Prepared by AmCham member

Slovak transfer pricing rules: inconsistent with EU law?

In this article, I briefly analyze a potential inconsistency between the transfer pricing rules as defined by Slovak Income Tax Act and principles of law of the European Union (EU), in particular the freedom of establishment stated in Article 49 of the Treaty on the Functioning of the European Union (TFEU) and the freedom to provide services pursuant to Article 56 of TFEU.

Transfer pricing

The term transfer pricing simply means pricing of various business transactions between related parties in a manner ensuring hidden transfer of profits. According to Slovak law, a related party means a close party or another party which is economically, personally, or otherwise interrelated with a foreign party. As such, transactions are potentially driven by other than business motivations of the parties concerned, tax authorities of many countries of the world, including the Slovak Republic, use laws aimed at protecting their national tax base from manipulated intra-group transactions. Such transactions must be booked for tax purposes at market value, using the well-known arm's length principle.

Legal framework of transfer pricing in the Slovak Republic

According to the Slovak Income Tax Act, if there is a relationship between "foreign related parties" (i.e., between a foreign party and a domestic party related thereto), the tax base of a domestic related party must also include the difference between the prices agreed in business transactions of such foreign related parties (including the prices of services, loans, and credits), and the prices applied between non-related parties in comparable business transactions, as long as such a difference results in a reduction of the tax base of the domestic related party.

Inconsistency with the law of the European Union?

What does Article 49 of TFEU say?

Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

What does Article 56 of TFEU say?

Within the framework of the provisions set out below, restrictions on freedom to provide services within the Union shall be prohibited in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended.

On the field of transfer pricing, Slovak law may be viewed as discriminatory against foreign parties interrelated with domestic parties on the basis of Article 49 of TFEU, since it may be challenged under the decision of the European Court of Justice (ECJ) (Case C-324/00) which held that the German thin-capitalization rules, which applied only to non-resident shareholders and did not apply to domestic shareholders, discriminated against non-resident shareholders and therefore was in opposition to the law of the EU. Notwithstanding the non-existence of thin capitalization rules in Slovakia, I believe that, by using *argumentum a minori ad maius*, such decision of ECJ may be used also in connection with transfer pricing rules, as they constitute more general anti-avoidance legal framework than thin-capitalization rules. On this note, let us imagine a foreign shareholder financing its subsidiary situated in the Slovak Republic through a loan with excessive interest payments, e.g., 50% (the market interest rate being 10%), with the sole or primary motive to benefit from the tax advantages. Slovak tax authorities would challenge this transaction on the basis of transfer pricing rules (the interest rate applied should be compliant with the arm's length principle) even though there are no thin-capitalization rules in the Slovak Republic.

Moreover, it should be remembered that according to the established case-law of ECJ, no discrimination on the basis of nationality is permitted even though the subject matter is direct taxation, which according to the decision of ECJ (Case C-279/93) does not fall within the purview of the EU.

Slovak transfer pricing rules may be challenged as discriminatory also by virtue of ECJ decision (Case C-318/10). In principle, any payments are to be regarded as deductible business expenses if they are only necessary for acquiring or retaining taxable income and if the taxpayer demonstrates the authenticity and amount of those expenses. Under this decision, Article 56 of TFEU must be interpreted as precluding legislation of a member state under which payments made by a domestic taxpayer to a foreign company for supplies or services are not to be regarded as deductible business expenses where the foreign company is not subject, in the member state of establishment, to tax on income or is subject, with regard to the relevant income, to a tax regime which is appreciably more advantageous than the applicable regime in the former member state, unless the taxpayer proves that such payments relate to genuine and proper transactions and do not exceed the normal limits.

Conclusion

Without a doubt, more activity is to be expected from Slovak companies in terms of tax avoidance as a result of the dramatic tax and social security payment increase effective as of 2013. Intra-group transactions may become more commonly used in this respect with tendency for transfer pricing. On this note, if a foreign party concerned by the application of Slovak transfer pricing rules refers this issue to ECJ, an interesting ruling with material implications can be certainly expected.

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