

Ministry of Finance
Direct Taxes Department

Ref.no.: 39/86 849/2009-393

Guidance D – 334
Communication by the Ministry of Finance in respect of the scope of transfer pricing documentation

1. Introduction

In consideration of present development in transfer pricing, Czech Republic's membership in international organisations as well as responses by private sector, the Ministry of Finance issues its **recommendation concerning the scope of documentation related to transfer pricing between related persons** in the frame of this communication.

This communication aims at publishing standards of documenting appropriateness of transfer pricing to make them compliant with section 23 par. 7 of the Act no. 586/1992 Coll., on Income Taxes, as amended (hereinafter "AIT") and Article 9 of most of the Double Taxation Treaties (hereinafter "DTA"), so bringing them into compliance with an arm's length principle specified in Chapter 1 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter only as "OECD Guidelines").

Related principles for application of provisions concerning transfer pricing in general are arising from AIT (mainly section 23 par. 7 and other provisions) and are described in details in the Guidance D-332 – Communication by the Ministry of Finance in respect of international standards application in taxation of transactions between associated companies – transfer pricing, ref. no. 39/86 829/2009-393 available at the Czech Tax Administration web-site: www.danovaspravacr.cz.

Each taxpayer should aim at determining transfer prices for tax purposes in compliance with the arm's length principle based on information reasonably available at the moment of pricing. In the frame of the price examination, he is obliged to demonstrate, how the prices were set-up, and whether they would have been set up in the same way also if effected between two independent companies.

It would be in the interest of the tax administration to determine as wide as possible requirements against taxpayers in order to be able to obtain all documents necessary for the taxation procedure. On the other hand, the private sector aims at as specific and narrow list of documents as possible to be provided to the tax administration. This recommendation aims at finding some kind of a consensus between the mentioned two tendencies so that the required volume of documentation would be sufficient for the purposes of tax administration and at the same time would not excessively burden the taxpayers.

Referring to chapter 1.4. of the above mentioned Guidance D-332 (in respect of OECD Guidelines principles applicability also to relations regulated by AIT), this communication applies both to purely domestic business relations between related entities in

the frame of the Czech Republic and to cross-border business relations, i.e. to entities being parts of multinational groups having their registered office in the Czech Republic.

2. The Czech Republic as the OECD member

The Czech Republic as the member of OECD applies principles and recommendations issued by this organisation.

As generally accepted manual used as guidance for taxpayers as well as the tax administrations in solving the issues of transfer pricing, there is a document called Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued in the form of OECD Fiscal Issues Committee Report (hereinafter just “Guidelines”). The Guidelines are not legally binding for the Czech Republic, nevertheless the document is considered as very effective, and its principles are followed not only by the Czech tax administration but also other OECD member states as well as a great number of non-member states.

Chapter V. of the Guidelines deals with the transfer pricing.

3. The Czech Republic as the EU member

In order to eliminate barriers within EU and aiming at unification of procedures and rules for documentation, a working group for the issues of taxation in multinational enterprises – EU Joint Transfer Pricing Forum (hereinafter just “EU JTPF”) created a concept of European documentation on transfer pricing (EU Transfer Pricing Documentation, hereinafter just “EU TPD”), based on which the **Code of Conduct in Transfer Pricing Documentation for Associated Enterprises in the EU** was adopted. The fact that existence of different arrangements in respect of documentation obligations in member states would cause creation of new obstacles and constrains in international trade, which the European Union strives to eliminate, was the reason for the definition of the rules. The existence of different arrangements in EU states complicates establishing or performance of business activities with associated entities having their registered offices in other member states. Processing of a great number of documentation packages could represent a burden for them, both from economic and time point of view.

4. Concept of European Documentation on Transfer Pricing (EU TPD)

The basic principle of EU TPD lies in the preparation of transfer pricing documentation by multinational enterprises in two parts:

- I. The first part contains **basic documentation** (called **Master-file**), i.e. precisely determined documentation package containing information of the whole multinational enterprise group applicable in a unified way in all the EU member states. Information contained should reflect all economic facts of the business and should provide a general overview of the multinational group. The group’s transfer pricing policy should be documented in the frame of this package, and all internal business relations should be explained there.

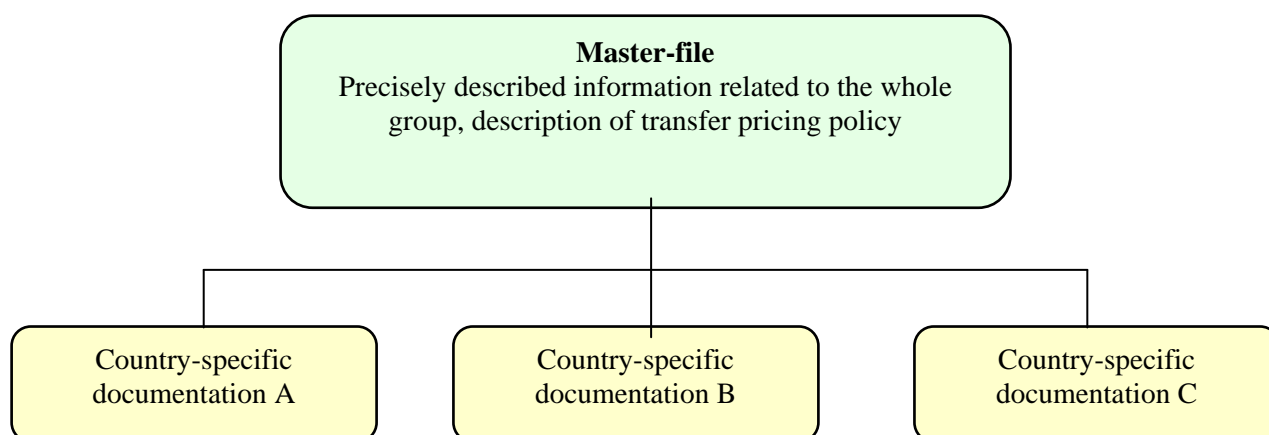
The basic documentation (Master-file) should contain namely following information:

- a) general description of the business activity and business strategy of the group of enterprises, including changes in the business strategy compared to the previous tax year;
 - b) general description of the group's organizational, legal and operational structure (including an organization chart, a list of group members and a description of the participation/share of the parent company in the subsidiaries);
 - c) general identification of associated enterprises engaged in business relations involving related enterprises within the EU;
 - d) general description of the business relations involving associated enterprises in the EU, i.e. a general description of:
 - flows of transactions (tangible and intangible assets, services, finances etc);
 - invoice flows;
 - scope of transaction;
 - e) general description of functions performed, risks assumed and description of changes in functions and risks compared to the previous tax year, e.g. change from a pure distributor to a commission entity;
 - f) the ownership of intangible assets (patents, trademarks, brand names, know-how, etc.) and royalties paid or received;
 - g) the MNE's inter-company transfer pricing policy or a description of the group's transfer pricing system that explains the arm's length nature of the company's transfer pricing;
 - h) a list of cost sharing agreements, list of Advance Pricing Agreements (Binding Rulings) and rules covering transfer pricing aspects, if they apply to the related entities within the EU;
 - i) a commitment of each domestic taxpayer to provide supplementary information upon request and within a reasonable time limit in accordance with national rules.
- II. Each company of the group will prepare in addition a **country specific documentation** required by the EU member state of its residence. Such documentation should contain, in addition to basic documentation, the following items:
- a) detailed description of the business activity and business strategy, including changes in the business strategy compared to the previous tax year;
 - b) description of business relations, which the company is involved in :
 - flows of transactions (tangible and intangible assets, services, finances etc);
 - invoice flows;
 - scope of transaction;
 - c) comparability analysis, i.e.:
 - characteristics of property or services;
 - functional analysis (functions performed, assets used, assumed risks borne);
 - contractual terms;
 - economic circumstances;

- specific business strategies;
- d) explanation of the selection and application of the transfer pricing method[s], i.e. why a specific transfer pricing method was selected and how it was applied;
- e) relevant information on internal and/or external comparables if available;
- f) description of the way how the company is involved in the group's transfer pricing policy.

Generally, it should be left at the discretion of the taxpayers what documentation will be processed for the group as the whole and what will be complemented by each company separately. The company should have the possibility of including some items of the country-specific documentation in the Master-file, keeping, however, the same quality and level of detail as in the country-specific documentation. The fact that the company should always have all the documentation required by the particular state available would be maintained as the main principle.

Expressed in graphic way, the concept of EU TP Documentation can be demonstrated as follows:



Documentation package for state A would contain Master-file complemented by the country-specific documentation required by the state A. In the same way, to meet the documentation requirements of the state B, the company would complement the Master-file with the country-specific documentation required by the state B.

It is assumed that the group's Master-file will be processed by specialists knowing more deeply transfer pricing issues so it is expected that it should have higher informative value and should contain higher quality data than in cases when each company prepares its documentation in a separate way. The tax administrator should obtain an overview of all the business relations within the group and should be able to understand its transfer pricing policy.

The utilisation of information obtained from various registers and paid databases is also an important issue. Information about comparable independent business relations (transactions) both internal and external is the part of the specific documentation. It has been stated that not all the companies have databases available to find comparable independent prices from external resources. So when requiring specific documentation, information about

the external independent transactions should be presented not until the internal comparable independent transactions are submitted .

The application of EU TPD is not mandatory for the multinational companies yet. It means the company may decide itself whether it shall process basic information (Master-file) for the whole group or not. It must be considered whether benefits arising from meeting the concept are worth the costs related to the processing of the documentation.

5. Principles applied when documenting transfer pricing between associated entities in the Czech Republic

All EU member states including the Czech Republic have decided to apply the European Code of EU TPD and to implement its rules either in their laws or using other binding instruments and other forms of notification. The Ministry of Finance has decided to issue a guidance concerning the scope of documentation of transfer pricing between associated entities, and processing the mentioned guidance followed the above stated concept while reflecting all national specific circumstances. **All the principles shall be applied in accordance with the valid regulations in the Czech Republic**, both in respect to domestic business relations with associated entities as well as international business relations with associated entities.

The taxpayer shall present its transfer pricing documentation to the tax administrator in the following cases:

- a) while proving his tax liability,
- b) when applying for the binding ruling under section 38nc of AIT – Binding ruling in respect of the pricing between associated companies,
- c) when initiating proceedings leading to double taxation avoidance under a bilateral Double Taxation Treaty or under the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises 90/436/EEC (hereinafter just “Arbitration Convention”).

As already stated, the application of the Master-file shall be voluntary for associated entities. It means that the companies may decide themselves, whether to process basic documentation for the whole group together. If the group of associated entities selects this option, the Czech tax administration shall apply the provisions of the Code of Conduct on Transfer Pricing Documentation for Multinational Enterprises in the EU in accordance with respective Czech law.

Irrespective to the fact whether the company applies the concept of EU TPD and decides to process the basic documentation for the whole group in a unified way or whether the company decides to document its transfer pricing independently, the documentation presented should contain the following information:

- **information concerning the group (possibly Masterfile)** – description of business activities, complete ownership and organisational structure of the whole group, legal forms of the associated entities, information on related parties engaged in business relations including an overview of financial results of particular related parties, allocation of functions within the group, allocation of risks, overview of intangible property ownership (licences, patents, know-how etc.) and licensing fees flow, overview of the transfer pricing policy implemented, list of agreements regulating sharing of costs and

expenditures, overview of Advance Pricing Agreements entered into by the associated companies (Binding Rulings issued), commitment of the company to submit other evidences in reasonable time if the presented information about the group is insufficient etc. If it is expected that some of the above mentioned facts could be changed in a close future or will be changed, the changes should be also stated together with their reasoning;

- **information concerning the company** – precise description of business activities, complete ownership and organisational structure, financial results for previous years and corresponding financial indicators, strategies adopted etc.;
- **information concerning the business relation (transaction)** – precise description of the business relation (i.e. precise description of goods and services traded), financial and trading terms, all relevant agreements and contracts entered into by the entities concerned, volume of the transaction, functions and risks associated to the business relation concerned etc. In case of providing the intangibles (management and marketing services, consultancy etc.), it is necessary to sufficiently describe characteristics of the services rendered and to identify purpose of the services and expected benefit arising thereof in large detail;
- **information concerning other circumstances effecting the business relation** – company's marketing strategy, specific economic conditions of the market, legislation specifics etc.;
- **information concerning transfer pricing** – what way of transfer pricing has been used, explanation, why the particular way of pricing has been selected, information concerning comparable business relations (internal comparables within the group and/or external comparables between two comparable independent companies), comparable analysis under paragraphs 3.1 – 3.83 of the Guidelines;
- **information whether the documentation has been compiled following the concept of EU TPD.**

The above stated content should be sufficient for the tax administrator to determine whether the company acts in accordance with the arm's length principle and whether its transfer pricing corresponds to prices and conditions of comparable business relations of independent companies. Simultaneously these requirements are compatible to EU TPD.

The company should archive its documents at least during the period in respect of which the tax may be assessed or additionally assessed (section 148 of Act no. 280/2009 Coll., Administration on Taxes, as amended) and simultaneously during the period determined in Act 563/1991 Coll., on Accounting, as amended (i.e. 10 or 5 years)

In respect of international transactions this period may be longer due to the application of international agreements.

This Guidance repeals the Guidance D-293 issued under the ref. no.: 39/116 682/2005-393, and comes into effect on January 1st, 2011.

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of the section Taxes and Customs