

DILEMMAS OF TRANSFER PRICING COMPARABILITY ANALYSIS IN MANUFACTURING ENTITIES. POLISH-CZECH CASE STUDY

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Abstract:

Modern manufacturing entities often operate in capital groups, and their role is sometimes limited to the function of cost centers. From the legal point of view, however, they are separate entities obliged to apply transfer pricing regulations. Meeting the requirements of the arm's length principle can be very difficult at this time, given the relationships and conflicts of interest in the capital group. Complexity increases in capital groups operating in different countries, due to differences in tax regulations. The main purpose of the paper is to demonstrate that the need to value the sale of finished goods to a manufacturing entity, which is a subject to a different tax jurisdiction, may lead to a problem of compliance with the arm's length principle. In addition, the paper proposes a methodology for comparability analysis that may be used by manufacturing entities to defend conditions of setting transfer pricing. The paper presents the different functional profiles of manufacturing entities and points out the difficulties that they may encounter when preparing the comparability analysis. It has also been noted that there are differences in transfer pricing regulations in different countries, for example by analyzing Polish and Czech regulations. The lack of uniform benchmarking legislation can cause inconsistencies in the selection of comparable data, resulting in differences in transfer pricing. The paper uses the method of legal regulation review and analysis of results of published studies concerning the scope of transfer pricing and comparability analysis. The paper also adopts a case study analysis.

Key words: *transfer pricing, comparability analysis, cost center, benchmarking, contract manufacturer*

INTRODUCTION

Entities operating within the capital group structure and performing reciprocal transactions are obliged to monitor the compliance of the conditions under which the transactions were concluded with the conditions under which the non-related entities would enter into the transaction. The principle of having a comparability analysis for tax transfer pricing documentation also applies to entities with a manufacturing business profile.

Depending on the specific functional characteristics of the manufacturing entity operating within the framework of the capital group, the above obligation may entail particular difficulties in obtaining comparable data and in compliance with legal regulations.

The aim of the paper is to propose a methodology for the development of comparability analysis tailored to the specificity of the functioning of manufacturing entities and the adoption of comparability analysis for transfer pricing.

The paper uses the method of legal regulations review and the analysis of the results of published studies concerning the scope of transfer pricing and comparability analysis.

BACKGROUND – ARM'S LENGTH PRINCIPLE AS A BASIS IN TRANSFER PRICING COMPARABILITY ANALYSIS

According to Cooper, Fox, Loeprick, Mohindra [5] capital groups are guided by two general objectives of utilizing transfer pricing:

- to maximize the present value of the group's overall profits,
- to minimize the present and future risks of uncertainty regarding the value of profits.

Implementation of the first objective may consist of: reducing tax liabilities due to different rates of tax in the world, trying to reduce import and export duties, bypassing foreign exchange restrictions, engaging in foreign exchange rate speculations, reducing profit to be shared with minority shareholders. In turn, the reduction of risk in terms of profits is based on the manipulation of the profit disclosure of a subsidiary to deter competitors from entering the subsidiary's market. The use of transfer pricing for winning maximum economic profits and enhancing the competitiveness of the enterprise was studied by Ching-Wen and Hsiao-Chen [3]. The authors analyzed the strategies of transfer prices used by multinational enterprises (MNEs) consisting in effective transfer of profits to parent companies in order to facilitate greater economic profits. Also Shunko, Debo, and Gavirneni [15] argued that although one of the main purposes of multinational firms is taking advantage of low production costs using offshoring, it is accompanied by a transfer pricing accounting for low tax rates.

The competence of each country is independent and sovereign shaping of tax policy taking into account the objectives of a given country. However, if the taxpayer of the country is a member of a multinational group, the consequent

ences of tax legislation applicable in the country can be transferred to other countries.

The widespread consensus on the arm's length principle for transfer pricing is supported worldwide by Organization for Economic Cooperation and Development [11, 17] and United Nations [18]. The arm's length principle states that the terms of a transaction between related enterprises should correspond to the terms of a transaction concluded by independent entities supports the thesis that transfer prices cannot deprive the state of part of the tax due from multinational group. No country, whether poor or rich or developing, wants to be disadvantaged as a result of the use of transfer pricing.

Despite the undoubtedly many benefits of adherence to the principle of the free market, there are also a lot of negative issues. First of all, in many cases, the application of this principle is very complicated, inter alia, in case of trading in intangible goods or the provision of highly specialized services. Moreover, the principle of full competition often disregards savings arising from the scale of operations and integration between related entities. The main disadvantage of the principle of full competition is the difficulty in obtaining relevant comparative data by both taxpayers and tax administrations.

Imperfections of the arm's length standard were studied, among others, by Chiang and Del Gaudio [2] who noticed that there is still space for firms to manipulate transfer prices because the arm's-length prices are often difficult and complicated to establish for many intermediate goods and services. Also, Franklin and Myers [6] examined various cases of income shifting occurring, despite IRS regulations, which should always assure that transfer-pricing transactions invariably account for the arm's length between related entities. The authors concluded their study in the USA, stating that the burden of proof rests exclusively on the Board, which has to set transfer prices in such a manner that they were part of a documented strategy of the company and were not an attempt to avoid tax.

There is a recommendation in the OECD guidelines that tax administrations do not automatically assume willingness to manipulate profits by related entities. However, if there is a suspicion of distorting profits, and thus tax obligations, countries allowed for the possibility of the profit adjustment, and thus they ensure that the principle of full competition is respected.

Noteworthy are the studies by Marques and Pinho [8] who asked the question whether the introduction and tightening of transfer pricing frameworks deter income shifting strategies in the European multinational companies. Peralta, Wauthy and Ypersele [13] also analyzed the level of corporate taxation and the tightness of control of profit shifting by multinational firms (MNF). The authors noted that some countries in order to attract investment choose not to control MNE in the field of transfer pricing. The authors found that even if, at first glance, a given country does not apply harmful tax competition, a national authority may actually rely on the ability of these firms to shift profits out of high tax into low tax regions to offer such indirect fiscal breaks. From the governments' viewpoint, being tougher on the enforcement of transfer pricing rules is costly if multinational firms respond to delocalizing.

From the above it follows that, despite the generally applicable arm's length principle in the valuation of transactions between related entities, respected forms of enforcement of this principle in different countries may be diffe-

rent, as illustrated by the comparison of legal regulations in Poland and the Czech Republic.

COMPARISON OF GENERAL TRANSFER PRICING LEGAL REGULATIONS IN POLAND AND CZECH REPUBLIC

For most capital groups in the world legal basis for the development of transfer pricing policies are Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations Guidelines of Organisation for Economic Cooperation and Development (OECD) [12, 17].

Due to the fact that most foreign investments both in Poland and in the Czech Republic originate from OECD countries, respect for the OECD Guidelines and other documents published by this organization is of major economic importance for Poland and the Czech Republic, and is reflected in tax legislation. The Table 1 presents a comparison of the generally accepted principles of transfer pricing in Poland and the Czech Republic.

After analyzing the data collected in Table 1, it is clear that both the documentation requirements and the comparability analysis are much higher in Poland than in the Czech Republic. The ambiguity of regulations may hinder the transfer of data within capital groups with subsidiaries in Poland and the Czech Republic.

FUNCTIONAL CHARACTERISTICS OF MANUFACTURING RELATED ENTITIES

When constructing a transfer pricing system in a capital group, the role of individual capital group entities acting as specific centers of responsibility should be taken into account. The concept of responsibility centers is useful because infrequently entities within the group retain full autonomy. Typically, in business reality, related companies realize the objectives of a capital group, and transfer prices act as a steering and controlling instrument. Entities within the capital group can play the role of: investment center, profit center, cost center, revenue center, expense center. The above division is usually referred to as so-called responsibility centers in a decentralized enterprise, however, separate, legally independent entities operating within capital groups also act as responsibility centers for the capital group [16].

By analyzing only the manufacturing entities, it should be stated that the extent of their responsibility can also take on all of these forms, except for the revenue center, due to the need to incur production costs.

Manufacturing companies in capital groups are rarely the typical investment centers. In practice, the most common form of capital group organization is vertical integration when a company controls more than one stage of the supply chain.

Manufacturing entities are most often cost centers in the capital group, and therefore their autonomy is relatively limited. An example is a function called toll manufacturers. Then the role of manufacturing entities is to process raw materials and materials into semi-finished products and finished goods, but they do not have the title to raw materials. Completed production orders are returned to the manufacturing principal and valued in such a way as to cover processing costs. Because of the need to ensure compliance with the arm's length principle, contract manufacturers usually carry out a minimum margin. Such a model of relations within a capital group usually assumes total dependence of the manufacturing entity on the subcontracting entity or entities from the capital group. Performance

Table 1
Main legal regulations with regard to transfer pricing in Poland and Czech Republic

	Poland	Czech Republic
Source of Law	Corporate Income Tax Act, articles 9a, 11, 19, and 27; Personal Income Tax Act, articles 25, 25a, and 45; Transfer Pricing Decree of September 10, 2009 (with further amendments), Decree on Tax Havens of April 23, 2015; Amendment to the Accounting Act of March 18, 2008, which requires entities to disclose in their financial statements information on significant transactions with related entities that are not at arm's length.	Income Taxes Act (effective January 1, 1993), Section 23 par. 7; Decree D-332 on the application of international standards to the taxation of transactions between related persons; Decree D-333 on binding ruling over the transfer pricing policy used in related-party transactions; Decree D-334 on the recommended scope of transfer pricing documentation.
Criteria of related parties	from January 1, 2017 parties are related if one party has direct or indirect ownership of more than 25 percent of the capital or voting rights of another party, or if it participates in the management or control of the other entity (it was 5% before January 1, 2017)	Parties are related if one party has direct or indirect ownership of more than 25 percent of the capital or voting rights of another party, or if it participates in the management or control of the other entity.
Transfer pricing documentation requirement – local file	From July, 27, 2000 all domestic and cross-border transactions if their total annual value exceeds the following thresholds: generally EUR 100,000 for tangible transactions, EUR 30,000 for services and intangible transactions, and EUR 20,000 for transactions with entities in tax havens. Since 2017 new document thresholds for taxpayers whose income in the preceding tax year exceeded 2 m euro are in force	Each taxpayer should aim at determining transfer prices for tax purposes in compliance with the arm's length principle based on information reasonably available but transfer pricing documentation is not mandatory
Master file requirement	From January 1, 2017, entities whose cost or revenues exceed the equivalent of EUR 20,000,000 in the year preceding the tax year	not mandatory
Country-by country report requirement	From January 1, 2017, entities whose consolidated revenues exceed the equivalent of €750,000,000 in the year preceding the tax year	not mandatory
Acceptable transfer pricing methods	The comparable uncontrolled price (CUP) method, the resale price method, the cost plus method, the profit split method (contribution analysis or residual analysis), and the transactional net margin method (TNMM)	as in Polish regulations
Comparability analysis/ benchmarking study requirement	From January 1, 2017, entities whose cost or revenues exceed the equivalent of EUR10,000,000 in the year preceding the tax year	The analysis of a controlled transaction and the identification of comparables could be useful but there are no statutory requirements
Benchmarking/ comparative data	Comparable data from commercial databases are available and usually accepted in practice. The tax authorities use the Amadeus/Orbis database, the QTPA database (a local database) and the RoyaltyStat database. Data from the Polish Central Statistical Office also acceptable ,local comparables are preferred	Pan-European database Amadeus is available to the Czech tax authorities. Companies are entitled to support their transfer pricing arrangements with benchmark analysis, Czech comparables are preferred
Deadline to prepare documentation	from January 1, 2017 – up to 3 months after the end of taxpayer's tax year	no statutory deadline
Deadline to submit documentation	7 days from tax authorities' request	no statutory deadline
Language of documentation	Only Polish language acceptable	Czech language preferable, but other acceptable
Penalties for discrepancy from arm's length principle	additional assessed income is taxed at the 50 percent tax rate (if there is no transfer pricing documentation submitted)	the taxpayer must pay a penalty of 20 percent on the additional tax assessed (1 percent if decreasing a tax loss).

Source: own elaboration based on [1, 14].

measures of such entities are cost-based, and managers account for their deviations from assumed budgeted costs.

Slightly more functions are shared by contract manufacturers, who have the freedom of decision-making in the selection of suppliers of raw materials and materials, but they bear the full risk associated with the purchase. Expected profit margin should therefore be higher than in the case of toll manufacturers, but also such entities carry out

production orders only within the capital group, without incurring the risk of seeking order contractors .

Full functions related to both supply and manufacturing as well as sales and marketing are performed by fully fledged manufacturers who should be treated as profit centers. This usually manifests itself in the selection of other performance measures based on operating profit and also the cost of invested capital. Entities acting as fully fledged ma-

manufacturers bear the risk of acquiring customers for their products and also selling outside the capital group.

The functions of the various types of manufacturing entities operating within the capital group are differentiated and influence the way in which the sales of goods and services are valued and the profit margin achieved. Measurement of results is a separate issue, which requires modern information system like ERP [9].

The design of the transfer pricing system should be based both on the assumption of the appropriate return for each company of the group and on the basis of the overall objectives and strategy of the capital group. From a tax perspective, the business conditions of entities operating in the capital group should not affect the allocation of the profit margins realized by individual entities, and hence should not affect the tax base. However, the functions of individual entities of the capital group, from the point of view of capital management, affect the performance measurement parameters. Managers responsible for the results of the capital group face, therefore, within the scope of "responsibility accounting," the difficult challenge of reconciling the appropriate, from a management point of view, transfer prices with "tax compliance". Tax compliance imposes the necessity to function as "profit centers" to entities treated as "cost centers" from a management point of view.

METHODOLOGY OF COMPARATIVE ANALYSIS FOR RECORDING TRANSFER PRICES IN MANUFACTURING COMPANY - CASE STUDY

The comparability analysis is the subject of third chapter of the OECD Guidelines [12]. According to the OECD Guidelines: "comparability analysis always aims at finding the most reliable comparables." But it is also said that there is no obligation to carry out an exhaustive search of all possible sources of comparables, since it can be burdensome and costly to the taxpayer.

The fundamental problem facing the multinational capital group is the burden of proof. For example, in the Czech Republic, the tax administration bears the burden of proof, unlike in Poland, where the need for comparability analysis has been imposed by the burden of proof on taxpayers. According to art. 9a, par 2b, entities whose income or expense, as defined in the accounting regulations, exceeded the equivalent of EUR 10000000 in the year preceding the tax year; or b) hold shares in a non-legal entity whose income or expense, within the meaning of the accounting regulations in force in that company, exceeded the equivalent of EUR 10000000 in the preceding financial year within the meaning of those provisions, should have a description of the data analysis of the independent entities or data established with an independent entity recognized as comparable to the conditions set in the transactions or other events referred to in par.1, further referred to as "comparative data analysis" [14].

Considering the exemplary situation of the capital group in which the labeling equipment manufacturer in Poland is located, and the parent company selling it in the Czech Republic, it may turn out that the prerequisites for valuing the transaction will be different for both parties.

How would the parent company's approach in the Czech Republic look like?

The company owns 70% of the share capital of the Polish company. It exerts influence on the management of the entity, which was established within the framework of opti-

mization of resources and costs in the capital group. Finished goods purchased from the Polish company are made to the order by the specific final customers. These are corporations in the automotive as well as household appliances and audio&video devices' industry. From the perspective of the parent company, the most advantageous and most reasonable method of valuation of the transaction will be the resale price method. The resale price method applies when a product that has been purchased from a related enterprise is resold to an independent enterprise. This price ("resale price") is obtained from an independent entity and is reduced by any possible resale cost. The remaining value is treated as the final transfer price. The scheme of fixing the transfer price using the resale price method is presented in Figure 1.

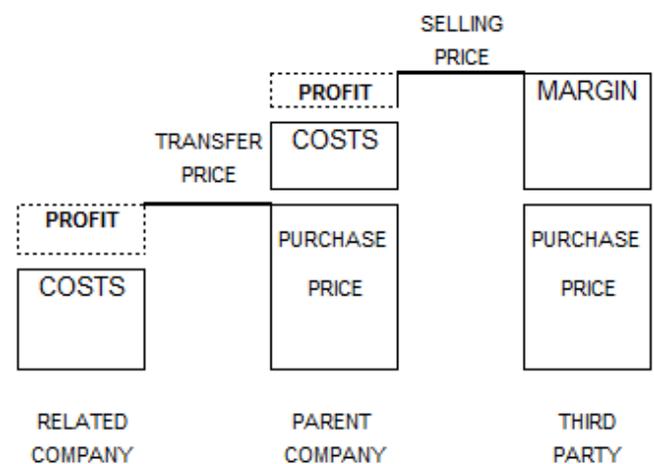


Fig. 1 The scheme of fixing the transfer price using the resale price method

Source: own elaboration based on [10].

An example of determining the transfer price for the leading product of the analyzed company is presented in Table 2.

Table 2
Method of determining the transfer price using the resale price method

Selling price to third party	3200 EUR
Average/expected profitability	15% · 3200 EUR = 480 EUR
Costs of parent company	650 EUR
Transfer price	3200 EUR – 480 EUR – 650 EUR = 2070 EUR
Costs of related company	1990 EUR
Profit of related company	104 EUR (3.9%)

Source: own elaboration.

With such a method there is a risk that the profit margin of the Polish company will not be sufficient and in line with market realities, especially if the parent company focuses on achieving the highest possible profit. According to the general principles of the resale price method, the profit margins realized by the parent company in the Czech Republic should meet the requirements of comparability with the profit margin that under similar business conditions it would have for an independent company. However, due to

the lack of comparability analysis in the Czech Republic, the parent company may wish to pursue its profit maximization objective without taking care of the situation of the reselling company.

How should the company in Poland behave as to meet the expectations of a Polish minority shareholder with a 30% stake in the capital and to minimize the tax risk of transfer pricing? In accordance with the provisions coming into force from 2017, it would be safest to make a comparative analysis internally or to purchase a benchmarking analysis from an external entity. The stages of comparability analysis are presented in Table 3.

Table 3
Comparability analysis steps

1.	Identification of the number and type of transactions executed, and on this basis the number of benchmarking analyzes required. In the case of homogeneous production activities, one benchmarking analysis is sufficient.
2.	Functional analysis for a particular type of transaction. Evaluating the terms and conditions of transactions, functions performed by both parties, the assets involved and the risks involved.
3.	Selection of a database for benchmarking. For a Polish entity e.g. QTPA. For entities from other countries e.g. Amadeus. Selection of supplementary data sources e.g. data from the Polish Central Statistical Office and public directory and company databases.
4.	Selection of a preliminary comparative group based on basic criteria such as geographical area of business activity, business activity code, legal form of the entity, key words in the names of entities, e.g. processing company, words in the description of activity, e.g. packaging production, The status of the entity, e.g. acting, not in liquidation or bankrupt.
5.	Elimination of entities from the initial comparative group on the basis of additional quantitative criteria, such as: asset value, sales value, accounting policy (Accounting Act or IFRS), continuity of data – e.g. access to financial statements for the past 3 years, share of sales revenues to related entities to total revenue,
6.	Elimination of entities from the initial comparative group on the basis of additional qualitative criteria, such as: information available on the website of the type of products offered, information about the functions performed on the basis of the interview, probability of occurrence of capital ties
7.	Identification of the final comparative group
8.	Choice of the benchmark – which is the basis of the parameter analysis. Typical benchmarks are: the gross profit margin on sales, net profit margin, operating profit margins, net profit margin
9.	Selection of statistical methods, calculation methods of ratios, first quartile, third quartile, median and inter-quartile range
10.	Elaboration and verification of results
11.	Assessment of comparability on the basis of the selected benchmark

Source: own elaboration.

In this case, the comparability analysis was carried out using the QTPA database. The entities according to PKD (Polish Code List of Business Activities) criterion 28.29. Z were searched – “Manufacture of other general purpose machinery not classified elsewhere”. This subsection inclu-

des, among others, manufacture of labeling devices. Manual selection was also conducted using Google's web search engine. The phrase used for the search is: manufacture of labeling devices.

Next, there were applied further criteria for the elimination of non-comparable entities. There were selected entities, which according to sources available in the source database:

- have maintained the 3-year continuity of the most recently available financial statements from 2016 to 2013.
- have shown a “Sales Revenue” value of over PLN 1m in each of the last three available reports for the 2016-2013 period.
- prepared the available reports in accordance with the Accounting Act (reports prepared in accordance with IFRS – International Financial Reporting Standards – were discarded).

43 entities were selected to the preliminary comparative group.

In addition, entities that reached the Related Revenues Ratio (RRR) of more than 5% for years 2014-2016 were excluded.

$$RRR = \frac{\text{Net sales revenue from related entities}}{\text{Net sales revenue}} \times 100 \geq 5\%$$

Moreover, there were also eliminated entities whose proportion of trade receivables from related entities in total value of receivables from deliveries (RSTR – related short-term receivables ratio) and services or payables from related parties in total value of payables from deliveries and services (RSTL – related short-term liabilities ratio) exceeded 5%. If, by way of analysis, it was found that entities in the period from 2014 to 2016 in any financial statement showed a negative result on sales, such entities were also eliminated from further analysis. A summary of the comparative sample is presented in Table 4.

Table 4
Elimination process summary of entities based on quantitative criteria

Initial number of entities subject to verification	43
Description of the selection criterion	Number of eliminated entities
Operational links (RRR)	12
Operational links (RSTR)	4
Operational links (RSTL)	6
Negative sales profit in the last 3 available financial statements	5
Total of eliminated entities	27
Number of entities accepted for further analysis	16

Source: own elaboration.

The selected sample of 16 entities was also subjected to qualitative analysis, eliminating 6 non-comparable products (labeling devices for other types of manufacture), and 3 entities whose characteristics of the manufactured products could not be verified (no website, no consent to pro-

Table 5
A method for determining the interquartile range (3 years period)

Revenues			Costs			Profit/loss			Net profit margin on sales (%)		
S11	S12	S13	C11	C12	C13	P11	P12	P13	$R_{11} = P_{11}/S_{11}$	$R_{12} = P_{12}/S_{12}$	$R_{13} = P_{13}/S_{13}$
S21	S22	S23	C21	C22	C23	P21	P22	P23	$R_{21} = P_{21}/S_{21}$	$R_{22} = P_{22}/S_{22}$	$R_{23} = P_{23}/S_{23}$
S31	S32	S33	C31	C32	C33	P31	P32	P33	$R_{31} = P_{31}/S_{31}$	$R_{32} = P_{32}/S_{32}$	$R_{33} = P_{33}/S_{33}$
...
Sn1	Sn2	Sn3	Cn1	Cn2	Cn3	Pn1	Pn2	Pn3	$R_{n1} = P_{n1}/S_{n1}$	$R_{n2} = P_{n2}/S_{n2}$	$R_{n3} = P_{n3}/S_{n3}$
Lower quartile									QUARTILE (R₁₁:R_{n3};1)		
Median									MEDIAN (R₁₁:R_{n3};2)		
Upper quartile									QUARTILE (R₁₁:R_{n3};3)		

Source: own elaboration.

vide company information). Thus, seven entities were included in the final comparative test.

For benchmark – the ratio estimating profitability level – the ratio of net profit margin on sales was selected, characteristic of the transactional net margin method, where the ratio is calculated on the basis of aggregated financial items from the annual financial statements:

$$\text{Net profit margin on sales} = \frac{\text{Profit on sales}}{\text{Net sales revenue}} \times 100\%$$

Interquartile ranges for annual profitability were calculated as shown in Table 5.

The final results of the comparative analysis are presented in Table 6.

Making a comparison of net profit margin resulting from

Table 6
Comparability analysis results

Measure	Result (%)
Lower quatrule	6.8
Median	9.9
Upper quatrule	17.9

Source: own elaboration.

the comparability analysis with the previously calculated profit margin on sales based on the product resale price method for the parent company in the Czech Republic, of 3.9%, the non-compliance with the arm's length principle is visible. The parent company's profit margin is below the lower quartile. The profit margin determined by the resale price has been set for a single product, so for the purposes of analysis one should assume the inability to sell products with a different profit margin.

CONCLUSION

The issue of applying comparative analysis results based on annual reports is debatable. Although the ultimate proof of action in accordance with the arm's length principle to the tax authorities will also be annual profitability, it is also appropriate, in line with the generally accepted economic practice, for the Polish entity to use a comparable profit

margin for the measurement of individual sales transactions.

The presented case study shows the weakness of the tax provisions in the field of evidence applying to the parent company in the valuation of related entities under arm's length principle. The multitude of the acceptable valuation methods is theoretically beneficial to taxpayers who have the possibility to choose the most advantageous pricing mechanisms for which they have market comparable data.

Capital groups have various relationships. From the perspective of the dominant entity, the individual subsidiaries can be treated simply as the responsibility centers. This is particularly evident in vertically organized capital groups where the manufacturing entities act as toll manufacturers or contract manufactures. The dominant position of a parent company usually manifests in the imposition of prices in purchase or sale transactions. On the other hand, subsidiaries are separate legal entities that are governed by the laws of the country in which they are located. It is clear from the case study that the problem of valuing transactions between related entities can often be the cause of an unsolvable conflict and give rise to tax risks for those entities in which transfer pricing is more rigorously regulated.

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