

Czech Republic transfer pricing rules for the recipients of investment incentives — recent court decision

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In brief

In the Czech Republic, specific transfer pricing rules apply to the recipients of investment incentives in the form of tax relief. A typical requirement of tax relief based investment incentives is that all transactions with related parties are conducted at arm's length.

In a recent Czech court case, a company lost all the tax relief it had already received as a result of the purchase price of the goods in a small transaction with a related party being lower than the arm's length price — it was held that the company had utilised a higher amount of tax relief than it was entitled to.

In detail

Investment incentives in the Czech Republic

Investment incentives are an important tool to attract foreign and domestic investors to locate their investment projects in the Czech Republic. One of the conditions for receipt of incentives is a minimum investment of EUR 2 million (CZK 50 million) into launching or expanding:

- production in the manufacturing industry;
- a technology centre; or
- a strategic services centre.

The incentives are provided in various forms:

- Full or partial income tax relief (for up to ten taxable periods).
- Purchase of land at favourable prices.
- Cash subsidy for the acquisition of long-term tangible or intangible assets (for a strategic investment project).
- Cash subsidy for newly created jobs
- Cash subsidy for training or retraining employees.

The amount of incentives actually provided depends on the level of eligible costs and the state aid rate. The relevant costs can be either investment in long-term tangible and intangible assets or payroll costs. In this respect, as of 1 July

2014, the maximum state aid rate will be reduced from 40% to 25% of total eligible costs. Therefore, if a company receives a decision on investment incentives after 30 June 2014 and carries out an investment in the amount of e.g. EUR 10 million, it will be entitled to a tax relief in the amount of EUR 2,5 million instead of EUR 4 million.

TP requirements for recipients of investment incentives

The most common form of investment incentive is tax relief. Recipients of tax relief investment incentives are required to meet **specific transfer pricing conditions** stipulated by the Czech Income Taxes Act. Specifically, a company cannot increase the

tax base for the calculation of the tax relief by means of business transactions with related parties in a manner which is contrary to the economic principles of standard business relationships.

This approach prevents profit shifting to the recipient of the tax relief. In practice, for companies with investment incentives, it is important that the intercompany sales price is not above the arm's length level, and the purchase price of goods and services should not be below the arm's length level. If these conditions are not met, a recipient of tax relief will lose all the tax relief already received and will incur associated late-payment interest and penalties in relation to the additional tax arising from the loss of the relief.

This approach was recently confirmed by the Czech Court. A company lost all the tax relief it had already received because the purchase price in a small transaction was lower than the arm's length price. The details of the case are summarised below.

Recent court case

The company was principally engaged in production (94% of turnover), with the remainder of its income arising

from a distribution activity. During a tax audit, the gross margin of the company's distribution function was challenged. The tax authority prepared its own benchmarking study and concluded that the company purchased goods from a related party below the arm's length price and thus received an amount of tax relief that was higher than it was entitled.

The company attempted to defend its transfer prices using documentation which supported the aggregated result of its manufacturing and distribution activities using the Transactional Net Margin Method, with Full Cost Mark Up (FCMU) as the profit level indicator. The company's aggregated result was in the arm's length range of comparable independent manufacturers.

However, the company was not able to defend its position as the aggregation approach was held to be a misinterpretation of the data. As the company's manufacturing and distribution activities are completely separate and different, it was in the Court's view necessary to analyse them separately. The company ultimately lost not only the tax relief granted in the period under review, but also the tax relief utilised in

previous periods (more than EUR 4 million) and also incurred interest and a penalty.

Solution: transfer pricing documentation or Advance Pricing Agreement (APA)

Despite the above Court case, investment incentives are a very useful and popular tool claimed by many Czech and foreign investors. The risk of losing tax relief can be decreased by preparing transfer pricing documentation supporting the arm's length nature of prices on all intercompany transactions. For greater certainty a company may also apply for an APA.

The takeaway

As mentioned above, specific transfer pricing rules apply for the recipients of investment incentives in the form of tax relief in the Czech Republic. It is necessary to set the prices in all (even small) transactions with related parties at arm's length. To avoid the risk of losing any tax relief due to incorrect transfer prices, it is recommended that either transfer pricing documentation be prepared covering all transactions or an application is made for an APA.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Transfer Pricing and Tax Controversy

David Borkovec, Prague

+420 251 152 561

david.borkovec@cz.pwc.com

Natalia Pryhoda, Prague

+420 251 152 647

natalia.pryhoda@cz.pwc.com

Iva Kuncova, Prague

+420 251 152 587

iva.kuncova@cz.pwc.com

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