Czech Republic vs ARGO-HYTOS s.r.o., January 2023, Supreme Administrative Court, No. 2 Afs 66/2021 – 57

Posted on January 9, 2023 | By Courts of the Czech Republic

Category: Benchmark, Range and Median | Tag: Benchmark, Comparability, Extreme results, Interquartile range (IQR), Loss making comparables, Statistical techniques

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Following an audit the tax authorities concluded that ARGO-HYTOS s.r.o. sold goods (valves, blocks and hydraulic aggregates) to related parties at a price that differed from the prices that would have been agreed between unrelated parties under the same or similar conditions. Furthermore, according to the tax authorities ARGO-HYTOS s.r.o. did not satisfactorily document the difference from those normal prices.

An appeal was filed by ARGO-HYTOS s.r.o. with the Regional Court which was dismissed the action by the above-quoted judgment No 30 Af 21/2019-46 ('the contested judgment').

In the judgement, the Regional Court concluded that ARGO-HYTOS s.r.o. had not satisfactorily demonstrated the difference between the prices agreed between it and the companies of the ARGO-HYTOS group and the prices which would have been agreed between unrelated parties under the same or similar conditions. The Regional Court held that, if the tax authorities wished to justify the reasons for the increase in the applicant's tax liability, it was incumbent on them to prove that the prices agreed between the applicant and its connected persons differed from those which would have been agreed between independent persons

Related Case Laws

Czech Republic vs. ARROW International CR, a. s., June 2014, Supreme Administrative Court , Case No 7 Afs 94/2012 – 74

The applicant, ARROW International CR, a.s., seeks a judgment of the Supreme Administrative Court annulling the judgment of the Regional Court, and referring the case back to that court for further proceedings. The question of whether the applicant carried out business transactions in the tax year 2005/2006 with a related...

Czech Republic vs. EWE s.r.o.,

would have had to establish the normal price at which independent persons trade in order to compare the price agreed between related parties.

The Regional Court did not find merit in the applicant's objection that the tax authorities had wrongly excluded from the analyses carried out companies which had made a negative operating profit in the period in question. The applicant considered that this procedure was unacceptable, since, in its view, it cannot be assumed that if a comparable entity is negative in one year, it is loss-making in the long term and cannot therefore be regarded as a comparable entity. On this issue, the defendant stated that the excluded loss-making companies could not be considered comparable, since the applicant, as a contract manufacturer, could be considered to perform such functions and bear such risks as to make a reasonable stable profit. Moreover, those companies were not only excluded on the ground of loss-making but also on the ground of non-compliance with other criteria such as NACE code, independence or accounting methods. The Regional Court fully shared that view and therefore found the plea unfounded.

On the question of the comparability of the sample of independent companies and the method of calculating the interquartile range, the Regional Court stated that the defendant agreed with the tax authorities which, after assessing the entities included by the applicant in the analysis comparing prices between related and unrelated entities in normal relations under similar or comparable conditions, concluded that none of those companies was comparable to the applicant. Therefore, the tax administration prepared its own SA5 analysis, which included seven companies that could be considered as comparable independent entities. For these companies, the interquartile range of EBIT margin values was found to be between 4,10 % and 8,19 % for the tax years under review, based on data for 2011 and 2013. The Regional Court agreed with this conclusion and thus found the procedure followed by the tax administrator and the defendant to be lawful and factually correct.

An appeal was then filed with the Supreme Administrative Court.

Judgement of the Court

The Supreme Administrative Court ruled in favor of ARGO-HYTOS s.r.o.

Excerpts (Unofficial English Translation)

"[22] The Supreme Administrative Court did not accept the complainant's arguments that the law does not provide for the obligation to use a specific database for the analysis of compliance with the arm's length criterion and that the tax administrator should therefore have respected the fact that the complainant chose the AMADEUS database and taken into account the information available to the complainant when negotiating prices for sales of

48/2013 – 31

EWE s.r.o first criticised the Regional Court for the lack of logical reasoning in the grounds of the judgment, based on evidence that it had established a legal relationship with another person mainly for the purpose of reducing the tax base. Although the facts adduced by the administrative court show...

Czech Republic vs Aisan Industry Czech, s.r.o., April 2022, Supreme Administrative Court, Case No 7 Afs 398/2019 – 49

Aisan Industry Czech, s.r.o. is a subsidiary within the Japanese Aisan Industry Group which manufactures various engine components – fuel-pump modules, throttle bodies, carburetors for

prices negotiated between related parties for the sale of goods or the provision of services differ from the prices normally negotiated between unrelated parties under similar or comparable conditions can be established objectively. It is not a subjective criterion for which the degree of prudence or effort of the taxable person could be taken into account. In other words, if the prices between related parties differ from those between unrelated parties, this is an objective fact, a bare fact which has tax consequences. If the taxpayer has assessed, on the basis of the information available to it, that there is no such difference, even though that assessment is contrary to the facts, then it must bear those tax consequences – it is its responsibility to ensure that it has the relevant information on how to set prices between related parties so that the tax base does not have to be adjusted. The complainant must therefore bear the consequences of having used a database for analysis which did not contain the information necessary to meet the comparability criteria in the relevant period under analysis.

[23] The Supreme Administrative Court also did not accept the complainant's objection regarding the calculation of the weighted average. Indeed, the method used by the complainant, according to which the average operating margin is calculated for all the companies together for each individual year and then averaged over the individual years, may not be more revealing than the method actually used by the tax authorities. The tax authorities are obliged to ascertain the prices at which unrelated persons trade under similar or comparable conditions to those at which the complainant traded with persons in the ARGO-HYTOS group. This can be done either by directly determining the normal value of the margin of the comparable entities for the relevant tax period, for example by taking a weighted average of the values of each of the comparable entities for that period. Alternatively, it can be done as the tax administrator has done, i.e. by first determining the average margin of each individual comparable entity over a longer period (several tax years in a row) and then determining (e.g. again by weighted averaging) the average margin for that type of entity from such averages for individual comparable entities. It is not for the Supreme Administrative Court to determine which of the two methods thus described is more accurate in the complainant's particular case. The complainant did not dispute the explanatory value of the method used by the tax authority; it merely argued that its method would also provide relevant data. However, that is not sufficient to challenge the method used by the tax authority – the complainant does not indicate how the method used by the tax authority is flawed or why it provides insufficient information in the complainant's particular case and why it is necessarily the method used by the tax authority that should have been chosen as the more accurate one.

[24] However, the Supreme Administrative Court agreed with the complainant's

documentation the Czech company was classified as a limited risk contract...

Czech Republic vs DFH Haus CZ s.r.o., November 2022, Supreme Administrative Court, Case No 4 Afs 98/2022-45 In 2013, DFH Haus CZ s.r.o. filed amended tax returns for 2006, 2010, and 2011, following the German tax authority's adjustment of its transfer prices in 2006, in order to claim the resulting tax loss for 2006 and apply it against its tax liability in the Czech Republic for 2010...

Czech Republic vs. M.V., April 2018, Supreme Administrative Court , Case No 3 Afs 105/2017 – 22

always have made a reasonable profit or not achieved a negative margin. Such a conclusion by the tax authorities is pure speculation and has no basis in the administrative file. If the tax authority wanted to draw the conclusion in question, it should have analysed the operating margins achieved by companies that can be considered as contract manufacturers in terms of their functional risk profile, irrespective of the market area, if it wanted to draw conclusions on what margins a contract manufacturer should achieve in general. Alternatively, if it wanted to assess the specifics of the functional risk profile of a contract manufacturer only in the market in which the complainant operates, it should also have done so. However, the tax authority did not do so, and it is not clear from the administrative file whether and which, if any, of the companies included in the tax authority's analysis could be considered to be contract manufacturers. Thus, the tax administration did not subject the independent companies it selected/excluded to the criterion it itself set as essential for the exclusion of entities with a negative operating margin – the functional risk profile of a contract manufacturer. At the same time, the tax administrator's conclusion is unreviewable because there is no way for the Supreme Administrative Court to verify the correctness of the tax administrator's reasoning that companies fulfilling the role of contract manufacturer from a functional risk perspective do not achieve negative operating margins.

[25] The Supreme Administrative Court also upheld the complainant's objection that neither the tax administrator nor the defendant had discharged the burden of proof in the tax proceedings, since they had not sufficiently demonstrated that the price at which the complainant sold the goods to the related parties in the ARGO-HYTOS group differed from the price that would have been agreed between unrelated parties in normal relations under similar or comparable conditions."

"[29] The Supreme Administrative Court further finds that the tax administrator not only adopted the method of statistical inference from the analysed data from the complainant in an unreviewable manner, but also adopted it incorrectly. First of all, it should be noted that the term interquartile range used by the tax administrator, the defendant and the Regional Court does not represent an interval at all, as the complainant and the administrative authorities try to suggest. In fact, the inter-quartile range (IQR) is a single value calculated as the difference between the value of the first and third quartiles of the sample analysed (i.e. between the 75th and 25th percentiles), i.e. IQR = Q3 Q1. The tax authorities use this statistic as if its use were common practice, without providing a reasoned explanation for its use. Yet the only thing the IQR explains is the 50% dispersion of the sample values around the median. However, the IQR statistic itself says nothing about these values and their "typicality" – the IQR is primarily used either to analyse the distribution of values around the mean or to identify outliers. While

M.V.sold on 4 January 2010 all the stock of goods of the range of garden supplies to AGROTECHNIKA Vaněk s.r.o. ("Agrotechnika") at an 80% discount on the sales price (i.e. purchase price + margin)....

Czech Republic vs. FISH MARKET a.s., January 2013, Supreme Administrative Court , Case No 1 Afs 101/2012 – 31

FISH MARKET a.s. was engaged, among other things, in the sale of live freshwater fish and that the margin on sales to a related party (KOLTER, a.s.) was much lower than on sales to other independent companies. The tax authorities therefore began to examine the reasonableness of the difference in...

Liechtenstein

intervals. In the complainant's case, each of the seven companies included in the tax authority's analysis had a unique average operating margin. The Supreme Administrative Court found no discussion in the contested decision as to why the defendant concluded that there was a trend in those values and why it had already found certain margins of the companies compared to be outliers while others were not yet outliers. It was certainly possible to choose different methods to find and possibly exclude outlying or otherwise atypical values which would not be included in the sample for the determination of operating profit, but it was always necessary to do so in the light of the specificities of the particular sample and of the individual entities and to explain the reasons for using one or another procedure or method.

[30] The IQR, conceived as the defendant did, cannot therefore be described as identifying a set of normal operating profit values. Nor did the tax authority provide any reasoning as to why the resulting set of average operating margins of individual companies should be 'trimmed' at all, i.e. why, for example, outliers identified in one way or another could not be acceptable in view of the nature of the entity or the sector of the market in which the entity operates.

[31] Lastly, the tax administrator did not even assess in a verifiable manner whether the number of companies used in the analysis was sufficient to trace a trend from which it could be concluded that the price at which the complainant traded with its related parties differed from the reference prices, and whether that conclusion could be drawn solely on the basis of the values found in the analysis, or whether further statistical procedures and judgments should be used to estimate the 'typicality' of prices in the relevant market sector."

Click here for English Translation

Click here for other translation

Administrative Court, Case No VGH 2021/085 "A-Geothermal Finance AG" (A AG) financed geothermal projects developed by the E GmbH. The sole shareholder is af A AG. Since 2012, B has also been the sole shareholder of C AG. C AG holds as a subsidiary E GmbH with developed two geothermal projects. These projects were financed by...

Czech Republic vs. Eli Lilly ČR, s.r.o., December 2022, Supreme Administrative Court, No. 7 Afs 279/2021 – 65 Eli Lilly ČR imports pharmaceutical products purchased from Eli Lilly Export S.A. (Swiss sales and marketing hub) into the Czech Republic and

Lilly Export S.A. is based on a Service Contract in which Eli Lilly...

Related Guidelines

TPG2022 Chapter II Annex II example 14 74. Below are some illustrations of the effect of choosing a measure of profits to determine the relevant profits to be split when applying a transactional profit split Scenario 1 74. Assume A and B are two associated enterprises situated in two different tax jurisdictions. Both manufacture the same widgets...

TPG2022 Chapter III paragraph 3.65 Generally speaking, a loss-making uncontrolled transaction should trigger further investigation in order to establish whether or not it can be a comparable. Circumstances in which loss-making transactions/ enterprises should be excluded from the list of comparables include cases where losses do not reflect normal business conditions, and where the losses...

TPG2022 Chapter III paragraph 3.63 Extreme results might consist of losses or unusually high profits. Extreme results can affect the financial indicators that are looked at in the chosen method (e.g. the gross margin when applying a resale price, or a net profit indicator when applying a transactional net margin method). They can also affect...

TPG2022 Chapter VI Annex I example 9 26. The facts in this example are the same as in Example 8, except as follows: Under the contract between Primair and Company S, Company S is now obligated to develop and execute the marketing plan for country Y without detailed control of specific elements of the plan by Primair....

TPG2022 Chapter VI Annex I example 27 97. Company A is the Parent of an MNE group with operations in country X. Company A owns patents, trademarks and know-how with regard to several products produced and sold by the MNE group. Company B is a wholly owned subsidiary of Company A. All of Company B's operations are...

OECD COVID-19 TPG paragraph 36 Second, it will be necessary to consider how exceptional, non-recurring operating costs arising as a result of COVID-19 should be allocated between associated parties.19 These costs should be allocated based on an assessment of how independent enterprises under comparable circumstances operate. Separately, as extraordinary costs may be recognised as either...

TPG2022 Chapter II paragraph 2.47 Following the principles in Chapter I, an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the cost plus method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between...

TPG2022 Chapter VI Annex I example 29 104. Pervichnyi is the parent of an MNE group organised and doing business in country X. Prior to Year 1, Pervichnyi developed patents and trademarks related to Product F. It manufactured Product F in country X and supplied the product to distribution affiliates throughout the world. For purposes of this...

TPG2022 Chapter VI Annex I example 10 30. The facts in this example are the same as

controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12). Thus, a transactional net margin method operates in a manner similar...