Supreme Administrative Court

7 Afs 31/2024 - 27

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CZECH REPUBLIC

SCHEDULE

ON BEHALF OF THE REPUBLIC

The Supreme Administrative Court (SAC), sitting as a Chamber composed of David Hipšr, President, and Tomáš Foltas and Lenka Krupičková, Judges, has given a judgment in the proceedings between the applicant: RR Donnelley Czech s.r.o., with registered office at Tuřanka 1328/102, Brno, represented by BDO Czech Republic s.r.o., with registered office at Nádražní 344/23, Prague 5, and the defendant: Odvolací finanční ředitelství, with registered office at Masarykova 427/31, Brno, in proceedings against the judgment of the Regional Court in Brno of 29 January 2024, No 55 Af 34/2022-44,

as follows :

The appeal is dismissed.

Orders the defendant to pay the costs of the appeal proceedings in the amount of CZK 4 114 to the applicant's representative, BDO Czech Republic s.r.o., within 30 days of the legality of this judgment.

Reasons:

I.

By decision of 12 September 2022, no 31935/22/5200-11431-706481, the defendant rejected the applicant's appeal and confirmed the decision of the Specialised Tax Office of 17 February 2021, no 23958/21/4222-21794-302647. By that decision, the applicant was assessed for the tax period from 1 January 2015 to 31 December 2015 for an increase in the amount of CZK 61 650 in corporate income tax and was ordered to pay a penalty of 20 % of the amount of the tax assessed, i.e. CZK 12 312.

II.

The applicant brought an action against the above decision before the Regional Court in Brno, which, by judgment of 29 January 2024, No 55 Af 34/2022-44, annulled the contested decision and returned the case to the defendant for further proceedings.

The Regional Court upheld the defendant's conclusion that part of the transaction 'the purchase of part of the material into the ownership on the order of Banta Ireland' should have been subject to the application of Section 23(7) of Act No 586/1992 Coll., on Income Taxes, as amended ('ITA'), and also found the applicant's objections that the purchase of disk drives ('HDDs') into the ownership increased its turnover and that it did not value its funds in any way to be unfounded.

However, the Regional Court concluded that the tax authorities (and, by extension, the defendant) did not bear the burden of proof in establishing the reference price. It emphasised that, although the administrative authorities had defined the transaction as risk-free, they had also failed to provide sufficient reasons for their decision, since no effort was made to establish the reference price properly and to select an adequate sample of comparable transactions, either from the content of the file or from the contested decision. It is, however, the tax authorities which must not only assert, but in particular prove, the difference between the agreed price and the normal price. However, if there are no comparable transactions, then, according to the Regional Court, the contested decision lacks a deeper consideration of

why the transaction is so specific that a comparative sample cannot be drawn. However, it is not apparent from the case-file how the tax administrator or the defendant reached such a conclusion and the contested decision is therefore unreviewable in that respect for lack of reasons.

The Regional Court noted that, if it were indeed not possible to draw up a comparative sample, the reasoning of the administrative authorities that the transaction in question could be likened to a deposit of funds valued at interest could be accepted in general terms. In that case, however, the administrative authorities should have attempted to draw up a comparative sample of deposit transactions which were at least broadly comparable to the transaction under examination. However, the administrative authorities did not do so and applied the USD LIBOR interest rate without further consideration, justifying its use only on the grounds that it was denominated in USD, in which the applicant mainly purchased, and because it was an average annual amount tied up in stocks. No other aspects were examined, although the applicant reasonably pointed out that USD LIBOR is the reference rate for short-term international interbank borrowing. Nor does the application of that rate in the present case make sense to the Regional Court, since neither the applicant nor Banta Ireland are banking institutions. The application of that rate is therefore not sufficiently reasoned and the contested decision is therefore also unreviewable in that respect for lack of reasoning.

The defendant ('the complainant') lodged a complaint against the judgment within the statutory time-limit on the grounds set out in Article 103(1)(a) of the Civil Procedure Code.

The complainant takes the view that the procedure followed by the tax administration in setting the reference price was in accordance with the principles laid down in the relevant case-law of the Supreme Administrative Court. In the absence of data on the prices of similar transactions between genuinely existing independent entities, the tax authorities used USD LIBOR as the reference price, as identical or at least comparable in substance (and the most advantageous for the applicant), and thus demonstrably quantified the difference in the amount of the remuneration for the provision of services by the applicant to Banta Ireland, i.e. the difference between the price agreed between him and that company and the price that would have been agreed between arm's length parties in normal commercial relations on the same or similar terms. The applicant, although it was informed of the difference and asked to prove it, did not satisfactorily prove the difference between the price agreed with Banta Ireland and the normal price. The procedure of the tax administrator, which increased the tax base by the amount of CZK 324 017 and increased the applicant's tax liability by CZK 61 560, must be considered to be in accordance with Article 23(7) of the ITA and the case-law of the Supreme Administrative Court. According to the complainant, the conditions for annulment of the contested decision on the ground of lack of reasoning were thus not met. The fact that the contested decision does not suffer from such a defect is also evidenced by the fact that the Regional Court, like the applicant, opposed the complainant's conclusions on the merits, which, however, would not have been possible if the contested decision was indeed unreviewable. In the final analysis, it has merely delayed the moment when the dispute will be taken up by the Regional Court and finally resolved, which is not in the interests of the parties to the proceedings or, after all, in the public interest in the economy of the proceedings before the administrative courts.

For the reasons set out above, the applicant requests that the Supreme Administrative Court set aside the judgment under appeal and refer the case back to the Regional Court for further proceedings.

In its statement of appeal, the applicant pointed out that the complainant justified the use of the USD LIBOR rate on the basis of the risk-free nature of the transaction in question, by likening the level of risk to short-term interbank transactions. The applicant disagrees with such a comparison in view of its business strategy, which is one of the aspects of comparability that should be taken into account when seeking a reference price. The applicant's business strategy, which was designed to generate sufficient profit, was to provide a manufacturing service consisting of assembling discs. In view of the difference in business strategies, the Regional Court's suggestion that a comparative sample of interest rates on deposits of funds should be drawn up cannot be accepted, since it is clear that the transaction under consideration was subject to quite different regulatory requirements and placed quite different demands on the types of activities which were necessary to generate profits. In general, the purchase of inventories for production cannot be considered a risk-free use of funds because of the risk of devaluation or theft. The risks inherent in the type of investment must be taken into account. In the applicant's case, however, the purchase of stocks was entirely risk-free. The buyer assumed all the risks, that is, both the risk of selling the stock and the risk of its loss and damage. The costs incurred in storing the stock (warehouse rent, energy, warehousemen's wages, transport costs, etc.) were included in the basis for the mark-up. Thus, on those costs the applicant received a remuneration in the form of a mark-up of 12,5 %. It can therefore be concluded that the risks arising from the purchase of stocks were lower than those arising from interbank transactions and no such comparison can be made. During the course of the tax audit, it was documented that the method of determining the remuneration for production services took into account the risks to which the applicant was exposed within the group of related parties and reflected them in the amount of the profit margin to which the applicant was entitled. The complainant has not disputed the amount of that mark-up. By splitting the transaction for the sale of production services into two components, the complainant is attempting to achieve the existence of a separate financial transaction. In this respect, the complainant pointed out that the funds spent on the purchase of inventories were only

reflected as an expense in the economic outturn if those inventories were used for production. The applicant was not exposed to any risk on account of the purchase of stocks and was therefore guaranteed, as a contract manufacturer, in the remuneration that the funds invested in the provision of production services would be returned to it plus a profit margin. Thus, if the complainant wished to dispute the way in which the applicant's remuneration was determined in transactions with related parties, it should have used a sample of manufacturing companies with comparable levels of inventory and tested their profitability. Only in that way was it possible to obtain a sample of manufacturing companies with a comparable business strategy which faced comparable risks in terms of inventory investment. The tax authority's argument that it was not necessary to carry out a benchmarking exercise is completely at odds with the principles of how a benchmark price should be found. Section 23(7) of the ITA considers only a price that was negotiated under comparable conditions to the transaction under review to be comparable (reference).

The Supreme Administrative Court examined the appeal within the limits of its scope and the grounds put forward and, in doing so, examined whether the contested decision suffers from any defects which it would have to take into account of its own motion (Article 109(3) and (4) of the Code of Civil Procedure).

The appeal is not well-founded.

Pursuant to Article 23(7) of the Income Tax Act, if the prices agreed between related parties differ from the prices which would have been agreed between independent persons in normal commercial relations under the same or similar conditions, and if that difference is not satisfactorily documented, the tax administrator shall adjust the taxpayer's tax base by the difference found; if the price which would have been agreed between independent persons in normal commercial relations under the same or similar conditions cannot be determined, the price determined in accordance with a special legal provision shall be used.

For the determination of the difference between the agreed and the normal price, reference may be made to the extensive decision-making practice of the Supreme Administrative Court (see, for example, judgments of 31 March 2009, No. 8 Afs 80/2007-105, No. 1852/2009 Coll. of the Supreme Administrative Court, of 27 January 2011, No. 7 Afs 74/2010-81, or of 22 November 2014, No 9 Afs 92/2013-27), summarised in paragraphs 20 to 25 of the judgment of 19 September 2019, No 5 Afs 341/2017-47, and from more recent times, e.g. the judgments of 29 January 2020, No 9 Afs 232/2018-63, of 27 October 2022, No 5 Afs 141/2021-37, of 10 November 2022, No 9 Afs 37/2022-37, or of 15 June 2023, no. 10 Afs 257/2022-60, No. 4505/2023 Coll.

There is no dispute between the parties that the tax administrator bears the burden of proof and the burden of allegation in relation to the determination of the comparative price.

The Income Tax Act does not specify how the tax administrator is to determine the comparative price. The comparative price is primarily a reference price, i.e. the price that would be negotiated between independent persons in normal commercial relations under the same or similar conditions. The essence is to compare the negotiated price on the basis of the arm's length principle, i.e. a comparison with the price generated by the relevant market. This price is presumed to be the price that related persons would have agreed if they were not related, i.e. if they were acting independently on the market and did not adapt their economic behaviour to the relationship of affinity (see judgments of the Supreme Administrative Court (SAC) No 9 Afs 232/2018-63, paragraph 20, and No 9 Afs 37/2022-37, paragraph 15).

As a rule, the tax administration determines the comparative price by comparing the prices actually achieved for the same or similar commodity between actually existing independent entities. If there are real independent transactions (transactions between independent persons in normal commercial relations) which are fully comparable, i.e. concluded for the same (similar) commodity or service under the same (similar) conditions, the data on the prices of these transactions are sufficient to establish the reference price. If the transaction under consideration is not fully comparable with the arm's length transactions, the arm's length transactions which are as close as possible in terms of their parameters should be used and their data should be adjusted accordingly to take account of the differences. However, the existence of independent transactions which are at least at their core comparable to the controlled transaction is always a prerequisite for determining the reference price (Judgment No 9 Afs 232/2018-67, paragraph 22).

In that sense, the interpretation made by the Supreme Administrative Court in judgment No 7 Afs 74/2010-81, according to which 'the reference price may be determined by the tax administrator, and usually will be, by comparing the prices actually achieved for the same or similar commodity between actually existing independent entities. However, it may determine it, in particular because of the absence or unavailability of data on such prices, only as a hypothetical estimate based on logical and rational reasoning and economic experience." The purpose of Section 23(7), first sentence before the semicolon, of the Income Tax Act is to compare the controlled transaction with the actual relevant market. Since in many cases there will not be a fully comparable market, a comparison of the regulated transaction with a real market as close as possible to the actual market may be admissible, subject to an appropriate adjustment of the data. The law does not provide for the determination of a reference price in the absence of at least substantially comparable transactions on the basis of a hypothetical estimate. The basis for the hypothetical estimate is therefore the existence of a comparable

parameter. In no case can it be an adjustment of the price of a controlled transaction according to the conditions of an artificial, hypothetical market (Case No 9 Afs 232/2018-63, paragraph 24, Case No 5 Afs 141/2021-37, paragraphs 32 to 36, No. 9 Afs 37/2022-37, paragraph 17, No. 10 Afs 257/2022-60, No. 4505/2023, paragraph 30). If it is not possible to determine a reference price that would be negotiated between independent persons in normal commercial relations under the same or similar conditions, the procedure is based on a special legal regulation (Act No. 151/1997 Coll., on valuation of property).

However, the range of arm's length transactions that can be used to determine the reference price is very wide. Even an independent transaction concluded in a different time period or location cannot be excluded without further exception, since the data obtained in this way can be corrected accordingly. The selection of the independent transactions and, if they are not fully comparable, the appropriate method of adjustment to eliminate the relevant effects of differences between them, must be made on the basis of objective, fair and reviewable criteria based on economically rational considerations. In the same respect, the appropriate method of comparison must also be chosen or, where appropriate, several methods must be used simultaneously (judgment of 9 Afs 232/2018, paragraph 23). When determining the reference price, the tax administrator should start from a certain price range, i.e. compare a transaction carried out by the tax entity with more than one transaction between independent persons (cf. judgments of the Supreme Administrative Court of 21 March 2018, no. 1 Afs 143/2017-32, paragraph 26, of 25 April 2018, no. 3 Afs 105/2017-22, paragraph 22, and no. 10 Afs 257/2022-60, paragraph 27). An important guideline when comparing the terms and conditions negotiated between related parties with those that would be negotiated between independent enterprises are also the principles enshrined in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the OECD, whose recommendations the Czech Republic has adopted in the form of methodological guidelines of the Ministry of Finance and the GFD D series (cf. judgment of the Supreme Administrative Court of 19 September 2019, no. 5 Afs 341/2017-47).

In the contested decision, the complainant merely stated in the determination of the benchmark price that it agreed with the tax administrator that the 12-month average USD LIBOR rate without an additional risk premium was chosen as the most appropriate risk-free market rate of return, on the grounds that the purchase of HDDs did not represent a significant risk. According to the complainant, the tax authorities correctly calculated the remuneration for tying up the funds in the purchased stocks, where the applicant de facto granted a loan to a related company with those funds. According to the complainant, if the applicant had used the funds in question freely in a market environment, they would have been valued at interest. In view of the fact that the tying up of the funds in stocks did not represent any major risk for the applicant, the appropriate remuneration was chosen, which the applicant would have received if it had lent those short-term funds tied up in stocks on the risk-free market. According to the complainant, the investment in stocks can therefore be compared by analogy with an appropriate interest rate reflecting the market environment (see paragraph 79 of the contested decision).

The Supreme Administrative Court agrees with the Regional Court's view that neither the administrative file nor the contested decision show any effort on the part of the administrative authorities to establish a proper reference price and to select an adequate sample of comparable transactions, or to explain why a comparative sample could not be drawn. The administrative authorities likened the transaction in question to a deposit of funds which is valued at interest. However, the administrative authorities did not attempt to draw up a comparative sample of deposit transactions which were at least broadly comparable to the transaction under examination and applied, without further consideration, the USD LIBOR interest rate, which they justified using only because it was denominated in US dollars, in which the applicant mainly bought and sold HDDs, and because it was an average annual amount tied up in inventories. No other aspects of the case were examined. In that connection, the Regional Court correctly pointed out that USD LIBOR is the rate which determines the reference rate for short-term international interbank lending, and that neither the applicant nor Banta Ireland are banking institutions. It is apparent from the foregoing that there was insufficient justification for the use of that rate. The Supreme Administrative Court therefore concludes that the Regional Court did not err in concluding that the contested decision is unreviewable for lack of reasons and therefore annulled that decision.

In the light of the above reasons, the Supreme Administrative Court dismissed the appeal as unfounded (Article 110(1) of the Code of Civil Procedure).

The Court of First Instance decided on the costs of the appeal pursuant to the first sentence of Article 60(1)

The applicant was not successful in the appeal proceedings and is therefore not entitled to the costs. The applicant was fully successful in the proceedings and is therefore entitled to reimbursement of the costs incurred in connection with its legal representation. The costs of the proceedings consist of the attorney's fee for one act of legal service in the amount of CZK 3 100 (statement of appeal) pursuant to Article 7(5), Article 9(4)(d) and Article 11(1)(d) of Decree No 177/1996 Coll., on lawyers' fees and lawyers' remuneration for the provision of legal services (Advocates' Tariff), as amended, and reimbursement of out-of-pocket expenses in the amount of CZK 300 pursuant to Article 13(4) of the aforementioned Decree. The applicant's representative is a VAT payer, therefore the fee and reimbursement of out-of-pocket expenses are

increased by the amount corresponding to this tax (Article 57(2) of the Civil Procedure Code), i.e. by CZK 714. The total amount of compensation for costs is therefore CZK 4 114.

C o n c l u s i o n : No appeal is allowed against this judgment.

Done at Brno, 28 February 2025.

L. S.

David Hipšr v. r.

President of the Chamber