

# Proposal of Transfer Pricing Rule for SMEs: Case Study of the Czech Republic

**Veronika Solilová, Danuše Nerudová**

Mendel University in Brno

Faculty of Business and Economics, Department of Accounting and Taxation

Zemедelska 1

Brno, 613 00

Czech Republic

e-mails: ritve@email.cz, d.nerudova@seznam.cz

## **Abstract**

*Generally, transfer pricing treatments do not reflect direct distinction between the type or size of the entity. SMEs are not able to bear the high administrative burden to comply with transfer pricing rules like as the large entities. Therefore, some European countries introduced specific transfer pricing rules for SMEs or excluded SMEs from transfer pricing rules. Our paper focuses on transfer pricing simplified measurements for SMEs operating in individual NACE sectors in the Czech Republic. The most important sectors, where SMEs operate, represent agriculture, forestry and fishing; manufacturing, construction, professional, scientific and technical activities, accommodation and food, real estate activities, information and communication, and wholesale and retail trade, repair of motor vehicles. The aim of paper is to propose transfer pricing rules for SMEs in the context of their specificity in order to reflect sectoral and size-classes differences in the Czech Republic. The proposed rule is in the form of safe harbours whose lower limits start at 2 percentage points and upper limits finish at 24 percentage points depending on the sectors where SMEs operate.*

*Keywords: SMEs, transfer pricing rule, Czech Republic, industry sectors*

*JEL codes: F23, K33, G38*

## **1. Introduction**

The European Commission (2003) provides the definition of the Small and medium-sized enterprises (hereinafter SMEs) according to the number of employees and their turnover or balance sheet total. Based on it, SMEs are categorized on micro, small and medium-sized enterprises, i.e. medium-sized enterprises are defined SMEs as enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million; small enterprises are defined as enterprises having less than 50 employees and turnover or balance sheet total of less than EUR 10 million, and microenterprises as a firm with less than 10 employees and a balance sheet or turnover below EUR 2 million.

Based on the definition of SMEs used by the European Commission, SMEs account for over 99% of all companies in each European country. They operate in a wide range of sectors, further they contribute significantly to total employment, however, their contribution differs by sectors (i.e. they provide 89 mil. jobs, mainly in the service sector) as states European Commission (2014). Furthermore, SMEs contribute a considerable proportion of value-added, which differs by countries (in most countries accounting for between 55% and 75% of value-added).

At the same time, SMEs face particular challenges and tax obstacles. There are 28 different tax systems in Europe which may inherently disadvantage SMEs due to their size and may have distortive impacts on commercial decisions and between different business forms and different business activities. The disproportionately high impact of regulatory requirements also creates the disproportionately high costs of tax compliance in comparison with large enterprises (hereinafter LEs). Understanding of the tax system and proposal of SME-specific tax rules are therefore critical in the growth of SMEs. As the taxation of SMEs, and the provision of SME-specific tax rules can, if carefully designed, play a useful role in addressing the challenges and the disproportionately high tax compliance burdens faced by SMEs (OECD, 2015).

The aim of paper is to propose transfer pricing rules for SMEs in the context of their specificity in order to reflect sectoral and size-classes differences in the Czech Republic. The proposal should also take into account the Guidelines on Low Value Adding Intra-Group Services issued by the EU Joint Transfer Pricing Forum and proposed modifications to chapter VII of the OECD TP Guidelines relating to low value-adding intra-group services based on the BEPS action 10.

## 2. Theoretical Background

In the international tax area there are exist a lot of issues, but one of them transfer pricing continues to be the most important international tax issue that many enterprises face. As mentioned (Green, 2008) transfer price in the context of the tax legislation is the price at which one entity supplies something (goods, services, the right to use tangible or intangible assets, loans, guarantees and other financial transactions) to another associated entity<sup>1</sup>. This associated entity usually engaged in cross-border transactions can used special conditions resulting from their relationship for the base erosion and profit shifting (hereinafter BEPS) as states Rojíček (2012). Further as Nerudova and Solilova (2011), Swenson (2001), Szarowská (2010) and Buus (2009) add it is possible through transfer prices to reduce tax risks and overall tax liability of the associated enterprises. To avoid this practice and to ensure the correct application of the separate entity approach<sup>2</sup>, the OECD<sup>3</sup> member countries and other countries have adopted the arm's length principle, under which the effect of special conditions on the levels of profits should be eliminated.

The authoritative statement of the arm's length principle is incorporated in paragraph 1 of the Article 9 of the OECD Model Tax Convention on Income and on Capital and the Model United Nations Double Taxation Convention between Developed and Developing Nations. Under this principle, associated entities must set transfer pricing for any inter-company transaction as if they were unrelated entities and all other aspects of the relationship were unchanged. Further, to ensure the practical application of the arm's length principle, the OECD issued the Transfer Pricing Guidelines for Multinational Enterprises and Tax Authorities (hereinafter OECD TP Guidelines) which is regulatory updated.

In applying the arm's length principle, one of the most difficult issues that have arisen is how determine appropriate transfer prices for tax purposes. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits of associated enterprises in different tax jurisdictions. Moreover, applying the arm's length principle is a resource-intensive process, as it imposes a heavy administrative burden on taxpayers and tax administrations, when such compliance burdens may be disproportionate to the size of the taxpayer, its functions performed, and the transfer pricing risks assumed in its controlled transactions. Particularly, OECD (2010) in TP Guidelines state that the application of transfer pricing rules may be more complex for SMEs in several places and therefore too burdensome. Due to this fact, OECD launched a project to improve the administrative aspects of transfer pricing and compliance issues in 2010, which resulted into the revision of the Section E on Safe Harbours<sup>4</sup> in Chapter IV of the OECD TP Guidelines, and into the recommendation to implement other simplified transfer pricing measurements. In addition, the survey of the transfer pricing simplification measures including safe harbours indicates, that 75% of available simplification measures are directed to SMEs, small transactions and low value adding intra-group services (OECD, 2011, 2012). Solilová and Nerudová

---

<sup>1</sup> Associated enterprise is an enterprise that satisfies the conditions set forth in Article 9, sub-paragraphs 1a) and 1b) of the OECD Model Tax Convention. Under these conditions, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if "the same persons participate directly or indirectly in the management, control, or capital" of both enterprises.

<sup>2</sup> In the context of the tax legislation, the separate entity approach means that all transactions between associated enterprises will be taxed without taking into account their relationship.

<sup>3</sup> The organization for economic co-operation and development is a unique forum where governments work together to address the economic, social and environmental challenges of globalization.

<sup>4</sup> A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime.

(2015) add that 18 of EU Member States provide simplification measures in the area of transfer pricing for SMEs, which are related mainly with the documentation, exemption from transfer pricing rules and advance pricing agreements.

The SMEs tax preferences or SME-specific tax rules is often justified by the special place of SMEs in the economy, particularly in terms of their contribution to employment, job creation and innovation. Moreover, in the respect of the transfer pricing issue SMEs performing transfer pricing analysis based on the same principles as LEs is carrying huge compliance cost of taxation mainly due to the lack of human and financial capital. Nerudová et al. (2009) also emphasize that the compliance costs of taxation have a regressive character with regard to firm size and are significantly higher in case of SMEs with foreign branch or subsidiary in comparison with SMEs which are not internationalized. Therefore, the EU Joint Transfer Pricing Forum (2011) and OECD (2013) in TP Guidelines recommend simplification measures for SMEs to save administrative resources and reduce compliance burden. Another solution can be in the form of payroll tax cut as mentioned Nerudova and Dobranschi (2015).

### 3. Data and Methodology

As state the OECD (2010) in TP Guidelines and Van Herksenm et al. (2015), the arm's length transfer price should reflect both the actual functions performed, risks assumed<sup>5</sup>, assets used<sup>6</sup> (known as comparable and functional analysis) and used business model (manufacturer, distributor, services provider). The crucial part of the transfer pricing analysis is considered the comparable and functional analysis resulting with selection of the most appropriate transfer pricing method and the determination of the arm's length range. Many tax administrations and the OECD (2010) in TP Guidelines recommend the application of interquartile range to eliminate extreme results and increase the reliability of the comparison of the results. The interquartile range represents a range from the 25th to the 75th percentile of the results derived from the uncontrolled transactions. Only those 50 percent of observations which are closest to the median are considered as a reliable range of arm's length results. However, it is also suitable to determine the 10 percent percentile and 90 percent percentile or lower and upper limit to ensure a larger range of results. The arm's length principle is met, if the margin of the tested party (associated enterprise) falls within this determined range.

To reach the aim of the paper, two groups of SMEs were analyzed, which were gained from the Amadeus database<sup>7</sup>. As a first one, SMEs with a branch or a subsidiary owned between 25% and 100% of capital, was researched. Only this group of SMEs is affected by the transfer pricing issues as they are considered as associated companies. This group of SMEs (6,477 entities) with parent company in the Czech Republic was analyzed in the respect of the residency of subsidiaries and their proportion on industries. Further, the determination of profit margin was considered to receive a range of profit margins for each industry, particularly the 10<sup>th</sup> up to 90<sup>th</sup> percentile. Based on this approach general data about profitability of associated SMEs is known. In following steps, only industries with more than 4.5% proportion of subsidiaries of associated SMEs were further analyzed, specifically agriculture, forestry and fishing industry (NACE A), manufacturing (NACE C), construction (NACE F), wholesale and retail trade; repair of motor vehicles and motorcycles (NACE G), information and communication (NACE J), real estate activities (NACE L) and professional, scientific and technical activities (NACE M), which are considered as the most important industry sectors, where SMEs are operating.

As a second one, SMEs without branches or subsidiaries owned more than 25% of capital, was considered. The selected industries (NACE A, C, F, G, J, L and M) cover together 13,266 SMEs presented as the representative dataset of independent SMEs operating in Europe for whom the arm's length ranges will be determined (see Table 1). This dataset was analyzed in the respect of profitability

---

<sup>5</sup> Typical risks include inventory risk, market risk, operational risk, supply risk, warranty risk, credit risk, R&D risk, foreign exchange risk and liability risk.

<sup>6</sup> The type of assets and nature of the assets are relevant factors. Important assets include working capital, plant and equipment and valuable intangible assets. The nature of assets used includes property rights, age, market value and so on.

<sup>7</sup> Amadeus database contains comprehensive financial and basic textual information on European companies across Europe (44 European countries). Amadeus database used for the research covers very large, large, medium and small companies, altogether 21,815,160 companies, version 11.01, release 244, January 2015.

of entities, when profit margins and operating profit margins (hereinafter EBIT margins) were used for the period between 2012 and 2014 and are defined in (1) and (2):

$$\text{Profit or loss before taxation}^8 / \text{Sales}^9 \text{ or Operating revenue} * 100 \quad (1)$$

$$\text{Operating profit or loss} / \text{Sales or Operating revenue} * 100 \quad (2)$$

Table 1: The Representative Data Set of Independent SMEs

NACE Code	No. companies
A – Agriculture, forestry and fishing	615
C – Manufacturing	3,993
F – Construction	1,677
G – Wholesale and retail trade; repair of motor vehicles and motorcycles	3,723
J – Information and communication	662
L – Real estate activities	1,468
M – Professional, scientific and technical activities	1,128
Total	13,266

Source: Amadeus, authors' processing

Furthermore, the average arm's length ranges in the form of interquartile range, 10 percent percentile up to 90 percent percentile and lower and upper limit were determined for each selected industry sector and time series in that dataset. The use of multiple year data, specifically 2012 to 2014 takes into account the cyclical nature of business and its application is recommended by the OECD TP Guidelines when determining an arm's length range of results.

In addition, the comparison of median of profit margins was performed in case of independent SMEs and associated SMEs for the researched period. Finally as the last step of the research, the proposal of safe harbours as a transfer pricing rule for SMEs was performed, when the currently effective Guidelines on Low Value Adding Intra-Group Services issued by the EU Joint Transfer Pricing Forum (hereinafter EU JTPF), the proposed modifications to chapter VII of the OECD TP Guidelines relating to low value-adding intra-group services based on the BEPS action 10 and Czech government Decree No. D-10 about low value-adding intra-group services were considered. These Guidelines provide the arm's length ranges between 3% and 10%, 2% and 5%, 3% and 7% respectively for this kind of services.

#### 4. Results

The Czech Republic implemented into the Czech legislation the definition of SMEs in accordance with the EU recommendation No. 2003/36/EC. However, contrary to a few areas in which entities are categorized according their size, there is not any definition of SMEs for transfer pricing purpose in Czech legislation. In addition, Czech Republic has no SMEs tax preferences or SME-specific tax rules in relation to transfer pricing. Generally, transfer pricing issue is followed by the OECD TP Guidelines and related decrees<sup>10</sup> published by Ministry of Finance. Although, the government Decree No. D-334 stipulates that the use of the EU Transfer pricing documentation is voluntary and in justified cases enterprises can submit documentation in simplified form, specifically in case of SMEs where the

<sup>8</sup> Profit or loss before taxation represents the sum of the operating profit and financial profit.

<sup>9</sup> In case that the states have defined an indicator of Sales, which is more accurate because it includes only sales of goods sold and sales of own products and services, unlike and Operating revenue, it is necessary to use this indicator. In that case, United Kingdom or Denmark do not specify this indicator, therefore operating revenue, which is more comprehensive has to be used.

<sup>10</sup> D-332 Communication by the Ministry of Finance in respect of international standards application in taxation of transactions between associated enterprises, D-333 Communication by the Ministry of Finance in respect of s.38nc of Act no. 586/1992 Coll., on income taxes – binding consideration over the transfer pricing policy used in related party transactions and D-334 Communication by the Ministry of Finance in respect of the scope of transfer pricing documentation issued by Ministry of Finance in 2006.

creation of full-scale documentation would be too burdensome. This approach can be considered as a simplification measure for SMEs. Moreover, in respect of the safe harbours, which do not have any similar statements in the Czech law, government Decree No. D-10 about low value-adding intra-group services provides the possibility to use the arm's length range between 3% and 7% for this type of services. This approach can be considered as safe harbours.

Associated SMEs acting in the Czech Republic and having at least one subsidiary searched in the Amadeus database cover together 6,477 subsidiaries and 3,934 Czech parent companies. The residency of those subsidiaries is mainly in the Czech Republic (i.e. 88.70%) and in the Slovak Republic (i.e. 8.18%), very small part (i.e. 3.16%) is presented by other EU Member countries and other countries such as Russia, USA, Ukraine and others. Further, based on the proportion of SMEs subsidiaries in industry sectors, can be concluded, that the most important sectors are NACE A, C, F, G, J, L and M, when sectors of G, L and M cover more than 1,200 of subsidiaries. For details see Table 2 below.

Table 2: The Residency of Subsidiaries of the Czech Parent Companies – SMEs

NACE Code	No. groups	No. subsidiaries	CZ	SK	other EU Member states	UK, RU, USA and others	Proportion of subsidiaries in industry %
A	250	358	350	7	1	0	5.53%
B	10	13	12	1	0	0	0.20%
C	496	668	552	81	31	4	10.31%
D	24	30	25	5	0	0	0.46%
E	38	58	54	3	1	0	0.90%
F	312	482	445	31	5	1	7.44%
G	959	1,403	1,131	194	70	8	21.66%
H	70	100	74	16	9	1	1.54%
I	65	99	88	11	0	0	1.53%
J	210	304	256	40	7	1	4.69%
K	16	37	35	2	0	0	0.57%
L	605	1,298	1,238	31	25	6	20.04%
M	633	1,241	1,137	80	18	7	19.16%
N	115	176	150	18	7	1	2.72%
O	0	0	0	0	0	0	0.00%
P	47	93	87	5	0	1	1.44%
Q	32	40	39	1	0	0	0.62%
R	36	57	54	2	1	0	0.88%
S	16	20	18	2	0	0	0.31%
T	0	0	0	0	0	0	0.00%
U	0	0	0	0	0	0	0.00%
Total	3,934	6,477	5,745	530	175	30	100%
%		100%	88.70%	8.18%	2.70%	0.46%	

Note: A – Agriculture, forestry and fishing, B – Mining and quarrying, C – Manufacturing, D – Electricity, gas, steam and air conditioning supply, E – Water supply; sewerage; waste management and remediation activities, F – Construction, G – Wholesale and retail trade; repair of motor vehicles and motorcycles, H – Transporting and storage, I – Accommodation and food service activities, J – Information and communication, K – Financial and insurance activities, L – Real estate activities, M – Professional, scientific and technical activities, N – Administrative and support service activities, O – Public administration and defence; compulsory social security, P – Education, Q – Human health and social work activities, R – Arts, entertainment and recreation, S – Other services activities, T- Activities of households as employers; undifferentiated goods- and services-producing activities of households for own use, U – Activities of extraterritorial organisations and bodies.

Source: authors' research and Amadeus database.

Table 3: Determination of Profit Margins of SMEs for all NACE Sectors in 2013

Percentile / NACE Code	Per. 10	Per. 20	Per. 30	Per. 40	Per. 50	Per. 60	Per. 70	Per. 80	Per. 90
A	0.00	0.71	3.27	9.38	16.91	32.53	51.40	96.13	182.55
B	0.12	0.67	2.29	9.33	29.89	43.51	135.00	209.78	247.22
C	0.00	0.63	2.82	4.76	9.24	19.48	40.08	70.95	118.59
D	0.39	4.03	5.14	7.07	18.45	48.67	100.59	187.32	220.49
E	2.70	3.61	3.92	4.56	5.16	7.18	10.08	28.47	147.98
F	0.02	0.47	1.33	4.01	10.24	22.23	37.67	75.38	198.71
G	0.00	0.55	1.97	4.99	9.98	18.92	32.40	62.82	151.64
H	0.19	1.50	6.52	12.11	19.86	55.56	95.31	251.63	251.63
I	0.00	0.05	3.10	3.79	14.80	20.27	41.13	65.72	213.45
J	0.33	1.34	2.34	4.73	7.25	14.52	34.47	55.67	105.40
K	0.75	1.27	16.59	27.57	80.30	163.03	281.34	359.40	592.00
L	0.00	0.26	1.27	3.73	7.85	19.19	47.60	136.38	306.43
M	0.03	0.61	1.93	4.28	7.81	14.05	26.90	60.34	136.06
N	0.20	0.73	1.61	5.39	10.83	30.07	50.46	69.98	135.69
P	0.58	2.28	3.56	4.26	5.75	7.19	8.98	23.38	48.02
Q	0.19	0.63	1.56	2.68	8.31	25.08	44.39	56.04	70.13
R	0.15	1.52	2.30	4.68	6.36	7.04	7.22	10.07	19.10
S	0.00	0.04	0.30	0.75	1.17	2.62	6.42	11.51	20.24

Source: Amadeus, authors' processing

The profitability of those associated SMEs in industry sectors (see Table 3) is running from 0% up to 592%, in case of the 10 percentile and 90 percentile.

Table 4: The Average Profit Margins of Independent SMEs

NACE Code	A	C	F	G	J	L	M
Average PROFIT margin 2014-2012							
Quartile 0	-94.02	-93.92	-99.05	-97.37	-93.40	-100.00	-90.92
Quartile 1	0.20	0.24	-0.17	0.21	0.37	-1.09	0.99
Quartile 2	3.63	2.15	2.43	1.47	3.79	10.99	5.39
Quartile 3	12.81	6.40	8.12	4.29	9.81	31.96	15.21
Quartile 4	95.74	95.89	95.72	98.67	59.76	100.00	99.64
percentil 10	-8.88	-5.42	-9.35	-2.54	-7.73	-19.41	-3.77
percentil 20	-0.96	-0.49	-1.74	-0.01	-0.67	-4.38	0.41
percentil 30	0.66	0.58	0.37	0.42	0.92	0.81	1.71
percentil 40	1.81	1.26	1.31	0.89	2.18	5.33	3.28
percentil 60	6.54	3.35	4.05	2.27	5.59	18.47	8.56
percentil 70	10.44	5.11	6.55	3.49	8.15	27.08	12.53
percentil 80	15.43	8.05	10.36	5.43	12.16	37.89	18.75
percentil 90	23.22	13.25	18.45	9.20	20.26	52.90	29.90

Source: Amadeus, authors' processing

The average profit margin of the representative dataset of independent SMEs in selected industry sectors is running contrary to the previous results between -19.41% and 52.90%. The highest

profit margins are generated in the NACE sector L – real estate activities and the lowest in NACE sector G (see Table 4).

As can be seen, the profitability of independent SMEs is significantly lower contrary to associated SMEs. To overcome negative effect of financial profit or loss in the research, the EBIT margins of independent SMEs were determined. As can be seen in Table 5 below, the average EBIT margins are running between -7.55% and 61.57%. Again as in previous results, the largest EBIT margins are generated in NACE sector L. However, the lowest EBIT margins are performed in NACE sector C – Manufacturing.

Table 5: The Average EBIT Margins of Independent SMEs

NACE Code	A	C	F	G	J	L	M
Average EBIT margin 2014-2012							
Quartile 0	-82.91	-89.71	-91.53	-81.97	-92.66	-97.95	-89.82
Quartile 1	0.76	0.82	0.99	0.53	0.42	5.35	1.30
Quartile 2	5.81	3.32	4.50	2.24	4.25	23.18	5.96
Quartile 3	14.84	7.28	11.76	5.09	10.06	44.06	15.36
Quartile 4	97.14	80.72	97.81	99.76	65.14	100.00	99.60
percentil 10	-5.96	-4.26	-4.45	-1.84	-7.23	-7.55	-3.08
percentil 20	-0.09	0.18	0.25	0.19	-0.83	1.93	0.60
percentil 30	1.64	1.37	1.65	0.86	1.24	8.86	2.13
percentil 40	3.55	2.35	3.02	1.51	2.68	15.76	3.86
percentil 60	8.59	4.56	6.57	3.11	6.18	30.92	8.88
percentil 70	12.53	6.20	9.52	4.31	8.48	39.21	12.83
percentil 80	17.57	8.70	14.66	6.10	12.18	49.78	18.82
percentil 90	26.07	13.74	29.45	9.65	20.43	61.57	29.19

Source: Amadeus, authors' processing

In respect of median profitability is visible a significant decrease of profitability if the EBIT and profit margins are compared. For example, in case of NACE L, it is more than double decline from 23.18% to 10.85%. Further, the variation of median profitability exists in individual NACE sectors, it runs between 2.17% and 23.18% in case of EBIT margin and between 1.41% and 10.85% in case of profit margin. In addition, the change of median profitability across time is not significant for both indicators of profitability, it is usually less than one percentage point. It indicates a stable generation of profits (for details see Table 6).

Table 6: Median Profitability of Independent SMEs

NACE Code	EBIT margin median			Median	Profit margin median			Median
	2014	2013	2012	2014-2012	2014	2013	2012	2014-2012
A	4.98	5.26	7.20	5.26	3.22	2.87	4.79	3.22
C	3.61	3.28	3.07	3.28	2.46	2.11	1.88	2.11
F	4.52	4.47	4.52	4.52	2.50	2.36	2.43	2.43
G	2.38	2.17	2.17	2.17	1.61	1.41	1.38	1.41
J	4.44	4.34	3.98	4.34	3.99	3.75	3.63	3.75
L	23.06	23.18	23.30	23.18	11.30	10.85	10.83	10.85
M	6.05	5.68	6.15	6.05	5.41	5.04	5.73	5.41

Source: Amadeus, authors' processing

The last part of the analysis of profitability before the determination of the SME-specific transfer pricing rule is the comparison of median profit margins of independent and associated SMEs. As can be seen in Table 7, independent SMEs generate significantly lower median profit margin in NACE sectors except NACE L, which generates the median profit margin by 3 percentage point higher.

Table 7: Comparison of Median Profit Margins of Independent and Associated SMEs

NACE Code	Independent SMEs	Associated SMEs
	2014-2012	2013
A – Agriculture, forestry and fishing	3.22	16.91
C – Manufacturing	2.11	9.24
F – Construction	2.43	10.24
G – Wholesale and retail trade; repair of motor vehicles and motorcycles	1.41	9.98
J – Information and communication	3.75	7.25
L – Real estate activities	10.85	7.85
M – Professional, scientific and technical activities	5.41	7.81

Source: Amadeus, authors' processing

The next part of the research is aimed at the proposal of the SME-specific transfer pricing rule in the form of safe harbours for selected NACE sectors. The EBIT margin is used for the determination of safe harbours as it is not negative influenced by losses from the financial part of business and moreover it is related to the operating activities. Further, the Guidelines related to low value-adding intra-group services presenting safe harbours (the arm's length ranges between 3% and 10%, 2% and 5%, 3% and 7%) were considered as a lower limit of the proposed safe harbours. As we assume, that SMEs should not apply lower EBIT margin for their core business activities in comparison with low value-adding intra-group services. Moreover, we assume that the upper limit of the proposed safe harbours should be exceeding 10 percentage point based on the same reason. Therefore the proposed safe harbours are usually running between first or second quartile (median) and third quartile or 80 or 90 percentile depending on whether the EBIT margin exceeded 2 and 10 percentage points (for details see Table 5 above, highlighted parts).

The result of the proposed safe harbours can be seen in Table 8. Generally, lower limit of safe harbours starts at 2 percentage points and upper limit finishes at 24 percentage points depending on the NACE sectors. Due to the fact that NACE sector G generates the lowest EBIT margins, its safe harbour is set between 2 and 10 percentage points.

Table 8: Proposal of Safe Harbours for Selected NACE Sectors

NACE Code	Safe harbours – EBIT margin	
A – Agriculture, forestry and fishing	5	15
C – Manufacturing	3	14
F – Construction	4	12
G – Wholesale and retail trade; repair of motor vehicles	2	10
J – Information and communication	4	13
L – Real estate activities	5	24
M – Professional, scientific and technical activities	5	16

Source: Amadeus, authors' processing

Determined SME-specific transfer pricing rule in the form of safe harbours should present a few advantages for taxpayer and tax authorities. For example, safe harbours mean mainly for taxpayers and tax administrators simplified transfer pricing approach that can reduce compliance costs and administration costs of taxation. Further, it also means higher certainty for taxpayers and improvement

in effectiveness of tax administration mainly due to the decrease in the number of transfer pricing disputes, audit and MAP cases. On the other hand, there are some disadvantages, namely an application for the specific category of taxpayers i.e. SMEs, which can create discriminations or some distortions, for example in the form of inappropriate tax planning and transfer pricing manipulation with results of lower tax revenues.

## 5. Conclusion

The SMEs tax preferences or SME-specific tax rules is often justified by the special place of SMEs in the economy, particularly in terms of their contribution to employment, job creation and innovation. Moreover, in the respect of the transfer pricing issue SMEs performing transfer pricing analysis based on the same principles as LEs is carrying disproportionately huge compliance cost of taxation mainly due to the lack of human and financial capital.

The aim of paper was to propose transfer pricing rules for SMEs in the context of their specificity in order to reflect sectoral and size-classes differences in the Czech Republic. The proposed SME-specific transfer pricing rule in the form of safe harbours was determined for the selected NACE sectors depending on the number of associated SMEs operating in them. Based on it the most important NACE sectors were chosen as follows NACE A, C, F, G, J, L and M. Further the determination of safe harbours was performed based on the analysis of profitability of independent SMEs operating in Europe, specifically EBIT margin was used.

The proposal of safe harbours takes into account the Guidelines on Low Value Adding Intra-Group Services issued by the EU Joint Transfer Pricing Forum, proposed modifications to chapter VII of the OECD TP Guidelines relating to low value-adding intra-group services based on the BEPS action 10 and government Decree No. D-10, where safe harbours are indicated for this kind of service. Generally, in case of the proposed safe harbours lower limits start at 2 percentage points and upper limits finish at 24 percentage points depending on the NACE sectors.

## Acknowledgement

The paper is the result of the GA ČR no. 15-24867S „Small and medium size enterprises in global competition: Development of specific transfer pricing methodology reflecting their specificities“. We would like to thank also to two anonymous reviewers and their valuable comments. We are particularly grateful to the participants of the 15th International Conference on Finance and Banking in Ostrava for their advice and comments given during the discussion.

## References

- Amadeus Database, Bureau Van Dijk.  
EUROPEAN COMMISSION. (2014). *Annual Reports on European SMEs 2013/2014*.  
EUROPEAN COMMISSION. (2003). *Recommendation 2003/361/EC of 6 May 2003*.  
EU JOINT TRANSFER PRICING FORUM. (2011). *Transfer Pricing and Small and Medium-Sized Enterprises*.  
GREEN, G. (2008). *Transfer Pricing Manual*. London: BNA International Inc.  
NERUDOVA, D., BOHUŠOVÁ, H., SVOBODA, P., ŠIROKÝ, J. (2009). *Harmonizace účetních standardů pro malé a střední podniky*. Praha: Wolters Kluwer.  
NERUDOVA, D., DOBRANSCHI, M. (2015). Double dividend hypothesis: Can it be validated by carbon taxation swap with payroll taxes? *Engineering Economics*, vol. 26, no.1, pp. 23–32.  
NERUDOVA, D., SOLILOVÁ, V. (2011). Transfer Pricing in Agricultural Enterprises. *Agricultural Economics – Czech*, vol. 57, no. 7, pp. 311–321.  
OECD (2015). *Taxation of SMEs in OECD and G20 Countries*.  
OECD (2013). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations – with the Revised Section E on Safe Harbours in Chapter IV*.  
OECD (2012). *Multi-Country Analysis of Existing Transfer Pricing Simplification Measures*.  
OECD (2011). *Multi-Country Analysis of Existing Transfer Pricing Simplification Measures*.  
OECD (2010). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

- ROJÍČEK, M. (2012). Vliv globalizace na fungování mezinárodního obchodu. *Politická Ekonomie*, vol. 60, no. 2, pp. 187–207.
- SOLILOVÁ, V., NERUDOVA, D. (2015). Transfer Pricing Rules in the Context of SMEs. In *Proceedings of the 20th International Conference Theoretical and Practical Aspects of Public Finance 2015*. Praha: Wolters Kluwer.
- SWENSON, L. D. (2001). Tax Reforms and Evidence of Transfer Pricing. *Nation Tax Journal*, vol. 54, no. 1, pp. 7–25.
- SZAROWSKÁ, I. (2010). The Effect of Tax Burden on Economic Growth in the European Union. In *Proceedings of the 28th International Conference on Mathematical Methods in Economics 2010*. České Budějovice: University West Bohemia, pp. 596–601.
- VAN HERKSEN, M., NERUDOVA, D., SOLILOVA V. (2015) Business Model. In BAKKER, A., OBUOFORIBO, B. (eds.) *Transfer Pricing and Business Restructurings. Streamlining all the way*. IBFD, pp. 13–48.