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Guidance of General Financial Directorate D – 34

Notification in respect of international standards application in taxation of transactions between associated enterprises – transfer pricing

(hereinafter just „Guidance“)

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Introduction

For the purposes of unification and simplification of the transfer valuation between associated persons, 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 Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development in 1979, and subsequently, since 1996, supplemented by other reports of the Committee on Fiscal Affairs of the OECD (hereinafter just "Guidelines"), see also chapter 1.1.3 for details. These Guidelines are a generally accepted document and, in the Czech Republic, it is a basic material that must be used primarily for the valuation of transactions between associated persons.

Principles and procedures stated in the Guidelines must be applied in compliance with the international Double Taxation Avoidance Treaties (hereinafter also just "Double Taxation Treaties" or "Treaties" or "DTAs"), which are applied in the Czech Republic, as well as in conformity with the applicable laws of the Czech Republic.

This Guidance (which replaces Guidance D-332 issued under Ref. no .: 39/86 829 / 2009-393) is issued following an updated version of the aforementioned Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration issued by the OECD in 2017. In particular, the principles stated in these Guidelines reflect the approach applied at the time before updating these Guidelines and merely supplement and clarify the interpretations of certain sections of the updated Guidelines.

This Guidance is issued in order to ensure an uniform procedure for determining the tax base affected by transactions between associated enterprises in cross-border relations, but also in domestic transactions between associated persons, both by the Financial Administration of the Czech Republic and by taxpayers.

This methodology Guidance has been processed with respect to the existing Czech legislation and implemented and applied relevant international conventions at the time of issuing the Guidance, 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 ARM'S LENGTH PRINCIPLE AND ASSOCIATED ENTERPRISES (RESP. ASSOCIATED PERSONS)

In general, it may be stated that transfer pricing means the "prices" applied in transactions between two or more taxpayers associated in economic or personnel sense (in the terminology of Double Taxation Treaties the term "associated enterprises" is used). These prices (so called usual 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 transfer prices determined in such a way are the prices determined on the basis of an arm's length principle. In the Czech Republic it is generally discussed the application of usual prices used for income tax base determination pursuant to provisions stipulated in our tax laws.

The arm's length principle (hereinafter just "ALP") is regulated:

A. In Double Taxation Treaties;

B. In the Act no. 586/1992 Coll., on Income Taxes, as amended (hereinafter just "AIT");

C. In the Guidelines.

D. In the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436 / EEC) of 23 July 1990 (hereinafter just "Arbitration Convention")

1.1 Arm's length principle

1.1.1 Bilateral Double Taxation Treaties

In general all cross-border tax relations are assessed not only in conformity with domestic laws, but also with the Double Taxation Treaties, while international treaties are superior to domestic laws. This is also applied to price adjustments for tax purposes for transactions between associated enterprises.

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 treaties, to the ratification of which Parliament has given its consent and by which the Czech Republic is bound, form a part of the legal order; if a treaty provides something other than that which a statute provides, the treaty shall apply."*

The obligation to proceed with tax administration in compliance with international treaties also arises from section 5 par. 1 of Act no. 280/2009 Coll., on Administration of Taxes, as amended (hereinafter "AAT").

This obligation also arises from the provisions of section 37 of AIT:

" The provision of this Act shall apply only if an international treaty by which the Czech Republic is bound does not stipulate otherwise.."

The above-mentioned international treaties in this case mean treaties for the avoidance of double taxation. For the purposes of entering into such treaties OECD has produced the Model Convention on Avoidance of Double Taxation, including its explanatory Commentary.

In addition to the OECD Model Convention, there is a Model Double Taxation Treaty drawn up by the United Nations, also with an appropriate Commentary. This document is also used to negotiate bilateral double taxation treaties, in particular with developing countries, or with regard to certain specific incomes, such as incomes from provided services.

Model conventions with Commentaries are used in practice as an interpretative document, respectively interpretative guidelines, using an updated text of the Commentary, provided that the text of the article under review of the specific double taxation treaty is not semantically different from the text of the article of the Model Convention to which the updated Commentary is issued. If the wording of the article of the convention under review is semantically different from the related text of the current Model Convention, it is necessary to use the Commentary on the Model Convention for the particular article, which corresponds to the text of the convention under review.

In the case of application of the Guidelines, the procedure is similar.

Relations between associated enterprises are regulated mostly by Article 9 under most of the bilateral DTA as well Model Convention on Avoidance of Double Taxation issued by OECD.

The arm's length principle and the related possibility of adjusting the tax base for transfers between associated enterprises results from Article 9 par. 1 of the particular concluded Convention.

The wording of Article 9 par. 1 of the Model Convention is:

„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 entitles the tax administration to adjust the tax base for associated enterprises if the price agreed by them does not respect the arm's length principle.

Most of the DTAs, which the Czech Republic has concluded, include Article 9 paragraph 2, which regulates the possibility to make subsequent adjustments of profits from transactions with associated enterprises in the other state. The Czech Republic has a reservation[1] on this article in the Model Convention, on the basis of which another paragraph is added to some DTA regulating the impossibility of subsequent adjustments arising from paragraph 2 in case of fraud, conscious neglect or negligence. In case of absence of paragraph 2 of Article 9, subsequent amendments may be dealt with under Article 25 of the Treaties, provided that both parties agree.

The double taxation treaties include references to the arm's length principle in the following articles[2]:

-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 of the Model Convention – „Dividends", par. 3 - definition of the term "dividend" (in relation to "reclassification" under section 22, par. 1, letter g) point 3 of AIT;

-Article 11 of the Model Convention – „Interests", par. 6 - interests that do not comply with the conditions of section 23, par. 7 of AIT may be reclassified to profit shares pursuant to section 22, par. 1, letter g) point 3 (so-called secondary adjustment);

-Article 12 of the Model Convention – „Royalties", par. 4 – royalties that do not comply with the conditions under section 23, par. 7 of AIT, may be reclassified to profit shares pursuant to section 22, par. 1, letter g), point 3 (so-called secondary adjustment);

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[1] The *Czech Republic* reserves the right not to insert paragraph 2 in its conventions but is prepared in the course of negotiations to accept this paragraph and at the same time to add a third paragraph limiting the potential corresponding adjustment to *bona fide* cases."

[2] Due to the fact that individual DTA differ more or less from each other, both in the text of individual articles and in their numbering, these guidelines considers only the wording of the OECD Model Convention.

-Article 24 of the Model Convention – „The principle of equal treatment“, par. 4;

-Article 25 of the Model Convention – „Mutual agreement procedure“ (refer to chapter 5 of this Guidance). Although this article does not refer to the arm's length principle in its own right, it is used, among other things, in cases when the taxpayer has doubts about the application of Article 9 of DTA, in the way one of the contracting states has done it.

In general, it is also necessary to take into account Article 5 of DTA, as due to transactions between associated enterprises a permanent establishment may arise in many situations. For example in providing services by one company to another in the territory of the other state, a permanent establishment may arise by virtue of a dependent representative. Another example is an arising of a permanent establishment as a result of restructuring, when functions are moved to a foreign enterprise, but it continues to operate in the state where the company that originally performed those functions resides.

1.1.2 Domestic legal regulation

The arm’s length principle is also regulated by the domestic law in section 23, par. 7 of AIT, which regulates and sets the conditions for the use of the "usual" price for the purposes of determining the income tax base as follows:

“ *If the prices agreed between associated persons differ from the prices that would be agreed between unassociated persons in normal business relations under the same or similar conditions, and if such difference is not satisfactorily substantiated, the tax base of the payer shall be adjusted by the ascertained difference;…”*

Beyond the above mentioned basic regulation (contained in section 23 par. 7 of AIT, Article 9) there are other specific provisions in the Czech national legislation containing principles to be applied in taxation of transactions realized between associated persons. This concerns namely:

- section 22 par. 1 letter g) point 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 into profit shares (so called secondary adjustment). This provision shall not apply to transactions with an associated person from another EU Member State or an EEA state. In the case of transactions with an associated person from a contracting state, the text of the Convention must be taken into account;

- some provisions of section 19, implementing the Council Directive 90/435/EEC of 23.7.1990 (resp. 2011/96/EU of 30.11.2011) 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 from different Member States;

- some provisions of section 23a to section 23d - implementing the Council Directive 90/434/EEC of 23.7.1990 (resp. 2009/133/ES of 19.10.2009) on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares relating to companies from different Member States and the relocation of the seat of the European Company or a European cooperative society between Member States.

- section 23 par. 3 letter a) point 17 - increase in profit by the amount by which the taxpayer's tax base was reduced pursuant to section 23 par. 7; This provision shall not be applied to the amount settled between associated persons;

- section 23 par. 11 – application of the arm's length principle for the purposes of permanent establishment tax base definition[3]

- section 25 par. 1 letter w) – so called thin capitalisation;

- section 35a par. 2 letter d) - the relation of transfer prices to the obligations of investment incentives holders

- section 35b - the relation of transfer prices to the obligations of investment incentives holders

- section 38nc - binding ruling of the way in which the price negotiated between associated persons has been created;

-section 38nd – binding ruling of the way of determining the tax base of a non-resident taxpayer from activities performed through a permanent establishment.

1.1.3 Transfer Pricing Guidelines

In 2017, the OECD issued an updated version of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, reflecting changes resulting from the OECD / G20 BEPS - Erosion of Tax Bases and Profit Shifting. So there have been changes, amendments and clarifications to certain sections of the Guidelines. It emphasizes the previously mentioned importance of the real economic substance of the realized economic activities, namely that it is not only the contractual arrangement between the parties to the transaction, but the actual content of such a transaction that is essential for the correct valuation of the transactions. Significant changes and clarifications include for example:

- refinement of the definition of intangible assets for transfer pricing,

- a more detailed description of the assessment of contractual transfer of risk (which is considered to be tax-relevant only if it involves the actual implementation of decision-making processes, e.g. for business restructuring),

- specifying that capital rich entities that do not carry out any real economic activity can only be attributed a reasonable amount of the profit, essentially corresponding to a risk-free interest rate,

- change in transfer pricing documentation structure (newly next to Local File and Master File – refer also to chapter 4 of this Guidance - also Country by Country reporting - reporting of transactional data between associated enterprises).

The Guidelines aim at unification of procedures applied by the tax administrations and associated enterprises when solving transfer pricing cases, minimizing 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 chapter 5 of this Guidance).

The procedures and methods of the Guidelines have not been directly implemented in tax laws of the Czech Republic nor there is any direct reference to them. Its binding effect in interpretation of Article 9 of the Guidelines arises from the fact that the Czech Republic is a signatory to multilateral Vienna Convention on Law of Contracts (published in Collection of

[3] Section 23 par. 11 does not deal with relations between associated persons. The provision is given for completeness, as the rules for the valuation of transactions between associated persons can be used similarly when determining the tax base for activities performed through a permanent establishment.

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 interpretation of international treaties, including the DTA (refer to Annex 2 of this Guidance).

Transfer Pricing Guidelines correspond in their character and way of adoption and implementation with 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.

The Guidelines are also currently a comprehensive and by practice proven material that implements graspable and rational standards for transfer pricing.

Over the time, the use of the Guidelines, respectively the use of the rules contained therein, has become a standard respected and applied by both taxpayers and tax administrators. The principles and rules contained in the Guidelines have thus been implemented in relations without an international element and, in some respects, have created the administrative practice of "sui generis".

In addition, another benefit of using TP Guidelines for domestic relations must also be taken into account - it creates important legal certainty for taxpayers and at the same time provides for predictable rules of conduct of the tax administrator.

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 or with an associated person from a non-contracting state).

1.2 Associated Enterprises / associated persons

1.2.1 Treaties

The Model Double Taxation Treaty defines associated enterprises in Article 9, as stated in chapter 1.1:

“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”.

1.2.2 Act on Income Taxes (AIT)

AIT in section 23 par. 7 uses the term associated person and defines it as follows:

For the purposes of this Act, associated persons shall mean

a) persons associated through capital

1. where one person directly participates in the capital or voting rights of the other person, or where one person directly participates in the capital or voting rights of several persons; and where, simultaneously, this share constitutes at least 25 % of the registered capital or 25 % of the voting rights of such persons, then all such persons are persons directly mutually associated through capital,

2. where one person indirectly participates in the capital or voting rights of the other person or where one person directly or indirectly participates in the capital or voting rights of several persons; and where, simultaneously, this share constitutes at least 25 % of the registered

capital or 25 % of the voting rights of such persons, then all such persons are persons mutually associated through capital,

b) persons otherwise associated which are persons

1. where one person participates in the management or control of another person,

2. where identical persons or close persons participate in the management or control of other persons, then such other persons are persons otherwise mutually associated. Persons otherwise associated shall not be deemed to be persons where one person is a member of the supervisory boards of two persons,

3. controlling and controlled and also persons controlled by the same controlling person,

4. close,

5. that created a legal relationship predominantly for the purpose of reducing a tax base or increasing a tax loss.

Ad b) 4 and b) 5 .: Associated persons are also close persons and persons who have created a legal relationship predominantly for the purpose of reducing a tax base or increasing a tax loss (hereinafter “persons pursuant to prov. of section 23 par. 7, letter b, point 5 of AIT”).

Close persons for the purposes of prov. of section 23 of AIT are persons defined in section 22 of Act no. 89/2012 Coll. Civil Code, as amended.

As persons pursuant to the prov. of section 23 par. 7, letter b, point 5 of AIT are considered to be mainly those who trade with each other “…*at prices that deviate significantly from the prices agreed in the ordinary business relations, even when the business partnership is based differently than capitally or personally, or if business transactions between capitally or personally associated persons are realized through a third party whose involvement in the business chain has no other significant economic purpose than to reduce tax liability. These include, for example, domestic sales at very low prices of a profitable taxpayer to a loss-making taxpayer or at very high prices of a loss-making taxpayer to a profitable taxpayer or purchases of goods and services at very high prices compared to normal prices from taxpayers based or resident in states with low or non-existent taxation of profits ("tax havens"). ",*as stated in the Explanatory Report to Act no. 210/1997 Coll., of 31.7.1997, amending and supplementing Czech National Council Act no. 586/1992 Coll., on Income Taxes, as amended (amendment 39).

From the definitions stated in the Article 9 of the Model Convention and in section 23 par. 7 of AIT, it is clear that associated enterprises, or associated persons (hereinafter "associated enterprises") are understood to mean that an enterprise of one state directly or indirectly participates in the management, control or capital of an enterprise of the other state or the same persons (identical legal or natural persons) directly or indirectly participate in the management, control or capital of an enterprise of one state and an enterprise of the other state.

What is meant by the share in control or capital of an enterprise under the Treaties is not specified in the Treaties. As the Treaties do not contain this definition, the domestic law is applied in compliance with the Article 3 paragraph 2 of the Treaties. In this case, the definition contained in section 23 par. 7 of AIT is taken over (at least 25% of the registered capital or voting rights). Examples of relations between associated enterprises are stated in Annex 1 to this Guidance.

When assessing whether one person (one enterprise) participates in the management of the other enterprise, it is necessary to follow the general regulations, i.e. Act no. 90/2012 Coll. on Business Corporations, as amended, resp. Act no. 89/2012 Coll. Civil Code, as amended. In this sense, management can be understood as acting on behalf of the company, i.e. the activity of statutory bodies or their members, e.g. executives (of limited liability companies) or partners (of limited liability companies, public trading companies), board of directors (of joint-stock companies, cooperatives) , general partners (of limited partnerships), etc. If an identical natural person is a member of the supervisory boards of two enterprises, they are not associated persons, only by virtue of this fact. However, if an identical natural person is simultaneously a member of the supervisory board of one enterprise and a member of the statutory body of another enterprise, they are associated persons[4]. It is always necessary to assess the specific activity of each person authorized to act on behalf of the enterprise, whether he can influence decision making or directly participates in decision making.

2 COMPARABILITY ANALYSIS

Each transaction related to the relations between associated enterprises is subject (from the perspective of the party bearing the cost) to three types of tests in the tax assessment, when the first two (substance test and benefit test) examine compliance with prov. of section 24 par. 1 of AIT. Before assessing whether the stated transaction meets the arm's length principle conditions (see below), it is necessary to assess whether the stated transaction has taken place (so called substance test) and whether the tax entity has benefited from it (so called benefit test). If both questions are answered in the affirmative, the third test (arm's length test), i.e. the examination of the conditions under section 23 par. 7 of AIT, may be applied, i.e. whether the transfer prices are in compliance with the arm's length principle.

It follows from the foregoing definitions that the subject of examination under the Guidelines are transactions between associated enterprises and their valuation, and the distribution of the profits arising from them between the associated enterprises involved in these transactions. Transactions between associated enterprises are referred to as dependent (controlled) transactions. As well as prices applied in these transactions are referred to as dependent (transfer) prices.

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

– members of multinational groups (resp. associated enterprises) are considered as if they were separate and independent enterprises of the group;

– the attention is focused on the nature of the transactions between them (e.g. what they are oriented on, what they are applied to etc.).

Although the objective of this Guidance is to define the principles of transfer pricing for tax purposes, it should be noted for the sake of clarity that the tax assessment of an accounting item does not play a role in determination of the price when determining the tax base. For example, for the purpose of determining the transfer price by methods based on the taxpayer's costs, the tax efficiency or inefficiency of these costs is not assessed when determining the cost base, because all relevant costs must be reflected in the price regardless of their tax deductibility. Therefore, the economic link between the cost and the controlled transaction is essential, not tax deductibility.

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[4] Refer to Judgment of the Supreme Administrative Court 1 Afs 67/2013 - 28 of 22.8.2013

Comparison between terms and conditions of controlled transactions and those of uncontrolled 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 between associated enterprises, when a so called “parent enterprise's order”, which means affecting an uncontrolled transaction by an associated enterprise, can also be considered a business relation. E.g. the parent enterprise orders the subsidiary to sell to independent customers at other than usual prices (i.e., the subsidiary does not come to that transaction by its own decision) when such a difference will be attributed to the “parent enterprise's order” and in this amount the subsidiary is entitled to compensation from the parent enterprise. It is often the case that the parent enterprise's orders are not explicitly contracted, are not accounted for, but still exist;

-uncontrolled transaction means a business relation between independent enterprises.

The comparability analysis represents the core of the arm's length principle and is based on comparing the conditions of a controlled transaction with the conditions that would be set by independent entities in comparable circumstances. The general factors of comparability are:

- contractual terms of transactions;
- performed functions, borne risks and assets used by individual enterprises;
- the characteristics of transferred assets or provided services;
- economic circumstances of the parties of the transaction and of the market;
- business strategy;

which are described in more detail in the following subchapters.

In order the transactions or the conditions under which the transactions are conducted could be considered as comparable the Guidelines state that one of the following criteria must be met:

a) none of the differences between the controlled and comparable (uncontrolled) 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.

When assessing and auditing the transfer prices, it is possible in some cases to find fully comparable transactions in respect of conditions and circumstances under which these transactions are realized. In justified cases it is necessary to make adjustments (elimination) of differences influencing pricing pursuant to point b).

2.1 Factors determining comparability

The correct and accurate delineation and description of a controlled transaction, along with performing a functional and risk analysis of the tested party of the transaction is a basic assumption and condition for the selection of comparable uncontrolled transactions and enterprises.

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

2.1.1 Contractual terms and conditions

Based on the ascertained contractual terms and conditions, it is possible to specify how the responsibilities and risks or revenues from transactions executed should be allocated (refer also to the previous chapter). If a transaction between associated enterprises has been formally confirmed through written contractual stipulations, these stipulations provide a starting point for delineation of the transaction. Contractual terms and conditions may be also identified from correspondence or other documents (e-mail correspondence, internal documents, meeting minutes, etc.), if there is no existing written agreement.

If there are no written conditions, the actual transaction is derived from the actual conduct of the parties identified through identification of the economically relevant circumstances of the transaction. It is essential that all aspects of the transaction are derived from the available evidence of the parties' actual conduct, even though there may be a written contract, i.e. the substance over form principle. The delineation of the transaction will, when contractual stipulations have been determined, focus on examining the actual content and actual conduct of the parties to these transactions. If the actual content of the transaction differs from the contractual stipulations, the transaction will be delineated on the basis of the actual content of the transaction and the actual conduct of the parties to the transaction.

2.1.2 Performed functions, borne risks, used assets - functional and risk analysis

Functional and risk analysis aims to find out what functions the parties to the transaction perform, what assets they use and what economically significant risks they bear. The results of the functional and risk analysis will be relevant for the selection of the tested party, the selection of the appropriate method of determining the transfer prices, the selection of profitability indicator and comparable entities. Thorough ascertainment and recognition of the functional and risk profile is an essential condition for determining which enterprise in the group will be the tested enterprise.

The tested party of the transaction in the group may be any associated enterprise in the group, including the parent enterprise. Determining which enterprise in the group is a tested party must be assessed from the perspective of the particular controlled transaction being examined, and in some cases the transactions can also be aggregated, refer to paragraph 3.9 - 3.12 of the Guidelines.

The tested party is usually the party to the transaction that performs less complex functions, bears less economically significant risks and does not own unique tangible or intangible assets usable in the controlled transaction under consideration. It is determined, for example, who has more decision-making powers, who enters into contracts with suppliers and clients and decides on the terms of the contract, who is responsible for pricing policy and stocks, who creates marketing strategies and plans production, who is responsible for the transportation of goods and product quality, who is responsible for enterprise financing and employment, who is responsible for research and development and owns patents and know-how, etc. The key to determining the correct list of evaluated functions is what the so called “value drivers” in the given sector are, resp. identifying key functions affecting pricing. When determining the tested party, different weights are attributed to the individual functions depending on the value chain, within which the value drivers are determined, which have the greatest influence on the price. The value chain usually consists of the following parts - R&D product, R&D production process, purchase, production, marketing, distribution and follow-up services incl. warranty. In every sector, different part of the value chain and different value drivers, are crucial.

In the case of intangible assets, the entity in a group that has the so called DEMPE functions i.e. development, enhancement, maintenance, protection, exploitation, and bears the associated risks, is considered as the owner of the intangible assets from an economic point

of view, and it is entitled to gains derived from them, resp. jurisdiction in which the taxpayer operates has the right to tax them. And vice versa - if the party of the transaction is the legal owner of an intangible asset and has provided financing for the performance of the DEMPE functions, but does not perform those DEMPE functions and does not bear the risks associated with them, it is not entitled to collect all revenues from them, but the income is assigned to the associated enterprises in a group that perform those functions and bear the risks associated with them. In this case, the legal owner is only entitled to remuneration related to the provision of capital.
So called functional and risk analysis means finding and comparing the functions and the level of responsibility (risk) of the transactions between associated enterprises.

The risk is the possibility of getting into a situation that is disadvantageous or threatening for the enterprise.

The level of risk is the probability that unwanted situation will occur.

The function is a decision-making power associated with responsibility that gives the possibility to influence further development and thereby directly affects the level of risk. At the same time, in order to state that a party performs the function, the party must be able to make decisions, to control the related activities and to have the financial capacity to bear the associated risk. Functions and risks arising from them cannot be separated. This is because the ability to perform functions (i.e. to decide) and to actually perform these functions (i.e. to implement decisions) in relation to the relevant risk assumes understanding the risk through the information necessary to assess the expected negative and positive effects of the risk associated with deciding on it (i.e. related to a function), refer to paragraph 1.66 of the Guidelines.

The function means to manage risk. Risk management is the performance of a function of assessing the risk associated with a business activity and responding to it (i.e. a decision on it). *"Risk management comprises three elements (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation."*[5]

It is essential to assess in analysis whether the distribution of risks is consistent with the economic substance of the transaction and whether the contractual risks and actual conduct of the parties correspond to the ability to control the risks and be financially eligible to take them over.

Financial capacity to assume risk can be defined as an access to funding to take over the risk or to suspend the risk, to pay for the risk mitigation function and to bear the consequences of the risk if the risk materialises, refer to paragraph 1.64 of the Guidelines.

Activity is the realization of a certain function. That is, an enterprise can actually produce - to perform an activity, but it does not have to perform a function - it does not decide what and how to produce, respectively, it will only have the function of operative production, when it decides only in situations of normal operational character, but the key function in relation to the produced quantity, used material, production processes or the production assortment itself (which can be value drivers) is performed by another entity in a group.

[5] Refer to Guidelines paragraph 1.61

Function does not mean the same thing as activity. The function and the associated risk cannot be separated. Individual enterprises can be entrusted with the performance of various functions within a multinational enterprise group, as well as independent enterprises have different functions. These include production, research and development, distribution, advertising, financing, management functions, etc. Similarly, individual enterprises may have different levels of risk they undertake in their activities.

An enterprise can be defined as a contractual / routine or fully-fledged in terms of functional profile depending on the level of dependence in each transaction on the counterparty or the rest of the group. An enterprise can also have more functional profiles for different transaction types at the same time. Furthermore, it may be defined as a producer, distributor or service provider. In practice, it is common to evaluate individual transactions as closer to the contractual / routine or, on the contrary, to a fully-fledged type. A brief description of typical business models is also stated in the "Toolkit" document mentioned in chapter 2.1.3.

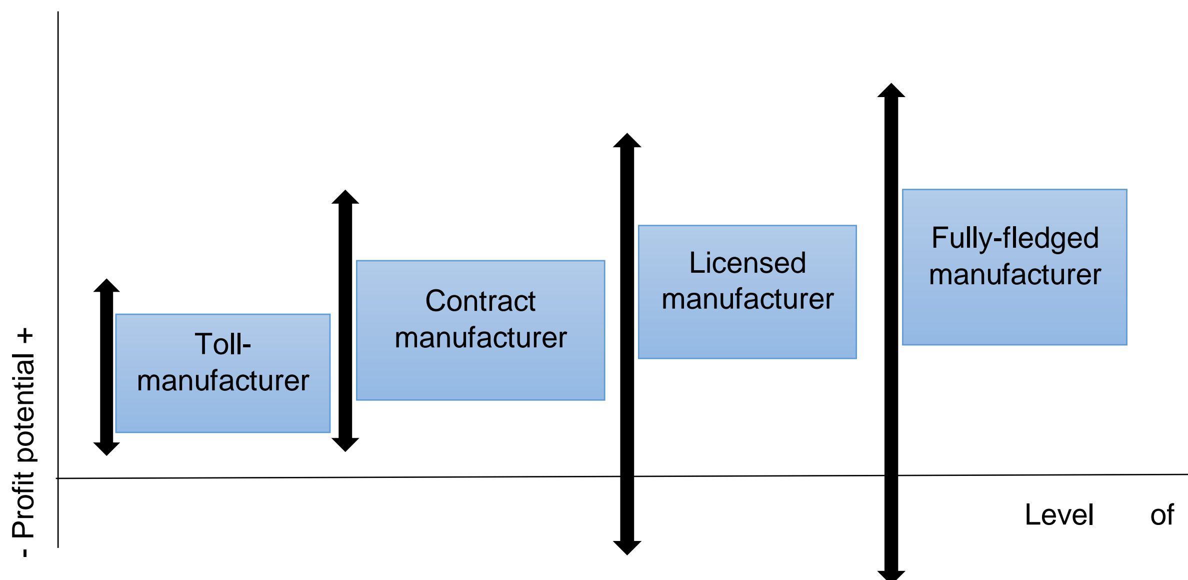
Routine entities perform only routine functions based on relatively detailed instructions from another entity (e.g., operative production, material processing, storage, delivery of goods). These entities subsequently bear limited risks proportionally to their functions and expect a lower but stable profit from the controlled transaction. In justified cases, even a routine entity may report a loss, exclusively from the functions it performs, so it has the possibility to make decisions and manage them, bears the risks arising from them, and has sufficient financial capacity to bear those risks if even an independent entity was loss-making in a similar situation and under similar circumstances.

A fully-fledged entrepreneur performs essential supply chain functions (e.g. identifying marketing strategies including sales procedures, management and performance of research and development, production management and planning) and bears the main risks associated with them (especially price and volume risk, risk of unsuccessful research and development etc.); at the same time, these entities usually own significant tangible or intangible assets (patents, brand, etc.).

The more important functions an enterprise performs in a controlled transaction, the greater risk it bears and the more valuable assets it engages, the greater its expectations are, and the greater its profit potential is, that means, it expects a higher future profit realized on the transaction. However, in the case of unfavorable market development, it may also realize higher losses related to its decision-making powers (e.g. due to strong competition, changes in input prices, etc.). The profit potential is determined by the weights (significance) of the individual functions determined on the basis of the value chain, by the significance of the risks associated with the functions and by the significance of the assets involved, and not by their number.

The typology of functional profiles for production and distribution entities is shown in the following diagrams, the boundaries between individual profiles cannot be precisely delineated and there will be a number of situations when an enterprise does not fit exactly into the definitions described below. What is important is that in all cases, the remuneration for each type of enterprise must reflect its functions, the risks borne and the assets used.

Pic. no. 1 Profit potential of the producer according to functionally risk profile



In production enterprises, on the one hand, there is a toll-manufacturer that usually performs only individual production operations (it provides the production service) and does not own the processed material either (it does not purchase raw materials or assembled goods), it plans the production operatively and fully guarantees its capacity to the customer. It does not bear significant risks (it does not bear the inventory or market risk). It is entitled to a reasonable, stable remuneration, which is usually based on processing costs (e.g. wages, depreciation, etc.) increased by a profit margin.

In contrast, the contract manufacturer usually owns material stocks and bears the associated risks and therefore the material value is included in its cost base for the application of the margin (refer to cost base in point 3.1.3.). It is also responsible for the planning of production (preparation of the production plan according to orders) and bears to a certain extent associated risks (increased defective production, inefficiency of production, etc.) following the specific setting of its responsibilities. The cost method preferences is applied to this type of the functional and risk profile (refer to cost and profit margin method, TNMM method, described in chapter 3). The contract manufacturer should earn more profits (assuming the same volume of performance) than the toll-manufacturer, because the profit margin will be applied to a larger cost base.

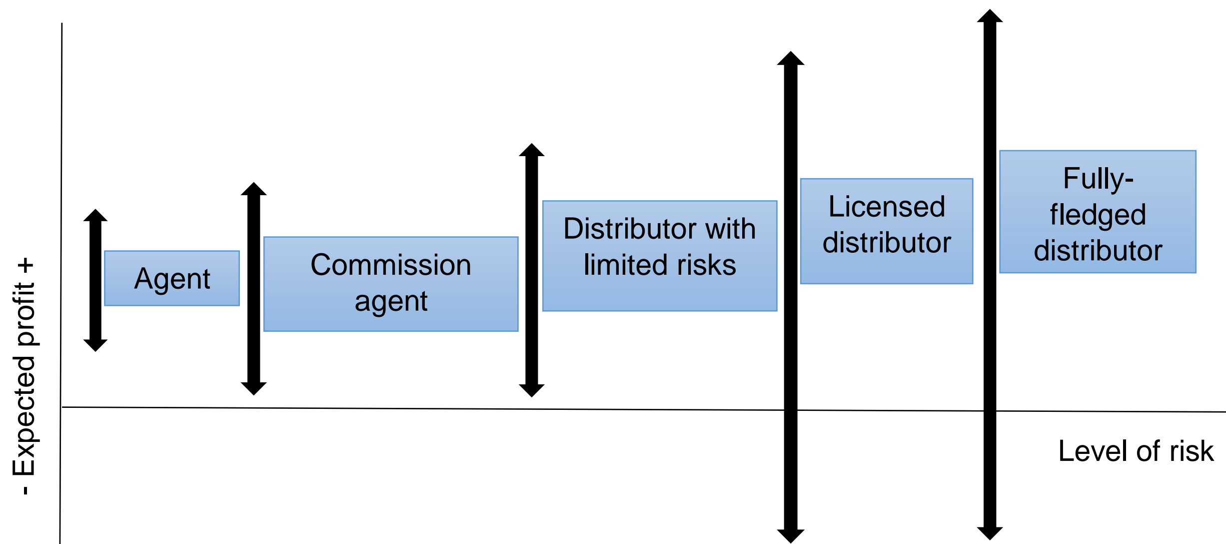
One of the basic characteristics of a contract and toll-manufacturer is that it usually supplies and invoices only to a group when it does not perform a business function or negotiate a price with a customer company. However, there may also be a business model when the producer supplies outside the group, but all significant supply conditions are determined by the group (in particular, customers, prices, volumes, etc.). In this case, the business model may meet the characteristics of the toll-manufacturer or the contract manufacturer and consequently, business risks should be reduced or compensated (refer to order of parent enterprise).

On the other hand, there is a fully-fledged manufacturer that performs essential functions. It purchases raw materials and semi-finished products on its own account, holds stocks of raw materials and finished products, invests in machinery and workforce, owns intangible assets (manages and bears major risks in relation to its production activity), performs business functions (active negotiations with suppliers and customers) and bears market risk. The profit potential of a fully-fledged manufacturer should be higher compared to the contract

manufacturer and the toll-manufacturer but this means that it is also subject to higher fluctuations.

A certain variant of a fully-fledged manufacturer is a licensed manufacturer. The licensed manufacturer does not own intangible assets compared to a fully-fledged manufacturer, but pays a license fee for the intangible assets used. Therefore, it does not perform functions related to the development of an intangible asset nor bears the associated risks. Otherwise, it performs similar functions and bears similar risks as a fully-fledged manufacturer.

Pic. no. 2 Profit potential of distributor according to functionally risk profile



An agent negotiates sales and collaborates with customers. **He does not sign contracts on his own behalf or on his account**. A fully-fledged enterprise supplies and invoices goods to its customers and also determines the price and other terms of sale itself. Terms and conditions and agreements are negotiated outside the agent's competence and without his intervention. **The agent does not own the goods sold.** He accepts routine remuneration for his services, i.e. in particular for mediation.

A commission agent is an example of a distributor with limited functions and risks within a group of enterprises. Unlike the below-mentioned distributor with limited risks, **the commission agent does not take title to the traded goods** (he signs contracts on his own behalf, but on account of another person in a group). As a reward for his services, he receives a percentage of sales or a margin to incurred costs from the associated enterprise.

A distributor with limited risks (dependent distributor) is usually set up by a group of enterprises to distribute the goods the group produces. He purchases goods and passes them on to customers **on his own behalf on his account**, the main functions and risks are borne by a fully-fledged enterprise within a group.

The dependent distributor performs typical sales and marketing functions in relation to the sale of products supplied from a group, i.e. preparation of marketing plans, sales forecasts and maintaining customer relations. The prices for which he purchases or sells can be determined by the group. This distributor bears only limited risks. **He takes title to the traded goods**, but most strategic business risks remain to a fully-fledged enterprise.

Typical risks borne by a fully-fledged enterprise under the agreement with a limited-risk distributor are inventory, trade receivables and currency risks (e.g. obsolete stocks are bought back and debts are offset).

The licensed distributor uses intangible assets that are not owned by him but he licenses them. He decides on the quantity of purchased goods with the aim of selling it. So he bears inventory and market risk. He performs similar functions and bears similar risks as a fully-fledged distributor.

A fully-fledged distributor purchases and sells goods on his own behalf on his account (he is the owner of the goods he sells, stores, markets and sells to customers). He bears the strategic functions of buying and selling, decides on the selection of clients. He bears the risks associated with these functions (e.g. unsaleable stock, obsolescence of stocks, reclamation of goods, risk of unpaid receivables by customers, currency risk etc.). He bears costs with warehouse management, logistics, marketing and other sales support, including after-warranty service. In addition, he provides after-sales service, may own marketing intangible assets (such as trademarks). He has the highest profit potential but he is also subject to the highest fluctuations.

2.1.3 Characteristics of transferred property or provided services

For tangible assets (e.g. goods, real estates, etc.), it is necessary to assess their physical characteristics, quality, reliability, market availability, market supply volume, goods turnover (daily or long-term consumption), etc.

For intangible assets, focus should be on the form of the transaction (e.g. licensing or sales), the type of assets (e.g. patent, trademark, know-how), the duration and the degree of protection, the expected profits from the use of intangible assets, and the performance of related functions (refer to the DEMPE functions described above in chapter 2.1.2.).

For the provided services, it is necessary to take into account the nature and the extent to which they are provided and their purpose and benefit.

2.1.4 Economic circumstances of the transaction parties and of the market

Usual arm's length prices may vary in different markets, including for transactions involving the same property or services. In order to ensure comparability, it is necessary that the markets on which the independent and the associated enterprises operate do not show differences with a significant effect on the price or it must be possible to make appropriate adjustments.

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.

2.1.5 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. However, even when taking into account the business strategy, it is necessary to take into account which of the enterprises has the function to define the business strategy or to revise it, i.e. to bear appropriate risks.

2.2 Recommendations on how to do comparability analysis

Recommended procedure for comparability analysis[6]:

[6] This is not a compulsory procedure, any other that can lead to the identification of reliable comparable data is also possible

1. An analysis of the circumstances in which an enterprise operates - analysis of the industry, competition, economic and regulatory factors and other elements that affect the taxpayer - it helps to understand the conditions of controlled transactions and conditions of uncontrolled transactions (refer to chapter 2.1.)
2. Functional and risk analysis to understand the controlled transactions under review and selection of tested party (refer to chapter 2.1.2.)
3. Assessment of possible internal comparable data – assessing a transaction between one party of a controlled transaction and an independent party. This may be the case when an enterprise carries out both controlled transactions with other enterprises in the group and uncontrolled transactions with independent entities when comparable goods, services, etc. are subject to these transactions.
   - data may be more closely related to the transaction under review than external comparable data;
   - analysis can be more reliable;
   - access to information can be less costly and more complete than selecting and editing external comparable data from commercial databases;
   - used especially in CUP method but also in other traditional transactional methods or TNMM method;
   - the use of existing internal comparable data will be difficult to apply, for example, in situations when the volume of the performance of uncontrolled transactions is significantly different compared to the volume of controlled transactions and / or the contract terms are so different that material and credible adjustments cannot be achieved.
4. Identification of external comparable transactions, entities and sources of information (refer to chapter 2.1.3.)
5. Choosing the most appropriate method for determining transfer prices, depending on the terms of the transaction, the tested party and determining the relevant profitability indicator (refer to chapter 3).
6. Finding and comparing profits and losses within the group of the associated enterprises (e.g., if the controlled enterprise in the group has declared a loss, whether other members of the group also declare losses).
7. Ascertaining whether the contractual terms include mutual compensation, for example, in connection with the delivery of goods, services are in progress, the price of which then adjusts the price of the goods. In the case of compensations, not only national accounting standards need to be taken into account, which either allow or regulate "compensations", but also the results of the substance test and other circumstances of the controlled transaction under review need to be taken into account.

2.3 Selection of external comparable independent entities and transactions - benchmark analysis (hereinafter "BMA")

In order to identify external comparable entities, their profitability and prices, it is necessary to determine the conditions (circumstances) to be met by any uncontrolled transaction in order to be considered as potentially comparable, based on the comparability factors identified in chapter 2.1.

The available sources of external comparable data are especially commercial databases and other publicly available information:

a) Commercial databases
   - their limitation is that not all countries offer the same amount of publicly available information about their enterprises, and disclosure requirements may vary, e.g. depending on the legal form of the enterprise;

- used to compare business results rather than transactions (information about transactions of the third parties is available only exceptionally, or only for certain types of transactions, such as the valuation of credit financial instruments);
- their use should not lead to the prevalence of the quantity of found data over their quality (concerns about the reliability of the analysis in terms of information for comparability assessment).

b) Other publicly available information
   - as a result of the above stated concerns, it may be appropriate to add other publicly available information (e.g. web, financial statements) to information from database to promote the quality of comparable information.

The selection of comparable independent entities can also be based on the European Commission Notification JTPF / 007/2016 / FINAL / EN of October 2016 to the EU Joint Transfer Pricing Forum, hereinafter "EU JTPF", containing the report "Report on the use of comparables in the EU"[7] or also from "A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses", published in 2017 by the OECD (hereinafter “Toolkit”)[8].

2.3.1 Quantitative BMA

Quantitative analysis refers to the use of a search strategy for appropriately selected factors / criteria to select enterprises from a selected database that meet the specified criteria. The search criteria must be selected in such a way that, the independent enterprises selected on the basis of them, are comparable to the tested party of a transaction. The criteria for the selection of comparable entities for the usual pricing must be objective, fair and reviewable.

The most common quantitative criteria are:

- selection by company status - whether it is active, in the state of insolvency or goes bankrupt, whether it is in liquidation or canceled and for what reason;

- selection of enterprises from a similar geographical area, a country with a similar market to that of a tested party; In case that the tested party is from the Czech Republic, the geographical aspect of the Czech Republic is preferred, and gradually in the absence of comparable independent enterprises, it will be extended to e.g. the countries of V4, EU, Europe;

- selection of the sector of activity according to NACE codes related to the activity of the tested party;

- selection of independent enterprises - determining the condition of independence in relation to existing legislation in the Czech Republic pursuant to section 23 par. 7 of AIT - enterprises in which no owner has more than 25% of the capital or voting rights are considered independent.

- If few or no such enterprise is found, the selection criterion can be extended, for example, to enterprises that are publicly traded, or to enterprises that are owned by natural persons, provided that, for example, that natural person or publicly traded enterprise does not own or are not owned by other enterprises at least by 25%;

[7] https://ec.europa.eu/taxation_customs/sites/taxation/files/jtpf0072016revencomparablesreport_.pdf
[8] https://www.oecd.org/ctp/toolkit-on-comparability-and-mineral-pricing.pdf

- selection of enterprises that hold less than 25% stake in other enterprises so that the results of the enterprise are not affected by other transactions in the group;

- do not include entities with start-up costs (entities created approximately 3 years before the tax period under review). In general, the issue of so called start-up (termination) costs is that enterprises in a group with a limited functional profile (e.g. contract manufacturers) should receive constant remuneration no matter what the position of the enterprise or the group in the market is, i.e. that the costs of the so called start-up phase should not be borne by this contract manufacturer. Depending on the circumstances of the transaction, the start-up costs of the tested enterprise will be included in the cost base (and thus included in the profit level indicator), or re-invoiced without a margin (i.e., these costs are not relevant to profit-level indicator). Usually, the occupation of a market is in the interest of the group and it is its decision, as it expects it to generate higher profits in the future, while an entity with a limited functional and risk profile will continue to be remunerated only for the functions it performs and the risks it bears, (contract production by the contract manufacturer). Thus, the costs of occupying the market must be borne by the person who has made the decision to enter that market (performing the function and bearing the associated risks) and will benefit from that decision in the future, resp. expects it. It is necessary to consider every particular situation, as the Guidelines say in paragraph 2.91, and to consider how independent entities would behave in a similar situation.

- another criterion for selecting a comparable subject may be financial data. It is possible to delineate certain financial boundaries for the selection of entities of comparable size, for example minimum and maximum amount of the turnover or the assets that comparable enterprises must meet. Furthermore, a period can be defined when selected enterprises have published available data, depending on the period under review and the necessity to have the data available for comparable enterprises, for example, it is possible to define that only enterprises that have available certain data in selected years will be eligible for selection. (For example, based on the examined three-year period, enterprises, where financial data is unavailable for two or more years, should not be included in the selection.);

- if the tested enterprise performs routine functions and bears limited risks, the EU recommends, in the above-mentioned report, to exclude enterprises with recurring losses and extreme profits from selection, to leave loss-making only in justified cases. In general, this EU material rejects exclusion of loss-making comparable independent enterprises simply because of a loss without any other reason (based on this single reason). This means that if a loss-making enterprise is excluded, this procedure must be justified. If a comparable enterprise has recurring losses or extreme profits, it may indicate certain specific economic conditions, business strategy or high risks that may mean that the loss-making enterprise is not comparable to the tested enterprise. Usually such loss-making comparable enterprises are rejected (if they are not in a similar phase of the business cycle with the tested enterprise, they do not implement a similar business strategy or do not bear similar economically significant risks).

2.3.2 Qualitative BMA

The qualitative analysis means manual selection of enterprises selected by the quantitative analysis, i.e., verifying facts from publicly available information (e.g. annual reports, web) - the actual type of activity, the type of products manufactured / sold or services provided, factual independence, property, ownership structure in the years under review. In case of incompatibility with the tested enterprise, the selected independent enterprise shall be excluded, stating a demonstrable reason for exclusion.

The arm's length price range is calculated from the final sample of selected comparable enterprises and their profitability indicators (refer to chapter 2.4 of the Guidance).

The search strategy is recommended to be renewed at least every 3 years and at the same time to verify annually whether there has been a significant shift in profitability affected by market fluctuations in selected independent enterprises. At the same time, compliance with conditions of independence should be tested annually and the arm's length price range observed for selected independent entities should be updated as described in par. 5.37 - 5.38 of the Guidelines. This range must then be compared with the profitability of the tested enterprise in the group and when the actual margin achieved by the enterprise in the group is outside the actual range of comparable independent enterprises and there is no satisfactory evidence of the difference between the range observed for independent comparable enterprises and the actual mark-up, it is necessary to make adjustments so that the adjusted margin of an enterprise in the group is within the range found for comparable independent enterprises.

To determine the right price setting, the latest publicly available data at the time of price setting should be taken into account (ex-ante approach), for example, for 2019, when the pricing is being set at the end of 2018, data for 2017 and earlier will be known. However, by law, associated persons should act as independent enterprises when setting prices, and for example a jump in oil prices, or other economic changes, would be reflected in their pricing and would not base their pricing decisions only on historical data, but also on other information available at that time. It also always depends on the industry's usual contract lengths and how they can change, that is, the usual market environment for uncontrolled transactions. In this context, the Guidelines mention the so-called ex-post approach, which means that most often at the time of compiling the tax return, it is verified whether the actual result of the controlled transactions under consideration corresponds to the arm's length principle, as would be the case of independent enterprises. For more see par. 3.69 – 3.79 of the Guidelines.

2.4 Market-usual range

BMA data will be used for determining the remuneration according to the arm's length principle.

When comparing and evaluating circumstances that may affect transfer pricing, the results will not always be in absolute numbers, but will almost always operate with a range within which the prices (margins) for comparable products or services can move.

The prices or profitability indicators of comparable independent entities show the arm's length price range. For a better and more comprehensive understanding of controlled transactions, the EU JTPF recommends the use of multi-year data for comparable independent enterprises, usually 3-5 years, depending on the product (service), its lifetime, etc. For example, by using data from past years, it can be clarified whether the reported loss is part of a number of losses in similar transactions, a result of specific economic conditions in the previous year, or a reflection of the fact that the product is at the end of its life cycle.

When using data from more years, an arithmetic or weighted average, which can improve reliability of range, is usually used. The use of multi-year averages, e.g. for a routine producer or distributor, dampens his fluctuations in profitability (cleans profitability, for example, by the effect of damping or expansion over the product life cycle, capital expenditures, emergencies, etc.).

If it is possible to ensure a really accurate or high comparability of independent entities in terms of comparability factors (i.e. business strategies, economic circumstances, properties of assets transferred, functions performed and risks borne, contractual terms of transactions, etc.) and

the data found is within a narrow price range (without extreme values), the use of a full price range is preferred to achieve reliable results.

In practice, when using data from commercial databases, a high rate of comparability of found comparable data is usually not ensured and the found data contain extreme values. Statistical tools such as interquartile range can help to increase the reliability of the analysis (eliminating market fluctuations). Internationally recognized interpretative rules (Guidelines, as well as the aforementioned output from JTPF and Toolkit) state that, in order to achieve the required rate of comparability, when the range includes a significant number of observations, statistical tools are used to increase the reliability of the analysis, taking into account the medium trend to reduce range (e.g. interquartile range). Consequently, a narrowing of the price range is a commonly used and agreed administrative practice when it is not possible to ensure accurate comparability of the entities and there is a significant amount of comparable data in a relatively wide price range.

Interquartile range is a statistical method working with a frequency of occurrences of values that cleans a set of selected data by taking away extremely low and high values to refine the data sample. It divides the selected data into four quartiles, and all values in the narrowed range, i.e. between the 2nd and 3rd quartiles - the interquartile range - being considered as market ones. The start of the 2nd quartile is considered to be the lower limit, i.e. values above 25% of the set of data, and the end of the 3rd quartile is considered the upper limit, i.e. up to a value of 75% of the set.

If there are reasons for using the interquartile range, it is recommended to use it as it offers a better comparison with the results of comparable independent enterprises, reduces the level of inaccuracy. However, when using it, it is necessary to state the reasons why it was approached.

3 METHODS FOR IDENTIFICATION OF TRANSFER PRICES

Based on the comparability analysis performed, it is possible to 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 selection of relevant method depends on comparability 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 comparability analysis. When selecting the appropriate method, it is recommended to proceed from the CUP method, through other traditional transactional methods, to transactional profit methods, when more methods are applicable. 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.

The choice of method should take into account the strengths and weaknesses of these methods, the appropriateness of the method in terms of controlled transaction, the availability of reliable information (especially on uncontrolled comparable transactions) necessary for the application of the selected method, and the rate of comparability of controlled and uncontrolled transactions.

Sometimes it may be more appropriate to use transactional profit methods than traditional transactional methods. For example, when each party of the transaction has a valuable and unique benefit, or when there is no (or limited) information about the gross margin of independent parties. However, it is always necessary to consider the reliability of the application of profit methods according to the circumstances. For more see par. 2.1 – 2.12 of the Guidelines.

3.1 Traditional transactional methods

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

3.1.1 Comparable Uncontrolled Price Method – CUP

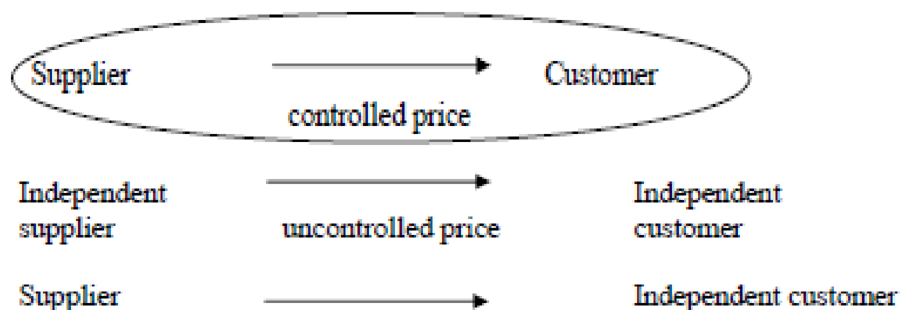
The method compares prices charged in controlled transaction with the prices of comparable uncontrolled transactions under comparable conditions. The party of the transaction is not tested, but the price is examined. This method is the simplest one in respect of its application although it requires a high rate of comparability. It must be a comparable product (goods or service), particularly as regards the type of produced product, location, etc. What is important is that the CUP method is also based on proper comparability analysis, including functional and risk analysis, and cannot be applied in situations when the same product is found, but parties involved in transaction will perform different functions and bear different risks.

The CUP method does not always need to determine the arm's length price range. If there is full comparability, one or a few transactions can be selected and the justification of possible differences can be examined.

The so called internal CUP is the case when the controlled enterprise sells the same product not only to the associated enterprise but also to the independent enterprise, or the controlled enterprise buys the same product from both the unassociated and the associated enterprise. An external CUP is the case when a comparable price is obtained from an independent (external) enterprise selling a comparable product.

Examples of external CUP are prices on commodity exchanges. An example of an internal CUP is, for example, the rent charged by a controlled enterprise to an associated and unassociated enterprise.

So: transfer (controlled) price = independent price



3.1.2 Resale price method – RPM

This method is based on the price, for which the product purchased from the associated enterprise (controlled price) is resold to an independent enterprise (final customer). Such uncontrolled price is then reduced by the gross margin usual to an independent comparable seller. The purchase price of the dependent seller is a dependent (transfer) price. The tested party is usually a dependent seller (distributor) purchasing from a supplier in the group (mostly the producer of the item). Gross margins, which are found to be the ratio of gross profit to revenues, are used here, refer to par. 2.27 of the Guidelines. Gross margin is the amount from

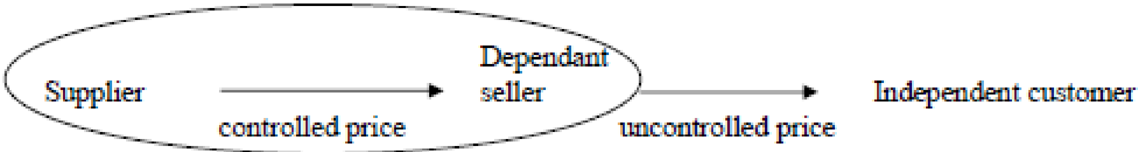
which the seller attempts to cover his selling and other operating costs (excluding the purchase price of the goods) and make a reasonable profit with respect to the performed functions.

The emphasis is on the performed functions. Differences in the product do not have such a significant impact on gross margin. The comparability is influenced by the functions of the tested party and the related risks, i.e. the position in the supply-client chain.

If the uncontrolled and the controlled transactions are comparable across all characteristics (i.e., in performed functions and risks associated with them) except the product, the RPM may provide a more reliable benchmark for market conditions than the CUP.

Subsequently, for the comparable independent enterprises, the range of gross margin is calculated and compared with the dependent seller's gross margin. If gross margin for controlled transaction of the tested party (dependent seller) is not in the range of gross margin found for comparable independent enterprises, an adjustment must be made.

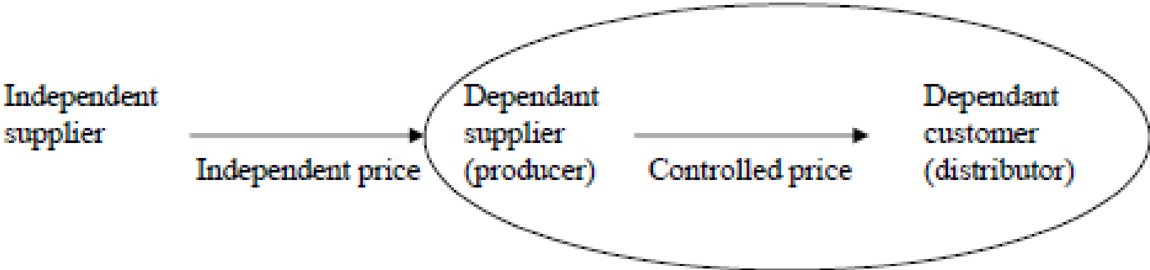
So: transfer (controlled) price = independent price (resale price) – usual margin by an independent seller.



3.1.3 Cost plus Method -C+

The method is similar to the resale price method. It is based on the costs incurred by the supplier in the controlled transaction for the purchase of assets or services provided to the associated enterprise by the independent seller. An appropriate mark-up found at an independent comparable supplier is than added to these costs. The tested party is usually a dependent supplier / producer. There is a gross profit mark-up, i.e. a comparison of gross profit, e.g. with production costs.

After finding comparable independent enterprises, the gross profit mark-up of the controlled transaction is compared to the gross profit mark-up in uncontrolled comparable transactions, and an adjustment must be made if the tested party's mark-up is not in the calculated range of the gross profit mark-ups in uncontrolled comparable transactions.



So: transfer (controlled) price = cost base (independent price) + usual mark-up by comparable independent supplier

The cost base includes all costs related to the production, the costs of the supplier for the supplied goods or the direct costs associated with the provided service. Types of costs should

be assessed individually in the context of whether their incurrence and existence are the basic assumption of the performance. E.g. it is necessary to evaluate whether or not exchange rate differences (both on cost and revenue side) should be included in the cost base.

The amount of the mark-up for an appropriately selected cost base should be set to cover the other operating costs of the enterprise (which did not enter the cost base) and to generate a reasonable profit. With respect to the functions being performed, it is necessary to assess whether the costs that are not associated with the risks, may or may not be excluded from the cost base for the application of the mark-up. In this case, it is necessary to make the same adjustments for comparable independent entities in order to determine the profit mark-up achieved by them in a comparable manner. That is, if, for example, the toll-manufacturer does not bear the risks associated with material inputs, because another enterprise in the group is fully responsible for the material supply, no mark-up is applied to these material costs (i.e. the costs are included in the calculation at the purchase price and not with the mark-up). In order to determine the mark-up of comparable independent entities, the mark-up must then be determined after the exclusion of the relevant material costs. This procedure is also applied to other transfer pricing methods.

The advantage of this method is that there is no need to pay much attention to the comparability of the product or service itself, as with the CUP method, but comparability focuses primarily on other characteristics of the transaction, i.e. the performed functions and the risks associated with them, market comparability, etc.

Gross profit mark-up is calculated as gross profit / production cost, respectively appropriately selected cost base (see above). Costs of production are costs directly attributable to the production of products sold by the enterprise, such as direct material, direct wages, other direct costs or, if applicable, also indirect (production) overhead costs, refer to par. 2.52, 2.53, 2.54 of the Guidelines.

The deficiency of RPM and C + methods is that, in most cases, sufficiently accurate data about transactions between comparable independent entities are not publicly available.

That is, it is not possible to determine precisely which costs are direct and indirect costs of production and which are other overhead costs, so either the application of another method, such as the TNMM method, which works with net margins, or adjustments to the results of comparable companies, should be considered so that their mark-up does not include these other overhead costs.

3.2 Transactional profit methods

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

3.2.1 Transactional Net Margin Method – TNMM

This method examines net profit range (in relation to respective base), i.e. it compares financial indicators related to the controlled transaction with the financial indicators related to a comparable uncontrolled transaction. Net profit can be regarded as operating profit (in some cases, the Guidelines recommend including in the selected indicator those items related to the transaction being tested, which are not generally included in the indicators).

Commercial databases are a good source of information. The tested party may be both the buyer and the seller, the one that performs fewer functions and bears less of the associated risks, i.e. does not add significant added value to the product, refer to par. 3.18 of the Guidelines.

TNMM works in the similar way as the resale price method or cost plus method with the difference that it does not work with gross margin but with a net profit margin (i.e., with operating profit). This is its strongest aspect, as net profit indicators are less affected by differences in transactions (transactions needn´t to be identical as opposed to CUP) and by the differences in performed functions that may affect gross margin (RPM, C+).

TNMM is also very often used in cases when transactions are aggregated, i.e. when transactions are very closely related to each other and it is difficult to value each of them separately.

The main difference between C + method and TNMM is in the costs entering into the calculation of the profitability indicator. For the C + method, the mark-up (gross profit mark-up) is calculated from the direct and the indirect production costs of the realized transaction (used at the level of individual transactions), while for TNMM, for example, all operating costs of the enterprise as a whole, including administrative and sales overhead costs, are calculated when calculating the net profit mark-up (determining the profitability of the company as a whole or of its part). The C + final price of the product is the sum of the direct and the indirect production costs and the calculated mark-up. When using TNMM, the final product price should be such that the company as a whole (or part of it) reaches a net profitability corresponding to the net profitability ascertained by benchmark analysis for comparable independent entities.

It is necessary to assess whether or not exchange rate differences (cost and revenue) should be included in the calculation of profitability indicator. The Guidelines regulate this fact in par. 2.88 and following. With respect to the functions performed, it is necessary to assess whether the costs contained in the cost indicators that are not associated with the risk, for the application of the mark-up, may or may not be excluded from the cost base, refer to par. 2.98 – 2.99 of the Guidelines. In this case, it is necessary to make the same adjustments for comparable independent entities, so that the profit mark-up achieved by them is ascertained in a comparable manner, refer to par. 2.100 of the Guidelines.

PLI – profit level indicator:

- Berry Ratio = gross profit / operating costs.
  If this coefficient is equal to one or more, it indicates that the enterprise generates profits above all operating costs. It is mainly used by distribution enterprises and service providers, refer to par. 2.106 – 2.108 of the Guidelines.

- Net cost plus mark-up or FCMU (Full Cost Mark-Up) = operating profit / total operating costs.
  Suitable for production enterprises and service providers. The mark-up is applied to all operating costs, refer to par. 2.92 – 2.95 and par. 2.98 – 2.102 of the Guidelines. It is less sensitive to differences in functions between controlled and uncontrolled transactions than gross margin.

- Net profit margin or operating margin = operating profit / revenues.
  It is less sensitive to differences in functions than gross margin, suitable for distribution enterprises, expresses how much net profit from sales remains, refer to par. 2.92 – 2.95 and par. 2.96 – 2.97 of the Guidelines.

- Return on assets - This indicator measures the profit against assets and shows to what extent the enterprise is able to generate profit or other alternative quantity measuring the company's performance from the available assets invested in the business (regardless of the financing method). This indicator may be useful in cases when assets

are a more appropriate, accurate indicator of added value for the tested party (rather than costs or revenues), for example in asset-intensive or capital-intensive activities.

Typically, assets that relate to a given transaction are used in the calculation and when selecting comparable transactions and entities, transactions with a comparable asset structure are selected. Refer to par. 2.103 and 2.104 of the Guidelines. This indicator is sensitive to other circumstances of transactions, such as purchase price of assets, their age, technical improvements or repairs, ownership of assets or their lease (operative or long-term), national accounting standards, etc. Without knowing how to finance an enterprise, it can lead to misleading conclusions, so when applying this indicator, it is necessary to be more careful with regard to its applicability.

The denominator of indicators should express the value of the functions of the tested party. It is necessary to compare the same quantities. That is, if, for example, for a comparable independent enterprise, exchange rate differences or interests are included into the operating costs, it is necessary to apply the observed mark-up for the tested party to costs that include exchange rate differences or interests.

Non-operating and extraordinary items should be excluded from the determination of the profit level indicator (e.g. interest income and expenses not related to operating activities, exchange rate losses / gains not related to operating activities, non-recurring items - depending on the circumstances of the particular case). The denominator should be as independent on the controlled transactions as possible – refer to par. 2.94 of the Guidelines.

The above-mentioned examples of indicators are not a complete list and in some situations others may be suitable, such as return on equity (ROCE), etc., always depending on the particular situation.

3.2.2 Profit split method

There are several approaches for profit split. E.g. contribution (benefit) analysis and residual analysis.

The contribution analysis is based on the profit generated by the associated enterprises from controlled transactions, regardless of where it is reported (i.e. total profit to split). This total profit (i.e. the profit of the associated enterprises from the assessed transaction) is then allocated between the associated enterprises involved in the controlled transaction based on contribution analysis (functional and risk analysis). It means the total profit realized by the transaction(s) is allocated to each participant in accordance with the share of each enterprise in the total profit (according to the quantity and importance of the functions performed by each enterprise and its associated risks). Tested parties are all participants in the transaction (both the buyer and the seller).

Residual analysis divides total profits from controlled transactions in two phases. In the first phase, each participant is assigned a market remuneration for its non-unique benefits in relation to the controlled transactions. This remuneration is most often determined using the net profit margin method (refer to chapter 3.2.1.). The remaining / residual profit / loss is then divided between fully-fledged associated enterprises (with a unique and valuable benefit) based on the contribution analysis as stated in the previous paragraph.

This method can be used when it is possible to identify the unique benefit of all parties of the transaction, for example owning a unique tangible or intangible asset and at the same time, if

parties contribute high added value and bear the corresponding risks within the functions they perform.

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, i.e., evidence that the tax entity respected the provisions of section 23 par. 7 of AIT.

Detailed explanation of the documentation content will be provided in the Guidance of General Financial Directorate D – 35, which will replace the existing Guidance D-334 (Notification of the Ministry of Finance in respect of the scope of documentation concerning pricing between associated entities, ref. no.: 39/86 849/2009-393), which will be published on the Czech Tax Administration website http://www.financnisprava.cz/cs/mezinarodni-spoluprace/mezinarodni-zdanovani-prime-dane.

According to the OECD's updated Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, transfer pricing documentation should contain three parts – Local File (a local document containing information about each entity that is part of the group and that is resident in that jurisdiction), Master File (a basic document containing data on the group as a whole) and Country by Country reporting - reporting and transferring data about transactions between associated enterprises (the obligation to submit it is regulated by Act no.164 / 2013 Coll., on International Cooperation in Tax Administration and on Amendment to Other Related Acts).

5 CORRESPONDING 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 action may lead to double economic taxation. In order to avoid double taxation, there are corresponding profit adjustments made pursuant to the Article 9 par. 2 of the Model Convention. Explanation of these adjustments is provided in both the Commentary on the Model Convention and in the Guidelines, chapter IV, section C. Corresponding adjustments and procedure determined by mutual agreement are regulated in Articles 9 and 25 of the OECD Model convention, as well as in Section III of the Arbitration Convention.

In 2019, Council Directive (EU) 2017/1852 of 10 October 2017 on Mechanisms for Resolving Tax Disputes in the European Union, which lays down rules for the resolution of disputes between member states arising from the interpretation and application of treaties and conventions that regulate the avoidance of double taxation of income and property, will be implemented into the Czech legislation. The implementation of the Directive in the Czech

Republic should apply to submissions made after 30 June 2019 regarding tax disputes concerning the taxation period beginning on or after 1 January 2018[9].

6 ADVANCED PRICING AGREEMENTS

Transfer Pricing Guidelines, chapter IV, section F Advanced pricing agreements, besides other, provide for the possibility to conclude advanced pricing agreements (binding ruling) as an instrument eliminating disputes between tax administration and taxpayers in respect of transfer pricing application.

It is a matter of arrangement between the taxpayer and the tax administration bodies concerning the taxpayer's transfer prices to his associated person and their conditions.

The terms and conditions associated with the APAs are regulated in section 38nc, resp. section 38nd of AIT and practical information is described in the Guidance of the General Financial Directorate D-32 (Notification of General Financial Directorate in respect of Binding Ruling on transfer pricing in related parties' transactions and the method of determining the non-resident tax base from activities performed through a permanent establishment), ref. no.: 58337/18/7100-40113-800219), available at the Czech Tax Administration web-site www.financnisprava.cz.

7 CONCLUSIONS

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

This Guidance replaces the Guidance D – 322 issued under the ref. no.: 39/86 829/2009-393.

Ing. Tatjana Richterová
General Director

[9] The specific date depends on the approval of the law implementing the Directive in the Parliament of the Czech Republic.

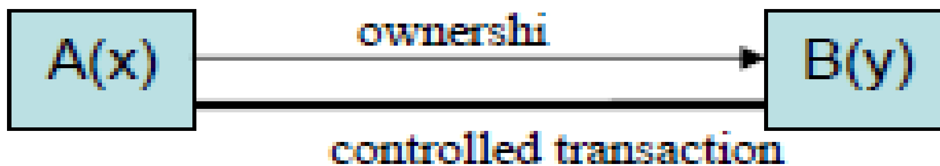
Annex 1

This annex contains illustrative examples and additional information concerning particular parts of the methodology Guidance D – 34:

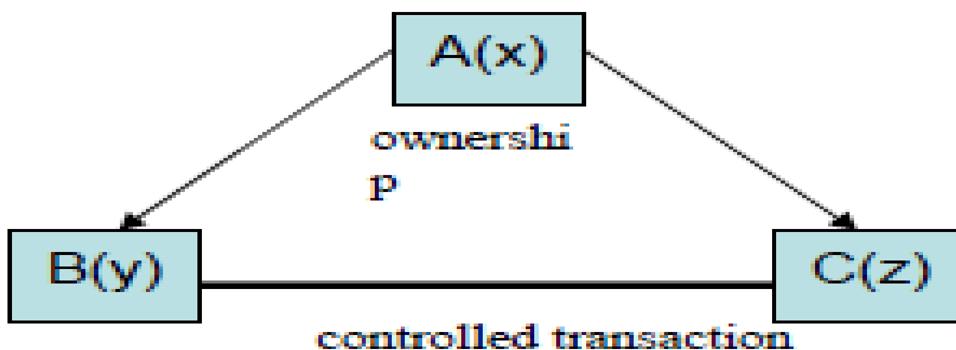
To chapter 1.5 Associated enterprises

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:



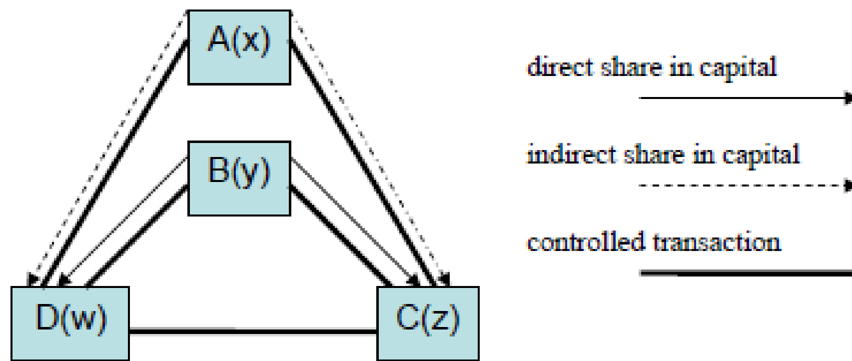
Besides that, in this case the controlled transactions may be executed also between the companies A and B or between the companies A and C.

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

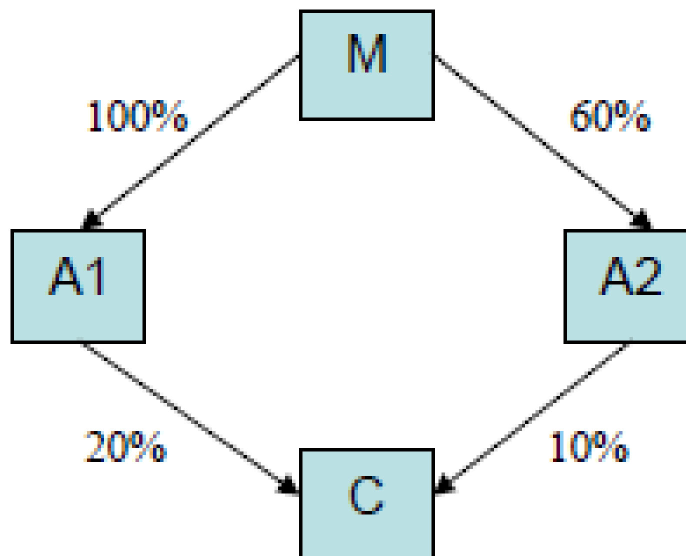
-between the companies B and C, between B and D as well as between C and D – all due to the direct share of the company B in the companies C and D

-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



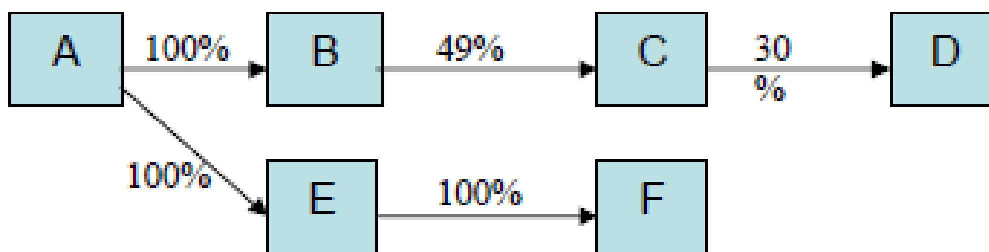
d) The mother company M owns 100% of the company A1 and 60% of the company A2; the companies A1 and A2 own shares in the assets of the company C in the following way: the company A1 owns 20% and the company A2 owns 10% of the company C; each of the mentioned companies has its registered office in a different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



Only the companies A1 and A2 shall be considered as associated persons as the condition of 25% share in registered capital or voting rights 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) point 1 of AIT. Companies A1 and A2 are persons mutually related through capital under s. 23, par. 7, letter a) point 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), point 1 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 take place between all the companies concerned.

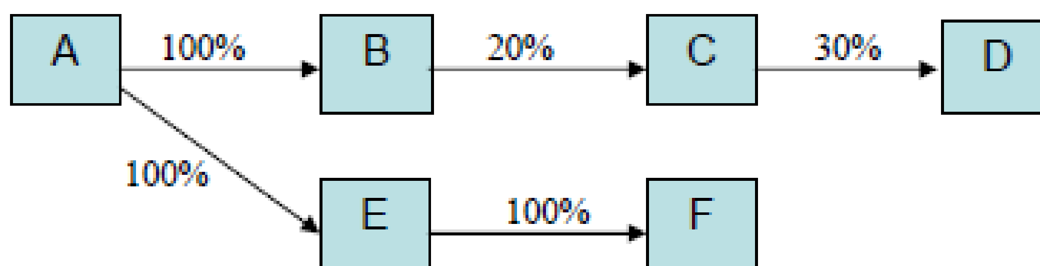
f) There are companies A, B, C, D, E and F. Each of the companies has its share in the registered capital of the other company as the following scheme shows:



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 are 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 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 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 considered as 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 chapter 2.1. Comparability analysis

In order the transactions or the conditions under which the transactions are realized 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 Czech Republic 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 Czech Republic. 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 uncontrolled 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 chapter 2.1.1.2. 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 chapter 2.4. Price range

Example of the price range use: Tax audit has ascertained that the company A uses the 5% mark-up 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 chapter 3. Methods for identification of transfer prices

The following example illustrates the principle of each transactional method functioning in the course of the transfer prices definition. Input information is the same for all the methods, the functional and risk profile of associated enterprises may differ for each method:

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
(line 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 gross margin deducted from the final sale price of the Distributor (dependent seller, line 6) is identical to the range of gross margins of comparable independent distributors in the case of comparable conditions of both the transactions, when the gross margin of the Distributor is 50%.

If the gross margin of the tested party's controlled transaction (dependent seller) is not in the range of gross margins found for comparable independent enterprises, adjustments must be made.

$$\text{i.e. } \frac{\text{line 1}}{\text{line 6}} * 100, \text{ so } \frac{10\,000}{20\,000} * 100 = 50\ \%$$

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 (dependent supplier, line 2) is identical to the range of gross profit margins of comparable independent producers in the case of the comparable conditions in both the transactions, when the mark-up of the Producer is 100%.

$$\text{i.e. } \frac{\text{line 1} - \text{line 2}}{\text{line 2}} * 100, \text{ so } \frac{10\,000\text{-}5\,000}{5\,000} * 100 = 100\ \%$$

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 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 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 (in this case the operating margin) is identical to the net range of the operating margin, which independent distributors would reach in the case of comparable conditions of both transactions. The example shows that the distributor’s operating margin is 30%.

$$\frac{\text{line 9}}{\text{line 6}} * 100, \text{ so } \frac{6\,000}{20\,000} * 100 = 30\ \%$$

Annex 2

Notice by the Minister of Foreign Affairs no. 15/1988 Coll. 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.