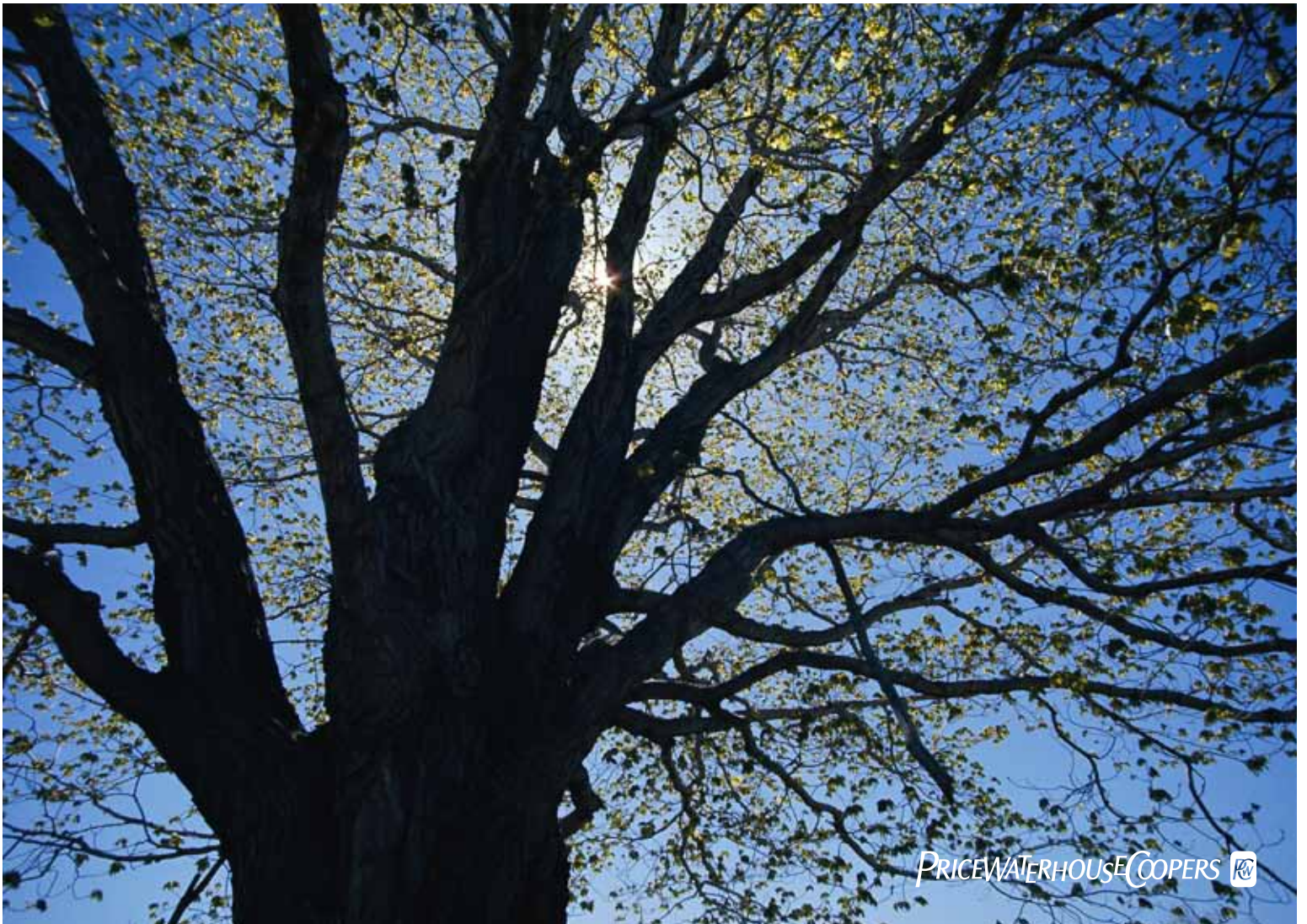


Tax offices in Central and Eastern Europe:
Wind of change?

Transfer pricing perspectives

Re:solutions
moving towards certainty



Tax offices in Central and Eastern Europe: Wind of change?

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Transfer pricing is rapidly evolving in Central and Eastern Europe and continues to be a major issue for taxpayers and tax authorities. Both Central and Eastern Europe are working to ensure the fair allocation of profits and tax revenues across borders while the Organisation for Economic Co-operation and Development (OECD) develops the concept of what should be regarded as fair by both entities and OECD member states. PricewaterhouseCoopers' network in the CEE region has gathered information on the practices of tax authorities there to consider the transfer pricing environment.²¹ This article is intended to summarise the major findings of our research.

CEE region

The CEE region encompasses 28 countries.²² This region differs from Western European countries in that it traditionally has shown greater economic growth, thus providing higher rates of return and continually attracting new investments. The region's diversity ranges from countries of the Commonwealth of Independent States (ex-Soviet Union republics) to new European Union members. A number of other factors that should be accounted for when interpreting the results of the search include but are not limited to:

- Stage of the development of tax law;
- General approach by the authorities toward investors;
- Use of various languages (almost all of the 28 countries have an individual language as the official way of communicating with the tax authorities); and
- Industry specifics.

Major observations—legislation

Of the 30 OECD member countries, only four are located in the CEE (the Czech Republic, Hungary, Poland, and the Slovak Republic); further, three CEE countries, Estonia, Russia, and Slovenia, are candidates for accession to the OECD.

Still, the OECD strongly influences transfer pricing regulations across the region. Only Azerbaijan²³ admits that the local regulations do not follow the OECD-style approach, while the remaining countries except for Croatia, Macedonia, Kazakhstan, Russia, and Ukraine fully follow the OECD rules. In particular, the arm's length principle is broadly recognised across the region (Russia and Kazakhstan to an extent, Azerbaijan is the only exception), and documentation rules are now used in eight countries (including Slovakia, which adopted them January 1, 2009).

²¹ PricewaterhouseCoopers' research covered Azerbaijan, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Macedonia, Poland, Romania, Russia, Slovakia, Slovenia, and Ukraine.

²² Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

²³ Please note summary table at the end of the article.

Major observations—practice and tax authorities' approach

It is often assumed that the tax authorities across the region are not as accomplished as their Western counterparts or that they are aggressive and difficult to approach. The truth lies somewhere in between; CEE tax authorities, at least at the top of the hierarchy, are well-educated now and aware of the economic circumstances of the world. That gives them insight into the drivers of processes taking place at large multinational organisations. At the same time, they have been more willing lately to talk with the taxpayers and take a more open approach.

“In examining the level of sophistication of the tax authorities, it is noted that the traditional stalwarts have experienced tax auditors or specialised/centralised transfer pricing teams. When meeting the tax authorities in the Czech and Slovak republics, Hungary, Poland, and Romania as well as the Baltic States, Slovenia, and Kazakhstan, you can expect that the discussion will be run by an experienced auditor or a member of a centralised, specialised transfer pricing team.”

Even more countries are starting to focus on transfer pricing matters. Croatia, Hungary, Latvia, and Slovakia are recognised as presenting a more aggressive approach toward transfer pricing. That may partially result from the recognition that the taxpayers in such countries as the Czech Republic, Poland, and Romania are already used to detailed transfer pricing audits.

Specific to this region, countries that only a couple of years ago started to learn transfer pricing are now advanced with both their legislation and the level of tax authorities' expertise. In addition to documentation rules first put in place in the region in Poland in 2001 or the general transfer pricing rules being fully aligned to the OECD style in the mid-1990s, there are now the following:

- Advance pricing agreement (APA) regulations have been adopted in five countries (the Czech Republic, Hungary, Kazakhstan, Poland, and Romania), and the Polish Ministry of Finance already has issued more than 10 APAs.
- At least eight countries use sophisticated statistical tools to benchmark related-party transactions, and other countries either use local data or plan to purchase the respective tools.
- Most of the countries are increasingly involved in the exchange of information, and they have used information gathered from their foreign counterparts during tax audits.

All these developments may be seen through the perspective of the training of the tax authorities' officials by their foreign counterparts. This also changes the tax officials' willingness to discuss and negotiate with the taxpayers. Except in Azerbaijan, Croatia, Lithuania, Russia, and Slovenia, the taxpayers may discuss outcomes of a tax audit with the authorities prior to the decision.

That being said, we stress that the tax authorities in the region are often rigorous and formalistic in their approach to documents and audits in general. First, they strongly prefer that all communications be in writing. Also, where they are seeking evidence, written proof is strongly preferred. The correspondence with the tax authorities normally should be in a local language. Only in a couple of countries do the tax authorities recognise the master file concept. In others, either they do not accept it or they require significant local adaptations to follow the country-specific regulations. In addition, global or pan-European benchmarking studies are accepted in only a few countries.

If you are looking for any "regional favourite," it is the central services, or cost sharing, arrangement. The tax authorities present a consistent approach across the region: They attempt to question whether services were rendered at all; whether the local recipient could benefit from these services; or state that the service fee was not commensurate to the benefit for a taxpayer because the taxpayer could purchase comparable services locally at a lower price (because of lower salaries on the local markets).

Foremost, it should be noted that even though the CEE region may seem to be homogenous, it consists of a number of countries with their sovereign jurisdictions. Therefore, each business structure should be examined locally to ensure its feasibility.

Key theme—restructuring processes

For a number of years, countries in the region have faced a huge inflow of direct foreign investments. Following the integration within the European structures and the economic processes taking place within multinational enterprises, business restructuring is common in most of the countries of the region. The technical aspects of the restructurings are not any different from what is happening across the globe; that is, limited-risk models are being put in place including:

- Commissionaire or agency structures for distribution activity;
- Toll or contract manufacturing; and
- Shared services centres serving the global operations in the areas of support services.

At the same time, companies should consider certain aspects when putting the structures into practice. Foremost, it should be noted that even though the CEE region may seem to be homogenous, it consists of a number of countries with their sovereign jurisdictions. Therefore, each business structure should be examined locally to ensure its feasibility. Additionally, a number of countries report that a taxpayer's changing of its business model can trigger the tax authorities' attention. Similarly, a reduction of the reported income that normally accompanies such business process restructuring may be noticed and analysed in detailed.

Restructuring processes that we observe are principally business-driven. Multinational enterprises are willing to change their modus operandi only if it leads to increasing efficiency, reducing costs, improving client service, etc. Restructuring processes taking place in the period of dynamic economic growth carry optimistic anticipations of further development in the market situation. The underlying assumption of most of the structures tax-wise is that the local entities bear limited business risk, which results in low but relatively stable profit. Such a financial model leads to extraordinary profits realised at the central level under positive market circumstances, but it is also the head office that faces the loss in a downturn. As a result, the limited-risk entities may still be entitled to earn a small profit (or at least break even), while the rest of the group will be in a loss position. Current market circumstances could make a number of entities going through restructuring processes lately reconsider the approaches adopted.

Summary of the research – legislation

	OECD principles followed	Arm's length principle adopted	Documentation required
Azerbaijan	—	—	—
Bulgaria	✓	✓	—
Croatia	Partially	✓	—
Czech Republic	✓	✓	✓
Estonia	✓	✓	✓
Hungary	✓	✓	✓
Kazakhstan	✓	Partially	From selected taxpayers only
Latvia	✓	✓	—
Lithuania	✓	✓	✓
Macedonia	Partially	✓	—
Poland	✓	✓	✓
Romania	✓	✓	✓
Russia	Partially	Partially	—
Slovakia	✓	✓	✓
Slovenia	✓	✓	✓
Ukraine	Partially	✓	—

Summary of the research—approach

	Experienced auditors or specialised/centralised teams	Aggressive tax auditors	Advance pricing agreements available	Use of statistical tools to benchmark transactions	Exchange of information	Training for tax auditors lately
Azerbaijan						
Bulgaria		✓			✓	
Croatia		✓				
Czech Republic	✓		✓	✓		
Estonia	✓					✓
Hungary	✓	✓	✓	✓	✓	✓
Kazakhstan	✓		✓	✓	✓	✓
Latvia	✓	✓		✓	✓	
Lithuania	✓			✓		
Macedonia					✓	
Poland	✓		✓		✓	✓
Romania	✓		✓	✓		✓
Russia					✓	
Slovakia	✓	✓		✓	✓	✓
Slovenia	✓			✓		
Ukraine						

Summary of the research approach

	Dialogue with the tax authorities possible	Master file concept recognised	European benchmarks acceptable	Restructuring triggering the tax authorities' attention	Drop in profitability triggering the tax authorities' attention
Azerbaijan					
Bulgaria	✓			✓	
Croatia		✓			
Czech Republic	✓	✓	✓		
Estonia	✓	✓	Conditionally*		
Hungary	✓		Conditionally	✓	✓
Kazakhstan	✓				
Latvia	✓			✓	
Lithuania		✓			✓
Macedonia	✓				✓
Poland	✓	Conditionally**	Conditionally	✓	✓
Romania	✓		Conditionally	✓	✓
Russia				✓	✓
Slovakia	✓	✓	✓		
Slovenia			✓	✓	✓
Ukraine	✓				

* If local observations are insufficient

** If supplemented according to local regulations

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