

Rendering of the Rules on transfer prices by the Minister of Finance, in July this year, designated that the Ministry of Finance and Economy has completed this round of legislative activity on the improvements in the field of transfer prices in the Republic of Serbia, initiated by the end of the last year by rendering of the amendments to the Law on Corporate Income Tax. Despite its deficiencies, these Rules are certainly a step forward within the procedure of complying of this important field of corporate income tax with the world standards. If the practice in application thereof by the Tax Authority reaches the level of the world standards, Serbia will significantly improve its business environment in the field of taxation of corporations.

Up to date development of regulations on the transfer prices

For years, the rules on transfer prices have been the weakest part of the corporate income tax in the Republic of Serbia. Scarce and incomplete legal regulations, squeezed in only a few articles, which resulted in more questions than replies, have been causing headache to everybody engaging in a commercial activity, especially to those from whom we have frequently expected, and still frequently expect, to, by investing in Serbia, contribute to the development of the country and improvement of the life standard of its citizens - the foreign investors.

In the period before the crisis, while the budget of the Republic of Serbia had been duly filled in, primarily by the money from sale of the companies within the privatization procedure, the Tax Authority, probably being itself aware of the inadequacy of the rules governing the transfer prices, has practically not even controlled the application of these rules. When the crisis occurred and when the inflow to the Serbian budget began to decrease, the transfer prices have been recognized as the part of the taxation system which could ensure the additional inflow. The Tax Authority has begun to exercise the first controls of application of the rules on transfer prices, in a manner which, justifiably, has been assessed by the taxpayers as very poor. And, while those who had, prior to these controls, been warning of the inadequacy of these rules, could be counted on the fingers of one hand, subsequently, the taxpayers started to request that this field be complied with the rules prevailing in the developed countries of OECD, from which the majority of the companies to which these rules relate originate.

The necessity for a more adequate governing of this field was finally recognized last year, by the Ministry of Finance and Economy, and by the end of 2012 the amendments to the Law on Corporate Income Tax were adopted, which was the first positive step forward in more than 10 years. The improvements achieved by these amendments may be divided in three groups. The first group includes defining in detail which company shall be deemed as related for the purpose of application of the rules on transfer prices. The second group includes defining in detail of the manner of calculating the amount to be included in the tax basis, after the difference has been established between the price in the transaction with

related party and the arm's length price. The third group includes introduction of the new, in Serbian tax law so far unknown, methods for establishing of the arm's length prices, as well as the rules for application thereof. The especially important novelty is the obligation to submit, together with the tax balance, the appropriate documentation as explained hereinafter in more detail.

At the same time, the amendments provide that the Minister of Finance, relying on the sources relating to the taxation of the transactions between related persons of the OECD and other international organizations, shall define in more detail the application of the provisions governing the transfer prices, while the final provisions of the amendments provide that he shall do that within 6 months following the effective date of the amendments from December.

Being in delay for less than a month after the prescribed deadline (amendments from December 2012 came into effect on December 25th, 2012, which means that the term expired on June 26th, 2013, while the Rules were rendered on July 5th, 2013, published in the Republic of Serbia official Journal on July 12th, 2013 and came into effect on July 20th, 2013), the Minister rendered the "Rules on transfer prices and methods of the arm's length principle to be applied in determining the prices of the transactions between the related parties".

New rules

Amendments from December have, for the first time, introduced the taxpayers' obligation to submit the documentation together with the tax balance, which documentation shall separately specify the value of the transactions at the arm's length prices. The Rules on transfer prices specify in details that such documentation shall contain: (i) analysis of the group of affiliates to which the taxpayer belongs, (ii) analysis of the activities, (iii) functional analysis, (iv) choice of the method for checking up the compliance of the transfer prices with the prices established under the arm's length principle, (v) conclusion and (vi) attachments.

The Rules further specify what each of the analysis should include, as well as the reasons for application of the appropriate method, and the conclusion whether the prices in the transactions with the related parties should be adjusted. Since the intention of this document is not the simple reproduction of the Rules on transfer prices, we are not going to specify the contents of the provisions thereof.

The amendments from December also provide for the methods used for determining of the arm's length transaction prices, as well as for the rule that, when defining such prices, the method to be used shall be the one being the most appropriate for the circumstances of the case, with the possibility to use combination of several methods, when so required. The Rules now establish further rules for choosing the method, providing that the choice shall be based upon the analysis of the facts, with the following to be taken into consideration: (i)

nature of the transactions being the subject of the analysis, (ii) availability and reliability of the data for the analysis, (iii) the extent of comparability between the transactions carried out at the transfer prices and the transactions carried out with or between the non-related parties (when these transactions are used for checking up of the compliance of the transfer prices of the taxpayer with the arm's length prices), (iv) appropriateness of use of the financial data of the non-related parties for the analysis of the compliance of the transfer prices for certain types of transactions the taxpayer carries out with the related parties and (v) nature and reliability of the assumptions.

The Rules further contain the additional rules on when and how which method is applied. It provides when the comparable market price method shall be applied, which are the most important comparability factors, and when a transaction may be deemed comparable despite of the differences from the transaction with the related parties. Also, the Rules establish what can be used as the comparable gross margin for the requirements of the resale price method, and the method of the cost plus. The same applies to the transaction net margin for the requirements of application of the transaction net margin method. Finally, the Rules establish in which cases it is recommendable to apply the profit division method and what shall be done in application thereof.

Open issues

The part of the Rules on the transfer prices governing the documentation to be submitted with the tax balance contains several incomplete statements, which could be corrected by regular application in practice, however, if applied so as to cause damage to the taxpayers, they could also cause headache to the taxpayers. So far we have frequently witnessed interpretation of the tax regulations by the Tax Authority in a way which is the best for the budget of the republic of Serbia, which can further burden the business operations of the taxpayers.

Namely, although Article 2 provides that the taxpayer is not obliged to submit, within the documentation, the "special documentation relating to the individual transactions and the relationships between the companies within the group", Article 9 provides that the tax authority in charge may request the additional documentation of the taxpayer should they establish that the documentation submitted by the taxpayer is insufficient for checking up of the compliance between the transfer prices and the arm's length prices, in the taxpayer's transactions with a concrete related party. Being well aware of the way in which the Tax Authority applies the regulations, we can say with utmost certainty that in practice, the taxpayers will have to submit the "special documentation relating to the individual transactions and the relationships between the companies within the group" as well, in the form of the additional documentation specified in Article 9, while the said provision of Article 2 will not be much used in practice. Of course, let's wait for the Tax Authority to surprise us and show that our statement was incorrect.

Additionally, the question which might arise during application of the rules contained in the Rules on transfer prices is the question of what is to be understood under the “special documentation relating to the individual transactions and the relationships between the companies within the group”, which does not have to be presented, especially if we know that the documentation which shall be submitted also contains the attachments. Namely, the attachments are not mentioned in the wording of the Rules, but Article 8 thereof, which, considering the structure of the Rules, should define the rules relating to the attachments, contains a rule, subject to which the taxpayer should provide the review of the data used for defining the price, and the range of arm’s length prices, and especially the information on comparable local or foreign transactions and companies. It seems that the idea of the Ministry has been that the taxpayer, through the submitted analysis, shall “justify” its prices, while by the attachments, he shall “justify” the arm’s length price/price range, meaning that the analysis represents the only documentation the taxpayer shall submit in connection with its prices and the relationships with the related parties. It is exactly for that reason that the doubt arises in terms of the practice to be developed for the “special documentation relating to the individual transactions and the relationships between the companies within the group” and the additional documentation specified in Article 9. Nevertheless, the major deficiency of the Rules on transfer prices in connection with the documentation is the rule entitling the Tax Authority to, should it, during the control, be established that the transfer prices documentation submitted by a taxpayer has not been prepared in a manner providing the adequate basis for establishing compliance between the taxpayer’s transfer prices with the arm’s length prices, without requesting additional documentation, make the additional documentation on transfer prices itself, by applying the provisions of the Rules on transfer prices. It seems to be completely unjustifiable that the Tax Authority, without at least once requesting the taxpayer to provide the additional documentation, makes additional documentation itself. Especially interesting is the issue of whether that represents violation of the taxpayers’ rights specified in the Law on Tax Procedure and Tax Administration, to protect their own interests before the Tax Authority, but also the rules of the same Law on bearing the burden of evidence within the tax procedure. Hopefully, in practice, the tax inspectors will not exercise this right.

Time of rendering

Finally, the time of rendering of these Rules, by the middle of the business year, should be negatively assessed. The taxpayers only in July 2013 learned of the rules subject to which they will have to establish the differences, if any, between the prices for the transactions with their related parties and the arm’s length prices, during the whole year 2013, and to prepare the documentation specified by the Rules. It is very important to avoid such cases. Although someone might say it is not a big deal, since the taxpayers had known that they would be obliged to provide the documentation, and anyway had to choose a model and

support by the documents justifiability thereof, such positions cannot be accepted for the simple reason - it is the duty of the Government to, before start of the "race", set clear rules to be followed, and not to announce the rules halfway. In that sense, it should be considered that a rule that no Law can be presented for discussion before the Parliament unless accompanied by all sub-legal acts required for application thereof should be introduced. Had it been the case on the occasion of presentation of the amendments to the Law on Corporate Income Tax from December 2012, these Rules would have been adopted by the end of that year, and the taxpayers would have been faced with the clear rules as of January 1st, 2013.

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