Bearing of the Burden of Proof by Tax Authorities within the Setting of Transfer Prices under Czech Legislation

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Abstract: *The objective of this work was to identify and evaluate the rules for the bearing of the burden of proof by tax authorities in relation to the regulation of the tax base as a result of an incorrectly set transfer price in a controlled transaction as embodied in the Czech legislation. For the given purpose, an analysis of selected provisions of the Czech legal regulations and related case law of higher level administrative courts was conducted. On the basis of the results of the conducted research, it can be stated that the statutory rules, interpretationally supplemented with the interpretation provided by the administrative courts, are clear, established, and respectful of the requirements of fair process. In view of the content of the analyzed judgments, the authors also incline towards the opinion that issues associated with the conducting of a quantitative and qualitative analysis (i.e. the selection and evaluation of entities serving as an etalon for the comparison and setting of a reference price being conducted) can be considered to be central (and, at the same time, some of the most problematic).*

Keywords: *associated entities, burden of proof, case law, Czech Republic, transfer prices*

JEL codes: H25, H26, K34

1 Introduction

The issue of transfer prices is an important current topic in regard to the taxation of holding companies (not only within the meaning of the taxation of large multinational enterprises). Transfer prices are perceived as problematic in terms of their potential abuse for the shifting of profits (in regard to selected issues, see for example Cooper *et al.* (2016)). Without any doubts, in the area of transfer prices, OECD standards play a key role, the OECD having recently published its amended *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, 2017). However, transfer pricing have not been disregarded at the European Union level either, where, in this regard, the European Commission plays a crucial role, or better to say, the *Joint Transfer Pricing Forum* falling under it (European Commission, 2017). However, even at the EU activity level in the field of transfer pricing, it can be stated that OECD standards hold primacy: the EU basically assumes them and, in addition, deals with issues specific for ensuring the functioning of the single internal market.

The OECD standards are evidently accepted and respected widely and without reservations, although the opinion on their legally binding nature may not be uniform or clear, primarily for purely domestic tax law relations. Leaving aside the potential problems with the acceptance, binding nature and options of enforcing compliance with standards (rules) that can, in certain situations, have the character of "mere" soft law, several problematic issues thus continue to remain. One of them is that OECD and/or EU standards do not cover and cannot cover all of the issues associated with transfer pricing. Many of them, both on a substantive law level as well as on a procedural law level, remain within the legal regulation of domestic legislation. That also pertains, for example, to the issue of the bearing of the burden of proof, as pointed out by the OECD itself (2017, p. 174; chapter *B.2 Burden of*

proof), when it states the following, "*Like examination practices, the burden of proof rules for tax cases also differ among OECD member countries.*".

2 Methodology and Data

This paper aims to identify and evaluate the rules for the bearing of the burden of proof on the part of the tax authority in relation to the regulation of the tax base as a result of incorrectly set transfer prices in controlled transactions (i.e. transactions between associated parties). Selected acts and primarily the case law of higher level Czech administrative courts were the object of the conducted research. The paper is based, as evident from the said objective and topic of research, upon qualitative research and builds upon the co-written publication of one of the authors (see Brychta and Trögnerová (2016)). To collect relevant data a content analysis of text was used – namely of the texts of selected acts and judgments of higher level Czech administrative courts. In the case of legal regulations, it is based upon the status of valid and effective as of the date of 1 July 2017. In order to obtain texts of court decisions, the computerized system of legal information (titled ASPI database) by Wolters Kluwer ČR (2017) was utilized.

3 Results and Discussion

The primary provision regarding transfer prices in the Czech legislation is contained in Section 23(7) of Act No. 586/1992 Coll., on Income Taxes, as amended (hereinafter the "AIT"), which provides the following: "*If the prices agreed between associated parties differ from the prices that would have been agreed between non-associated parties in usual business relations under the same or similar conditions, and if such different is not satisfactorily substantiated, the taxpayer's tax base shall be adjusted by the ascertained difference. If the price that would be agreed between non-associated parties in standard business relations under the same or similar conditions cannot be determined, the price determined according to the legal regulation governing property appraisal shall be used.*". The wording of Section 23(7) of the AIT then further exhaustively sets out the situations in which the rule stated above shall not be used. The legal provisions governing transfer prices contained in the Czech AIT are relatively brief. Besides the said rule, the AIT only defines situations in which the rule stated above does not apply, and further defines the key term of *associated parties*. The AIT divides associated parties into two groups: into *parties associated through capital* and *parties associated otherwise.*

As far as the rules for the bearing of the burden of proof are concerned, these are embodied in section 92 of Act No. 280/2009 Coll., Tax Procedural Code, as amended (hereinafter the "TPC"). For easier clarity, the fundamental rules set out therein are specified in Table 1 below.

Table 1 Selected fundamental rules for proofs under the TPC

Provision	Text of the Provision
Section 92(2)	The tax authority shall ensure that the circumstances decisive for correct ascertainment and setting are ascertained as completely as possible, and, in doing so, is not bound by just the proposals of the tax subjects.
Section 92(3)	The tax subject shall have to prove all circumstances that it is obligated to state in a due tax return, additional tax return and other submissions.
Section 92(4)	If so required by the course of the procedure, the tax authority can call upon the tax subject to prove circumstances necessary for the correct setting of tax, provided that the necessary information cannot be obtained from its own official records.
Section 92(5)(c)	The tax authority shall have to prove ... circumstances refuting the credibility, conclusiveness, accuracy or completeness of mandatory records, accounting records, as well as other records, documents and other means of evidence asserted by the tax subject.
Section 92(5)(d)	The tax authority shall have to prove ... circumstances decisive for the evaluation of the actual content of a legal act or other circumstance.

Provision	Text of the Provision
Section 92(5)(e)	The tax authority shall have to prove ... circumstances decisive for the application of consequences for breach of obligation in tax administration.

Source: own processing with the utilization of the TPC.

The wording of the legal regulations as stated above is altogether clear. Nevertheless, it was natural that, sooner or later, the judiciary would, in view of the opposition of interests of the interested parties and the size of impending retrospective tax assessment, be called upon to interpret the relevant rules, including, among other regards, in light of the burden of proof in the case of the adjustment of the tax base as a result of incorrectly set transfer prices for controlled transactions.

In this regard, we can now state that the current case law of the administrative courts has been established: i.e. in new decisions, the courts continually adhere to their previous conclusions and assessments. Such is also the situation in the case of the fundamental rules establishing the pre-conditions for the application of Section 23(7) of the AIT. In its judgments, the Supreme Administrative Court of the Czech Republic, see, for example, the Judgment of the Supreme Administrative Court of the Czech Republic dated 27 June 2007 file No. 1 Afs 60/2006 or the newer Judgment of the Supreme Administrative Court of the Czech Republic dated 20 November 2014 file No. 9 Afs 92/2013), establishes that the rule of Section 23(7) of the AIT can be applied only and exclusively upon the fulfillment of three cumulative conditions. Those conditions are as follows:

1. Proving that it is a case of associated parties; the Supreme Administrative Court of the Czech Republic has defined the said relationship more broadly, for example, in the Judgment of the Supreme Administrative Court of the Czech Republic dated 27 January 2011 file No. 7 Afs 74/2010, as the need to prove that these are: *"… entities linked economically, personally or in another manner through a connection functionally equivalent to an economic or personal link."*.
2. Proving that the prices agreed upon between them differ from the prices that would be agreed upon between independent parties in standard relationships under the same or similar conditions, and, at the same time,
3. such difference was not satisfactorily substantiated by the taxpayer.

The fulfillment of the first mentioned condition logically does not tend to be disputed so often. That is generally an issue that the parties themselves do not dispute in any way due to the clarity that follows, for example, from the publicly available data in the Register of Companies on the capital-based interconnectedness of the entities. The second item tends to be, in terms of practice, undoubtedly the more frequent and definitely more problematic in terms of the bearing of the burden of proof on the part of the tax authority. According to the conclusion set out, for example, in the previously mentioned Judgment of the Supreme Administrative Court of the Czech Republic dated 27 January 2011 file no. 7 Afs 74/2010, it is the obligation of the tax authority to ascertain the price agreed between associated parties (*which is generally not a problem in view of the obligatory records of tax subjects*) and, at the same time, to ascertain the so-called reference price. The reference price is, in that regard, understood to mean a simulation of prices that has been created on the basis of the consideration of what price such parties would agree upon in a situation identical to the situation of the related parties if they were not related and if they had standard business relations between one another. However, even the existence of differences does not automatically represent the possibility of adjustment of the tax base by the tax authority. The Supreme Administrative Court of the Czech Republic provided a clear conclusion in regard to the said issue, for example, in the Judgment of the Supreme Administrative Court of the Czech Republic dated 31 October 2013 file No. 7 Afs 86/2013, when it stated: " *... prior to the actual enumeration of the ascertained difference between the price accounted for by the plaintiff and the price set by the tax authority – price usual in the market – the tax authority must always notify the plaintiff absolutely clearly and specifically of the amount of the actual usual market price being extrapolated by it, and how it reached such price (on the basis of what*

documents/criteria/tools).". The tax subject must have space to not only provide a statement in regard to the evidence shown or to the criteria, but also to eventually propose other evidence or criteria which, in its opinion, prove a different amount of the usual market price (according to the Judgment of the Supreme Administrative Court of the Czech Republic dated 31 October 2013 file No. 7 Afs 86/2013).

The conclusions set out above are, in the opinion of the authors of the paper, logical and consistent with the text of the relevant legal regulations. At the same time, one can conclude that they maintain sufficient space for the protection of rights on the part of the taxpayer. As stated in the Judgment of the Supreme Administrative Court of the Czech Republic dated 23 January 2013 file no. 1 Afs 101/2012, the burden of proof passes on to the taxpayer to: "... *prove unusual reasons, defying the standard conditions on the market, while being economically rational, for which the price between it and a related party was agreed upon differently from the reference price. It is thus now up to the tax subject to prove the occurring price difference ascertained and substantiated by the tax authority. If the tax subject bears such burden successfully, the adjustment of the tax base by the tax authority is not possible.*". Within the context of the conclusions of the administrative courts, the principle of *Ignorantia Iuris Non Excusat* and the need for the active participation of taxpayers in the process of showing proof are very relevant. In the event that the taxpayer remains inactive for any reason, it exposes itself to the risk that it can have additional tax assessed or its tax loss reduced on the grounds of failing to bear the burden of proof successfully. However, overall, it can be stated that the current legislation and principles deduced from it in the case law of the administrative courts place great procedural demands upon the tax authority. However, in terms of the assessment (review) of the decisions of the tax authorities, it is necessary to point out one relevant fact. The Supreme Administrative Court of the Czech Republic has repeatedly stated (according to the Judgment of the Supreme Administrative Court of the Czech Republic dated 31 March 2009 file No. 8 Afs 80/2007) that, "*if a legal rule does not specify the mechanism for determining the usual market price, and an administrative authority is called upon to determine it, the determination of the usual market price must be approached with special attention and its amount must be determined on the basis of objective criteria and in such a way so that the conclusions of the administrative authority lead to a reliable opinion and so that it is possible to scrutinize the manner of its determination as well as the actual amount of the usual market price ... Interfering in the selection of criteria, or determining which of the criteria the administrative authority is to take into consideration in determining the usual market price, is not within the powers of the Supreme Administrative Court, and the choice of criteria is left up to the administrative authority, whereby, however, the Supreme Administrative Court reiterates that such criteria must lead to a reliable and objective conclusion.*".

The framework rules are thus given. However, the actual fulfillment of the generally defined criteria is a great challenge, primarily in regard to the requirement of upholding due process within the meaning of the conducting of a quantitative and qualitative analysis of suitable entities for comparison. The issue of comparability, as also demonstrated, for that matter, by certain decisions of administrative courts (see, for example, the Judgment of the Regional Court in Hradec Králové (branch office in Pardubice) dated 16 March 2016 file No. 52 Af 34/2014), is very problematic. However, it is one of the key, logical requirements set out by the OECD standards (2017). The European Commission (2016, 2017) also points out certain problems and issues associated with the comparability.

Conclusions

This work has aimed to identify and evaluate the rules for the bearing of the burden of proof on the part of tax authorities in relation to the conducting of an adjustment of the tax base as a result of incorrectly set transfer prices in controlled transactions (i.e. transactions between associated parties). On the basis of a conducted analysis of the legal rules and related case law, it can be stated that the statutory rules, interpretationally supplemented with the interpretation provided by the administrative courts, are clear, established, and respectful of the requirements of fair process. The actual fulfillment of

relatively general criteria is, nevertheless, very difficult in many aspects. In view of the content of judgments (contentious issues having been dealt with), the conducting of a corresponding quantitative and qualitative analysis is one of the principal yet very problematic issues.

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