of the Model Convention:

„Where

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

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

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

Letters a) and b) of this provision define associated enterprises, the following part then determines terms for the application of an arm's length principle. This provision is in fact an equivalent to provisions of s. 23 par. 7 of AIT, and entitles the tax administration to check and determine the tax base for associated enterprises.

1.2. National Law

The arm's length principle is regulated by s. 23 par. 7 of AIT, which:

- 1) regulates and determines conditions for application of the “usual” price for the purposes of income tax base definition as follows:

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

- 2) determines associated enterprises.

Compared to Treaties, AIT uses the term “usual” price in a wider context, and namely in case of persons next in kin and persons under letter b) of item 5. Under these provisions such tax base adjustment with regard to transactions between persons associated differently or close persons may be applied only on relations between the persons who are the tax residents of the Czech Republic or the tax residents of a state, which the Czech Republic has not entered into Treaty with.

The limit of 25% share in registered capital or right to vote shall be applied under AIT also in cases of associated enterprises under the Treaties.

1.3. Transfer Pricing Guidelines

When applying the arm's length principle in the sense of the Article 9 of Treaties, in the course of tax base determination the definition of prices for tax purposes is perceived as the most difficult problem in transfers of goods, intangible assets and services between the

associated enterprises. For this purpose, the OECD Committee on Fiscal Affairs processed the report “**Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations**” (hereinafter only Guidelines) in 1995. In 1997, these Guidelines were reviewed down to chapter VIII and expanded with “Guidelines for monitoring of procedures used in application of OECD Transfer Pricing Guidelines and involvement of business community in the process” and “Guidelines for conducting Advance Pricing Arrangements under the Mutual Agreement Procedure“ (MAP APAs).

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

The Guidelines were updated in 2009, namely the chapter IV. – Administrative cooperation. OECD member states (including the CZE) also re-drafted chapters I – III and produced a new chapter IX dealing with transfer pricing aspects in company restructuring cases. Chapters I – III and IX were then promulgated in 2010.

The Transfer Pricing Guidelines pricing aim at unification of procedures applied by the tax administrations and associated enterprises when solving transfer pricing cases, minimising conflicts between them and avoidance of costly court litigations as well as assistance in application of par. 2 of Article 9 of the Model Convention – adjustment of profit for tax purposes (refer to item 6 of this Guidance).

1.4. Implementation of the Guidelines into the Czech Legislation

The principles of the Guidelines have not been directly implemented in tax laws of the Czech Republic nor there is any direct reference to them. Nevertheless its **binding effect** in interpretation of the Treaties arises from the fact that the Czech Republic is a signatory to multilateral Vienna Convention on Law of Contracts (published in Collection of Acts under the number 15/1988 Coll. as Notice by the Minister of Foreign Affairs on Vienna Convention on Law of Contracts dated on September 4, 1987). Article 31 of the Convention states general rules for its interpretation.

Transfer Pricing Guidelines correspond in their character and way of adoption and implementation to the documents stated in Article 31 of the Vienna Convention, namely par. 2, as the OECD member states (the Czech Republic joined OECD in 1995) have reached consensus in this matter. In this respect the Guidelines may be used for tax purposes in the same way as other OECD member states use them – as interpretation rule for the Article 9 of the Treaties.

With respect to the above stated, the procedures and principles provided for in the Guidelines are applicable also in relation to AIT (i.e. also in the cases of transactions between associated persons seated in the Czech Republic).

1.5. Subject of examination

The above stated definitions show that under the Guideline **transactions¹⁾ and their valuation as well as allocation of profits** brought by them between associated enterprises involved in the transactions concerned are subjected to the examination. As the Guidelines are understood as an interpretation rule for the Article 9 of the Model Convention (i.e. bilateral Treaties) it always must concern the relations between “a company in one State and the company in another State”, in other words **between domestic and foreign taxpayers**.

If the transactions, their valuation and allocation of profits brought by them between domestic associated companies are subjected to the examination, domestic tax laws are to be followed, and methods and other procedures recommended by the Guidelines may be used.

1. 6. Associated Enterprises

Definitions stated in the Article 9 of the Model Convention and in s. 23 par. 7 of AIT show that the term “associated enterprises” (associated persons) means the situation, when an enterprise of one State is engaged directly or indirectly in management, control or assets of the other State enterprise or when the same persons (same legal or natural persons) are engaged directly or indirectly in management, control or assets of both enterprises, the enterprise of one State as well as the enterprise of the other State.

What is meant by **share in control or assets** of the company is precisely defined in s.23, par. 7 of AIT (more than 25% share in registered capital or right to vote). Treaties do not contain this definition, and that is why the national law is to be applied. Examples of associated enterprises’ relations are stated in Annex 1 to this Guidance.

When assessing whether one person (one enterprise) is involved **in the management** of the other enterprise, it is necessary to refer to general regulations, i.e. Commercial Code. Under the term “management”, one can understand acting on behalf of or in the name of the enterprise, i.e. acts performed by authorised representatives of a body corporate or its members, e.g. corporate agents (limited liability companies) or partners (limited liability companies, public limited companies), Board of Directors (joint-stock companies, cooperatives), general partners (limited partnership company) etc. Companies may not be considered as associated enterprises just on the ground of the fact that an identical natural person acts in the Supervisory Boards of the companies concerned. It is always necessary to evaluate particular activity performed by each person entitled to act on behalf of the enterprise, namely whether the person may influence decision taking or whether the person is directly involved in the decision-making process.

1.7. Other provisions including the arm’s length principle

Beyond the above mentioned basic definitions (section 23 par. 7 of AIT, Article 9 of the Treaties) there are both in the Czech national legislation and international conventions other

¹⁾ Transactions between associated enterprises are also denominated as controlled transactions (from the English original “controlled transaction”) or dependant transactions. In the same way the prices of these transactions are denominated as controlled or dependant ones.

specific provisions included containing principles to be applied in taxation of transactions realized between persons of special relationship. This concerns namely:

AIT:

- **section 22 par. 1 letter g) item 3** – “reclassification” of differences between the transfer price arranged and the price usual in the market under section 23 par. 7 of AIT and interests non-deductible as expenditure (cost) under section 25 par. 1 letter w) of AIT and their expression as profit shares;
 - **section 23 par. 7** – interests on loans; the „usual“ price, i.e. price which would be realized between independent enterprises, means the price determined pursuant to a special legal regulation;
 - **section 23 par. 11** – an arm’s length principle for the purposes of permanent establishment tax base definition;
 - **section 25 par. 1 letter w)** - thin capitalisation;
 - **section 35a par. 2 letter d)** – investment incentives;
 - **section 35b** - investment incentives.
- On the day the Czech Republic joined the EU, the provisions of AIT amendment no. 438/2003 Coll. come into effect implementing the rules for taxation in respect of some transactions between associated persons within the EU member countries:
 - Some provisions of **section 19**, implementing the Council Directive 90/435/EEC of 23.7.1990 on the common system of taxation applicable in the case of parent enterprises and subsidiaries of different Member States and the Council Directive 2003/49/EC of 3.6.2003 on the common system of taxation applicable to interest and royalty payments made between associated enterprises;
 - **section 23a to section 23d** – implementing the Council Directive 90/434/EEC of 23.7.1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares.
 - Double Taxation Treaties:
 - **Article 7 of the Model Convention – Profits of enterprises:** pursuant to this Article, the profits of permanent establishments (determined in Article 5 of the Treaties) are allocated under the similar arm’s length principle with a certain modification arising from the specific position of the permanent establishment against the company carrying out its activities through the permanent establishment;
 - **Article 10, par. 3 of the Model Convention** – definition of the term “dividend” (in relation to “reclassification” under section 22, par. 1, letter g) item 3 of AIT);
 - **Article 11 of the Model Convention** – Interests, par. 6;
 - **Article 12 of the Model Convention** – Royalties, par. 4;
 - **Article 23 of the Model Convention** – Methods for avoidance of double taxation.

These provisions are rather specific, and have their own solutions slightly different from classical application of transfer pricing principles, and this methodology guidance does not engage in them further on.

2. BASIC PRINCIPLES

When examining whether the **transfer prices are in compliance with the arm's length principle**, the following principle is followed

- members of multinational groups are considered **as if they were separate and independent enterprises** (i.e. as independent taxpayers);
- the attention focuses on **nature of transactions** between them (e.g. what they are oriented on, what they are applied to etc.).

Comparison between terms and conditions of controlled transactions and those of independent transactions, i.e. performance of due **comparability analysis**, is the basis for the arm's length principle application. While:

- **controlled transaction** means any business relation (transactions, transfers) between associated enterprises;
- **independent transaction** means a business relation between independent enterprises.

2.1. Comparability analysis

To perform comparability analysis it is necessary to identify **independent transactions** comparable to the controlled transactions which are subject to tax examination procedure of the tax administration. In order the transactions or the conditions under which the transactions are effected could be **considered as comparable**, one of the following criteria must be met:

- a) none of the differences between the controlled and comparable transaction should influence a condition (factor) being assessed, i.e. possible differences identified may be considered as insignificant and unimportant for the purpose of comparison

or

- b) there is a possibility to implement relevant adjustments so that the influence of the identified differences may be eliminated.

However, when applying and auditing the transfer prices, it is only rarely possible to find fully comparable transactions in respect of conditions and circumstances under which these transactions are realized. In most cases it is necessary to make adjustments (elimination) of differences influencing pricing pursuant to item b).

2.2. Factors determining comparability

When undertaking comparability analysis, the following **5 factors** have to be taken into account:

2.2.1. Characteristics of assets and services

- In respect of things (e.g. goods, real estates etc.), their physical features, quality, reliability, market availability, market offer volumes must be assessed;
- In respect of the property of intangible nature, it is necessary to concentrate attention on the form of transaction (e.g. whether it concerns licensing or sale), property type (e.g.

patent, trade mark, know-how), duration and level of protection, expected profit from intangible property use/enjoyment;

- In respect of services provided, the nature and scope of the services, purpose and benefit received must be considered.

2.2.2. Functions performed

So called **functional analysis** means identification and comparison of activities and responsibility level (risks) borne by each associated enterprise in comparison to independent enterprises.

Individual companies may be charged with performance of different functions within the multinational group, and independent enterprises may also carry out different functions. This concerns, for instance, production activities, research and development, distribution, advertising, financing, management functions etc.

Similarly, each enterprise may bear different risk level when performing their activities.

2.2.3. Contractual terms and conditions

Based on the contractual terms and conditions, it is possible to find out how the responsibilities and risks or revenues from transactions executed should be allocated (refer also to the previous point). Contractual terms and conditions may be also identified from correspondence or other documents, if there is no existing written agreement.

2.2.4. Economic circumstances

Comparing economic circumstances means comparison of market conditions, such as geographic location, market size, competition level, availability of similar products, supply and demand level, purchasing power, production costs, transportation costs, time factor (seasonality, implementation of novelties etc.), market regulation etc.

2.2.5. Business strategy

As a typical example of business strategy, an effort to penetrate into new markets may be mentioned, when the prices may be significantly twisted due to the higher costs related to market launch of a specific product while applying lower final selling price on that product.

2.3. Other Factors

When assessing whether the transfer prices between associated enterprises have been set up in accordance with the arm's length principle, other facts must be also taken into account as, for instance:

- determination whether the declared transaction has been **actually realized**,
- determination whether the controlled transaction is not closely related to another one (so called **combined transactions**) – in some cases it is impossible to assess individual transaction separately,
- determination whether there are no **mutual compensations** included in the contractual terms, for instance there are services charged against the delivery of goods and then the price of services reduces the price of goods,

- use and comparison of **data from several taxable periods** (e.g. development of profits in the recent years),
- **comparison of profits and losses within the whole group** of the associated enterprises (e.g. if the controlled entity reports losses, do the other group members also report losses?).

2.4. Price range

When comparing and evaluating circumstances which could influence the level of transfer prices, we shall not always use absolute values, but on the contrary we shall nearly always use certain **price range** whereof the prices of comparable products or services are located.

3. METHODS FOR IDENTIFICATION OF TRANSFER PRICES

Based on the comparability and functional analysis performed, one may proceed to identification of transfer price level. For the mentioned purposes Transfer Pricing Guidelines recommend to use 5 basic methods of transfer price identification and/or combination of these methods.

The recommended methods may be divided in two basic groups:

- traditional transactional methods
- transactional profit methods

3.1. Traditional transactional methods:

These methods are based either on comparison between independent (uncontrolled) transaction prices and prices charged in controlled transactions, or on gross margin comparison.

3.1.1. Comparable Uncontrolled Price Method

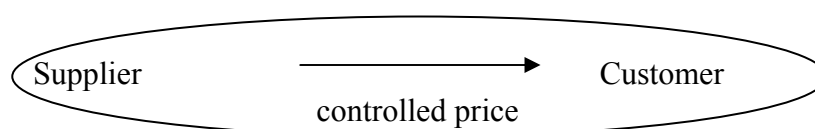
(**CUP**, also Comparable Uncontrolled Transaction – CUT)

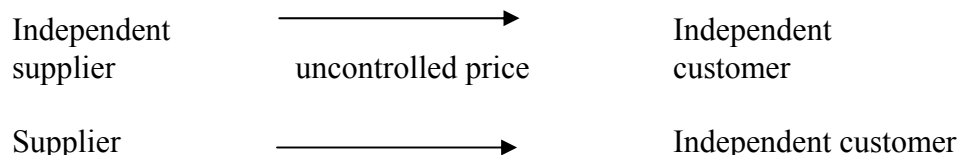
The method compares prices charged in controlled transaction with the prices of comparable uncontrolled transactions under comparable conditions.

This method is the **simplest** one in respect of its application although it requires a **high rate of comparability**.

[So: Controlled price = independent price]

Use: preferably if there is a fully comparable (identical) product.





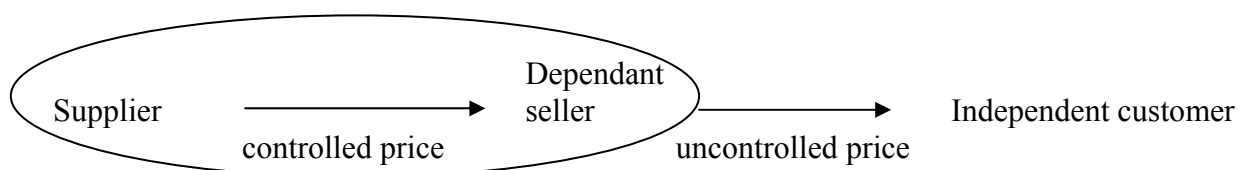
3.1.2. Resale Price Method

(RPM, also Resale Price Minus)

This method is based on the price, for which the product purchased from the associated enterprise (supplier) is resold to an independent enterprise (final customer). Such uncontrolled price is then reduced by the gross margin (gross surcharge) of the dependant seller.

[So: Controlled (transfer) price = uncontrolled price – surcharge of the dependant seller]

Use: where the seller does not contribute to the value of the product sold, e.g. distributor



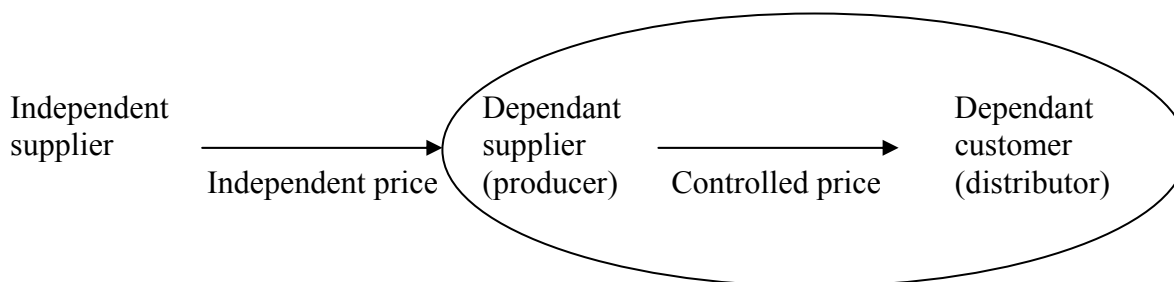
3.1.3. Cost Plus Method

(Cost Plus Method – cost+)

The method is based on supplier's costs in relation to property or services provided to an associated company in the frame of controlled transaction. These costs are then complemented with the relevant surcharge charged by the dependant supplier.

[So: Controlled (transfer) price = independent price + surcharge by dependant supplier]

Use: Where the dependant supplier (producer) does not contribute significantly to the value of products sold, e.g. in sale of semi-finished products, in entering purchasing or sub-delivery agreements etc.



3.1.4. Summary for the traditional methods

The traditional transactional methods are always based on knowledge of the price or knowledge of gross trading range (in our practice we know this term also as „gross margin“). When comparing the mentioned indicators, it is always necessary to “clean” the indicators off the effects which may influence the level of price or surcharge.

3.2. Transactional profit methods

When using transaction profit methods, profits generated by the transactions between the associated enterprises are examined.

3.2.1. Profit Split Method

The method is based on the profit generated by the associated enterprises from the controlled transactions. This profit is then allocated between the associated enterprises involved in the controlled transaction based on contribution analysis (functional analysis). It means the total profit realized by the transaction(s) is allocated in accordance with the share of each enterprise in the total profit.

In order to identify appropriateness of the profit allocation, we have to find enterprises with the functions comparable to those of the associated enterprises involved in the transaction. Simply said, according to the profitability rate identified at those comparable independent enterprises we shall determine what profit share should be obtained by the associated enterprise.

Use: where individual transactions are so much mutually associated that they cannot be assessed individually.

3.2.2. Transactional Net Margin Method (TNMM)

This method examines pure profit margin in relation to respective base, i.e. compares financial indicators related to the controlled transaction with the financial indicators related to a comparable independent transaction (e.g. profitability, cost-effectiveness etc.)

TNMM works in the similar way as the resale price method or cost plus method.

3.3. Method selection

The selection of relevant method depends on analysis carried out, but it is impossible to determine strictly, which method should be used in specific cases. The appropriateness of each method must be assessed, namely in relation to the functional and risk profile of the enterprise. That is why it is necessary to obtain information about comparable transactions and to adjust this information accordingly for the purpose of determination of the correct transfer price.

With respect to the development from 1995 and upon the experience from the use of transactional profit methods, OECD recommends to apply the selection of the particular transactional profit method with respect to the assessment of “the best method according to the circumstances of the case” in each particular case.

4. DOCUMENTATION

In the Czech tax law there is no specific provision imposing an obligation on a taxpayer to present documentation on transfer pricing. However, provisions of **section 92 of AAT**, and

namely par. 3 and 4, state “Persons liable to tax must prove all the facts which they are obliged to state in their tax return, amended tax return and other tax submissions. If the course of proceedings requests so, the tax administrator is entitled to call upon the taxpayer to prove the facts decisive for determination of tax, namely when this necessary information cannot be obtained from tax administrator’s own official materials and information.”

Pursuant to the provision mentioned above, the tax administrator may require from the taxpayer to provide **evidence and plausible reasoning** of the transfer pricing used in accordance with the arm’s length principle.

If the tax administration requires having transfer pricing documentation submitted, provisions of the AAT are to be followed **in the frame of tax proceedings**.

Detailed explanation of the documentation content is provided for in Guidance D-334 (Communication by the Ministry of Finance in respect of the scope of documentation concerning pricing between associated entities, ref. no.: 39/86 849/2009-393) available at the Czech Tax Administration web-site: www.danovaspravacr.cz .

5. CONSEQUENT PROFIT ADJUSTMENTS

Provisions of section 23 par. 7 of AIT and the Article 9 par. 1 of the Model Convention entitle tax administration bodies to determine a new tax base on the ground of finding that there were prices different from “usual prices” charged in the transactions between associated enterprises. This one-sided act may lead to double taxation. In order to avoid double taxation, there are subsequent profit adjustments made. Explanation and methodology of these adjustments are provided in separate Guidance (available at the Czech Tax Administration web-site: www.danovaspravacr.cz).

6. ADVANCED PRICING AGREEMENTS

Transfer Pricing Guidelines, besides other, provide for the possibility to conclude advanced pricing agreements as the instrument eliminating disputes between tax administration and taxpayers in respect of transfer pricing application.

It is a matter of arrangement between the taxpayer and tax administration bodies concerning the prices and supply conditions for transactions between associated enterprises before their performance.

Procedures related to advanced pricing agreements, including practical information are described in separate Guidance (available at the Czech Tax Administration web-site: www.danovaspravacr.cz).

7. CONCLUSIONS

This methodology guidance is not a closed document. It will be continuously complemented and/or substituted with new wording reflecting both changes in legislation and latest knowledge and experience concerning transfer pricing application.

This Guidance repeals the Guidance D-258 issued under the ref. no.: 491/1554/2004, and comes into effect on January 1st, 2011.

Jan Knížek
General Director
of the section Taxes and Customs

Annexes:

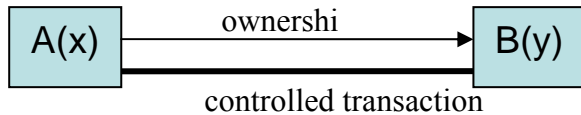
Annex 1

This annex contains illustrative examples and additional information concerning particular parts of the methodology Guidance D – 332:

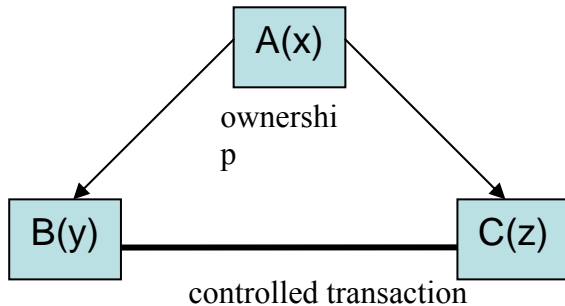
To item 1.6. Associated enterprises

To explain the use of transfer prices between associated enterprises and relations between associated enterprises there are the following examples:

a) The mother company A having its registered office in a state X owns 100% of its daughter company B in a state Y. Then the transaction between A and B is considered as controlled transaction:



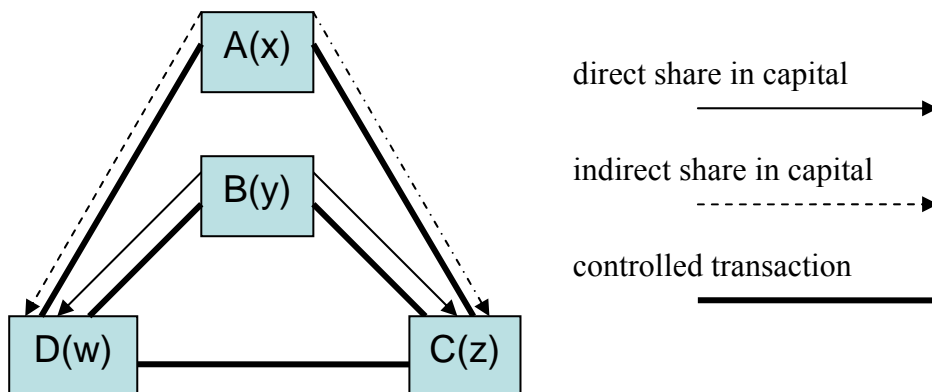
b) The mother company A having its registered office in a state X owns 100% of its daughter company B in a state Y and company C in a state Z (the company A has direct share in the assets of the company B as well as the company C). Then the transaction between the daughter companies B and C is considered as controlled transaction:



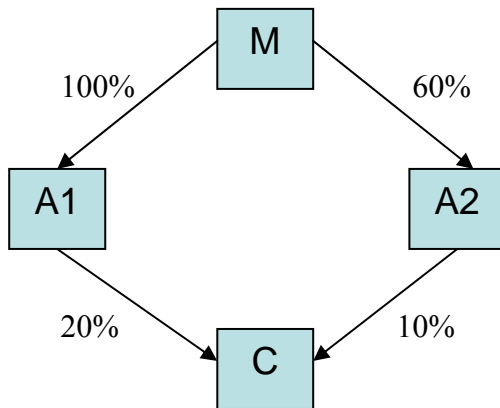
Besides that, in this case the controlled transactions may be executed also between the companies A and B or between the companies A and C.

c) The mother company A having its registered office in a state X owns 100% of its daughter company B in a state Y, the company B owns 50% of a company C in a state Z and also owns 70% share in a company D in a state W (i.e. the company A has direct share in the assets of the company B and has indirect share in the assets of the companies C and D). Then the controlled transactions may be performed

- between the companies B and C, between B and D as well as between C and D – all due to the direct share of the company B in the companies C and D
- between the companies A and B due to direct share of the company A in the company B’s capital
- between the companies A and C, between A and D as well as between C and D - all due to indirect share of the company A in the companies C and D



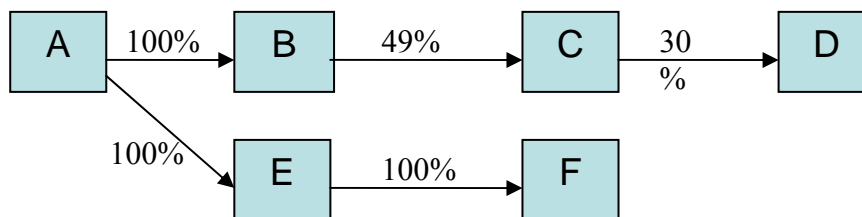
d) The mother company M owns 100% of the company A1 and 60% of the company A2; the companies A1 and A2 own shares in the assets of the company C in the following way: the company A1 owns 20% and the company A2 owns 10% of the company C; each of the mentioned companies has its registered office in different states.



Only the companies A1 and A2 shall be considered as associated persons as the condition of 25% share in registered capital or right to vote is met only in this relationship. That means M and A1 and/or M and A2 are persons mutually related directly through capital under s. 23, par. 7, letter a) item 1 of AIT. Companies A1 and A2 are persons mutually related through capital under s. 23, par. 7, letter a) item 2 of AIT.

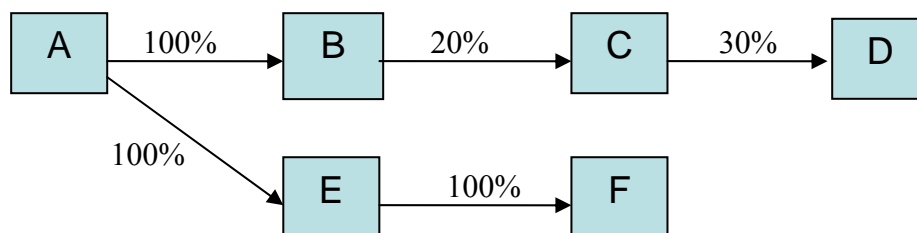
e) Initial situation is the same one as in the example d) with the only difference that the owner of the company M (natural person) is an authorized agent of the company C at the same time. In this case, the transactions between the companies M and C are the controlled ones as the identical person controls the company M and at the same time participates in the management of the company C (s. 23, par. 7, letter b), item 2 of AIT). Other controlled transactions may appear in the relations between the companies M and A1, between the companies M and A2 as well as between the companies A1 and A2. So in this example, the controlled transactions may have place between all the companies concerned.

f) There are companies A, B, C, D, E and F. Each of the companies has its share in the registered capital of the other company as the following scheme shows:



As each of the companies owns always at least 25% share in the registered capital of the other company, all the mentioned companies may be considered as mutually related persons through capital. For instance, the companies B and D are mutually indirectly related through capital as the share of the company B in the company C is higher than 25%, and the share of the company C in the registered capital of the company D is also higher than 25%. The condition of at least 25% share possession must be always met in the case of immediately successive links (companies) in the chain of the companies. So the transactions between all these companies shall be the controlled ones.

g) Similarly to the previous case, there are companies A, B, C, D, E and F. Each of the companies has its share in the registered capital of the other company as the following scheme shows (there is a change in the share of the company B in the registered capital of the company C):



The companies A, B, E and F may be considered as mutually related persons, further the companies C and D are also mutually related persons. As the share of the company B in the company C is lower than 25%, opposite to the situation described in the example f) there are two independent groups of related companies (associated enterprises), and namely the group of the companies A, B, E and F and the group of the companies C and D. Controlled transactions then may be performed only within each of these groups.

h) There is the company A, s.r.o. (limited liability company) and the company B, a.s. (joint-stock company) Mr. C is the authorized agent (jednatel) of the company A. Mr. C is simultaneously also a member of the Board of Directors of the company B. Then both the companies are considered as “otherwise related entities” due to the participation of an identical person in the management or control of them. So the transactions between the company A, s.r.o. and the company B, a.s. shall be the controlled ones.

These are very simplified examples of relations between associated enterprises. There may be much more varieties and combinations of various relations in practice, including various forms of management or controls over daughter companies.

To item 2.1. Comparability analysis

In order the transactions or the conditions under which the transactions are effected could be considered as comparable, one of the following criteria must be met:

a)
none of the differences between the controlled and comparable transaction should influence a condition (factor) being assessed, i.e. possible differences identified may be considered as insignificant and unimportant for the purpose of comparison

Example: a German company has established its daughter company in the CZE producing window blinds, which are to be then supplied to the German mother company. For that purpose, the German company has supplied all machinery equipment, technical documentation and materials to be processed to the CZE.

Then it would be appropriate to find an independent producer of blinds or similar (comparable) type of products who produces them for an independent customer (a German one would be the best) under the same (comparable) conditions as the mentioned Czech daughter company.

Or

b)
there is a possibility to implement relevant adjustments so that the influence of the identified differences may be eliminated.

Example:

- the price of the controlled transaction includes the costs of transportation to the customer
- the price of the independent transaction does not include these transportation costs

In such a case, it is necessary to eliminate the price difference caused by inclusion/non-inclusion of the relevant transportation costs in the frame of comparison of the two transactions.

To item 2.2.2. Functions performed

Performance of so called functional analysis may be illustrated in the following example:

Associated enterprises:	Company A – producer
	Company B – distributor
Independent enterprises:	Company X – producer
	Company Y – distributor

When comparing the transactions between A and B with the transactions between X and Y, it was found out that

- the companies A and X perform comparable functions (production), and the companies B and Y also perform comparable functions (distribution);
- goods sold by the companies A and X is comparable (has similar parameters);
- activity of the company B includes also research and development for a group of associated enterprises.

So it is clear that when assessing and comparing profits, the fact that the company B has a little bit different functions (distribution + research and development) from the company Y (distribution only) must be reflected in the course of comparison.

To item 2.4. Price range

Example of the price range use:

Tax control has ascertained that the company A uses the 5% surcharge to its costs. Comparable independent companies X, Y, Z acting in the same sphere in a comparable market were determined in the course of proceedings. The mentioned companies apply the following margins on their costs: 10 % in case of X, 12 % in case of Y and 15 % in case of Z.

It arises from the facts ascertained that the margin of the company A should be within the range 10 – 15 %. Under the assumption that the company A reports the costs of 1 piece of product in amount of CZK 100, then the price determined based on an arm's length principle should be in the range CZK 110 – 115.

To item 3. Methods for identification of transfer prices

The following example illustrates the principle of each transaction method functioning in the course of the transfer prices definition. Input information is the same for all the methods.

The Producer and Distributor are associated enterprises under the provisions of Article 9 of the Model Convention. The Producer sells its goods to the Distributor for the transfer price. This transfer price is the subject to the calculations presented in the following examples.

Note: Terminology used in this example need not necessarily correspond to the terminology usually used in the Czech accounting and tax regulations.

Producer:

(line 1) Sale to distribution company	\$ 10.000 (transfer price)
(line 2) - Production costs	\$ 5.000
(line 3) = Gross profit	\$ 5.000
(line 4) - Other costs	\$ 3.000
(ř.5) = Profit after deduction of other costs	\$ 2.000

Distributor:

(line 6) Sale to independent enterprise	\$ 20.000
(line 1) - Purchase from the producer	\$ 10.000 (transfer price)
(line 7) = Gross profit	\$ 10.000
(line 8) - Other costs	\$ 4.000
(line 9) = Profit after deduction of other costs	\$ 6.000

1. Comparable Uncontrolled Price Method

When using the *Comparable Uncontrolled Price Method*, it is necessary to identify whether the transfer price (line 1) used between associated enterprises (\$ 10.000) is identical to the price used between independent companies in the case of comparable products and comparable conditions.

2. Resale Price Method

When using the *Resale Price Method* it is necessary to identify whether the range deducted from the final sale price of the Distributor (line 6) is identical to the gross margin of independent distributors in the case of comparable conditions of both the transactions, when the gross margin of the Distributor is 50%.

line 1	10 000		
i.e. -----	* 100, so	-----	* 100 = 50 %
line 6	20 000		

3. Cost Plus Method

When using the *Cost Plus Method* we identify whether the gross profit margin added to the production costs of the Producer (line 2) is identical to the gross profit margin of an independent producer in the case of the comparable conditions in both the transactions, when the surplus of the Producer is 100%.

line 1 – line 2	10 000-5 000		
i.e. -----	* 100, so	-----	* 100 = 100 %
line 2	5 000		

4. Profit Split Method

When using the *Profit Split Method*, the profit is allocated based on the proportional share of all the members of the group in the controlled transaction, e.g. based on the share in the development costs, based on the risk level associated with the sales etc. The stated example shows that the total profit of both the associated enterprises reached \$ 8000, i.e. selling price of the Distributor \$ 20 000 (line 6) minus the sum of the production costs of the Producer \$ 5000 (line 2) and total of other costs \$ 7000 (lines 4 and 8).

5. Transactional Net Margin Method

When using the *Transactional Net Margin Method*, it is necessary to identify whether this net margin is identical to the net margin, which an independent distributor would reach in the case of comparable conditions of both the transactions. The example shows that the distributor's net margin is 30%.

line 9	6 000		
-----	* 100, so	-----	* 100 = 30 %
line 6	20 000		

Annex 2

Notice by the Minister of Foreign Affairs dated on September 4th, 1987 – on Vienna Convention on the Law of Treaties

Article 31

General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 - (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
 - (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
 - (c) any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

Annex 3

List of Double Taxation Treaties containing an article concerning associated enterprises
(as of July 15th, 2010)

Contractual Country	Article	This Article contains paragraph 2 pursuant the Model Convention (subsequent adjustment of profits)	This Article contains paragraph 3 (reservation by the CZE limiting paragraph 2 to cases of unintentional behaviour)
Albania	9	yes	yes
Armenia	9	no	no
Australia	9	yes	yes
Azerbaijan	9	yes	yes
Belgium	9	no	no
Belarus	9	no	no
Brazil	9	no	no
Bulgaria	9	no	no
Bosnia and Herzegovina	9	yes	yes
China	9	yes	no
Denmark	9	yes	no
Egypt	9	no	no
Estonia	9	no	no
Ethiopia	9	yes	yes
Philippines	9	no	no
Finland	9	yes	yes
France	9	no	no
Georgia	9	yes	yes
Croatia	9	yes	yes
India	9	no	no
Indonesia	9	no	no
Ireland	9	yes	no
Island	9	no	no
Italy	9	no	no
Israel	9	yes	yes
Japan	9	no	no
South Africa	9	yes	no
Jordan	9	no	no
Yugoslavia	9	no	no
Canada	9	yes	yes (here it is par. 4)
Kazakhstan	9	yes	yes
Korea	9	no	no
Korea – People’s Dem. Rep.	9	yes	yes
Kuwait	9	yes	yes
Cyprus	9	no	no
Lebanon	9	yes	yes
Lithuania	9	no	no
Latvia	9	no	no
Luxembourg	9	yes	no
Hungary	9	no	no
Macedonia	9	no	no
Malaysia	9	no	no
Malta	9	yes	yes
Morocco	9	yes	yes
Mexico	9	no	no
Moldova	9	no	no
Mongolia	9	no	no
Germany	9	yes	no
Nigeria	8	yes	no
Netherlands	9	no	no
Norway	9	no	no
New Zealand	9	yes	yes

Poland	9	no	no
Portugal	9	yes	no
Austria	9	no	no
Romania	9	yes	no
Russia	9	no	no
Greece	9	no	no
Singapore	9	no	no
Slovakia	9	yes	yes
Slovenia	9	yes	yes
United Arab Emirates	9	no	no
Serbia and Montenegro	9	no	no
Sri Lanka	6	no	no
Syrian Arab Republic	9	yes	yes
Sweden	9	no	no
Spain	9	yes	yes
Switzerland	9	yes	yes
Tajikistan	9	no	no
Thailand	9	no	no
Tunisia	9	yes	no
Turkey	9	yes	yes
Ukraine	9	no	no
USA	9	yes	yes
Uzbekistan	9	yes	yes
United Kingdom	9	no	no
Venezuela	9	no	no
Vietnam	9	no	no