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Czech Republic

Introduction

The Czech tax authorities have begun to recognise the importance of transfer pricing, resulting in an increase in the number of tax audits that focus on related party transactions, or at least much more frequent scrutiny of these transactions.

Statutory rules

Acceptance of OECD Guidelines

The Czech Republic has been a member of the Organisation for Economic Co-operation and Development (OECD) since 21 December 1995. The OECD Guidelines on transfer pricing were translated into the Czech language and published by the Czech Ministry of Finance in 1997 and 1999. Although the OECD Guidelines are not legally binding, they are generally accepted by the Czech tax authorities.

Arm's-length principle in Czech tax legislation

Czech transfer pricing legislation covers transactions between companies as well as individuals and applies equally to domestic and cross-border transactions. The legislation contains a general definition of the arm's-length principle, which basically reflects the arm's-length principle in the OECD Guidelines.

The legislation states that a taxpayer's tax base will be adjusted for any related party transaction undertaken by the taxpayer in which the price differs from what would have been agreed between unrelated parties in current business relationships under the same or similar terms (conditions).

Definition of related parties

Based on Czech tax legislation, parties are considered to be related if one party participates directly or indirectly in the management, control or capital of the other, or if a third party participates directly or indirectly in the management, control or capital of both of them, or if the same persons or their close relatives participate in the management or control of the other party (excluding the situation where one person is a member of the supervisory boards of both parties). Participation in management suffices for the assumption of a relationship, even without equity ownership. Participation in control or capital means ownership of at least 25% of a company's registered capital or voting rights. Individuals are related if they are close relatives. Parties are also deemed to be related if they enter into a commercial relationship mainly for the purpose of reduction of the tax base (or increase of a tax loss).

Methods for determination of the arm's-length price

In general, there are no provisions in the Czech tax legislation on how an arm's-length price should be determined in related party transactions. However, as mentioned above, the OECD Guidelines are generally accepted by the Czech tax authorities. It is therefore recommended to apply the methods described in the OECD Guidelines.

Czech transfer pricing guidelines and documentation rules

In accordance with the guideline of the Czech Ministry of Finance D-332 (regarding use of the international standards for taxation of transactions between related parties), followed by the guidelines of the Czech Ministry of Finance D-333 (regarding transfer pricing advanced pricing agreements) and D-334 (regarding scope of transfer pricing documentation), Czech companies should follow the principles of the OECD Guidelines.

The Czech tax legislation does not prescribe any obligation to maintain any transfer pricing documentation (including preparation of a benchmarking study or a functional and risk analysis). Nevertheless, documentation proving that the arm's-length principle was followed in related party transactions might be required by the Czech tax authorities during a potential tax audit. It is therefore highly recommended that such documentation be prepared in advance and that the transfer pricing methodology applied in transactions with related parties be properly documented.

In addition, as a member of the European Union, the Czech Republic has adopted the EU Transfer Pricing Documentation Code (master file approach). However, it is at the taxpayer's discretion to follow the code.

Based on the legally nonbinding guideline D-334 on transfer pricing documentation issued by the Czech Ministry of Finance, documentation for transfer pricing should contain at least the following information:

- Master file:
  - Information about the group (business description, organisational structure, inter-company transactions, functional and risk profile of companies within the group, etc.).
- Local file:
  - Detailed description of the business and business strategy.
  - Description of the business transactions in which the above company participates.
  - Benchmarking analysis including a functional and risk analysis.
  - Information about the transfer pricing policy and selection of the method.
  - Relevant information on internal and/or external comparables if available.
  - Description of the role the company plays in the group's inter-company transfer pricing policy.

The above contents should be sufficient for the tax administrator to determine whether the company acts in compliance with the arm's-length principle.

Advance pricing agreements (APAs)

Based on the Czech Income Taxes Act, if a company is in doubt as to whether the method used for determining the prices applied in existing or future transactions is in compliance with the arm's-length principle, it can submit a written request to the Czech tax authorities for an APA (i.e. a binding transfer pricing ruling).

Practical experience shows that the average time needed for processing an APA in the Czech Republic is approximately eight months. So far, mostly unilateral APA requests have been filed along with one bilateral APA request. However, the Czech Ministry of Finance has expressed that it is also prepared to deal with a multilateral APA, if required.

Customs

According to customs legislation, the base on which customs duty is calculated may be adjusted when the seller and buyer are related. There is a description of how an arm's-length price will be determined for customs duty purposes using available data on comparable goods.

Reporting under the Commercial Code

Starting in 2001, the Czech Commercial Code introduced new rules and regulations relating to groups of companies, including reporting requirements. Group companies may conclude a controlling agreement listing the companies that are subject to common management by the controlling company. In the absence of such an agreement, the new reporting requirements impose an obligation on companies having a common majority shareholder to report intragroup transactions.

A document on intragroup transactions is to be prepared as part of the annual report and filed with the relevant commercial court. This document must outline all transactions carried out in the fiscal year between the subsidiary company and the majority shareholder, and also with any sister company. There are no guidelines in the legislation as to what level of detail is required. The document is available to the public, including the Czech tax authorities and minority shareholders, which increase the risk of transfer pricing investigations. The report on intragroup transactions is also subject to a statutory audit review.

Penalties and interest on late payments

If the tax authorities successfully challenge a company's transfer prices, then additional tax, a penalty and interest on late payments may be due.

With effect from 1 January 2011 (for tax due after 1 January 2011), the penalties and interest on late payments are calculated as follows:

- A penalty in the amount of 20% applies if tax is increased or a tax deduction is decreased as a result of the tax audit.
- A penalty in the amount of 1% applies if a tax loss is decreased as a result of the tax audit.

In addition to the penalty, interest on late payments applies. Interest is calculated as the National Bank's repo-rate (effective on the first day of the relevant half-year) increased by 14%. This interest charge is applicable for a maximum period of five years.

No penalty applies if the taxpayer reassessed the tax base voluntarily in an additional tax return (only interest on late payment applies in that case).

Tax audit procedures

Obligations of the taxpayers

Based on the Tax Procedure Code, which governs tax audit procedures, the taxpayer has two main obligations:

- To declare the tax liability to the tax authorities in a tax return.
- To be able to substantiate the liability declared.

In principle, the tax authorities may request that the taxpayer provide evidence to substantiate all facts relevant to the tax return. This also applies to documentation on the taxpayer's approach to transfer pricing.

Approach of the tax authorities

In practice, rather than requesting general information, the authorities will specify their requirements. They must grant the taxpayer sufficient time to compile the required information (although practice shows that in a transfer pricing inquiry situation, this might be an issue, given the complexity of transfer pricing and the documentation required).

In cases where the tax authorities have requested evidence to substantiate items included in the tax return, it is the tax authorities themselves that decide whether that evidence is adequate. Where it is considered inadequate, the tax authorities may reassess the taxpayer's liability on the basis of their own sources of information, such as third-party valuations or information obtained from other taxpayers' returns or investigations.

However, in order to be able to make an assessment, the tax authorities should have a reasonable basis to challenge the declared tax liability. In transfer pricing disputes, they should primarily:

- provide sufficient evidence that the arm's-length principle was not followed, and
- demonstrate that, as a consequence of non-compliance with the arm's-length principle, the taxpayer has declared an incorrectly low tax liability.

Negotiations between the taxpayer and the tax authorities on the tax liability are rare (e.g. they may occur when the taxpayer cannot substantiate the declared liability and the tax authorities cannot obtain adequate evidence from their own sources to issue a reassessment).

Burden of proof

The burden of proof effectively lies with the taxpayer because, in order to mount a challenge, the tax authorities must only demonstrate that there is some basis for that challenge. It is the taxpayer who must then provide the evidence to refute the challenge.

Transfer pricing practice

Transfer pricing inquiries

The number of transfer pricing inquiries has increased in recent years, and the Czech tax authorities are becoming more confident in this area. The practical knowledge of transfer pricing and the level of detail under review by tax offices when scrutinising transfer prices may vary in different regions. However, the level of sophistication of the tax authorities is constantly increasing.

As of 2012, a new Specialised Financial Office was established and will focus on companies with turnover exceeding 2 billion Czech koruna (CZK); banks, including branches of foreign banks; credit unions; insurance and reinsurance companies, including branches of foreign insurance and reinsurance companies; and companies which form a VAT group with entities defined above. The Specialised Financial Office has audit teams dedicated to transfer pricing.

These developments prove that the Czech tax administration recognises the importance of transfer pricing, which has resulted in an increase in the number of tax audits that focus on related party transactions, particularly those involving services, low-risk functions and losses.

Further, there is a growing trend in relying on the APA process with the Czech tax authorities to resolve transfer pricing uncertainties.

Investment incentives

Currently, the Czech government gives the opportunity for manufacturing companies, technology centres and strategic services investing in the Czech Republic to participate in an investment incentives programme. The investment incentives package contains various benefits such as a ten-year tax holiday.

Czech tax legislation contains a specific provision on the interplay between a tax incentive and transfer pricing. Based on this provision, if a company that was granted investment incentives does not comply with the arm's-length principle, it may lose the granted tax incentive. This may result in suspension of the tax relief and assessment of severe penalties. Therefore, the Czech tax authorities are highly focused on transfer pricing when examining companies that utilised investment incentives.

Anticipated developments

Because many of the neighbouring countries (e.g. Poland, Hungary and Slovakia) have introduced transfer pricing documentation rules, the Czech Republic will likely follow this trend.

Thin capitalisation rules in Czech tax legislation

A thin capitalisation provision is also included in the Czech tax legislation.

The main rules are outlined below:

- The debt-to-equity ratio for related party loans to equity is 4:1 (6:1 for banks and insurance companies). Unrelated party loans (e.g. bank loans) are not subject to thin capitalisation.
- The tax deductibility test applies to interest as well as to other financial costs on loans (i.e. interest plus other related costs such as bank fees, etc.).
- Financial costs paid on profit participating loans are fully tax non-deductible.
- Back-to-back financing (i.e. credits and loans between related parties provided through an unrelated intermediary, such as a bank) is also subject to thin capitalisation rules.