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FACULTY OF ECONOMICS

MASTER'S THESIS

**AN ANALYSIS OF TRANSFER PRICING ADEQUACY IN A
SELECTED COMPANY**

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GRUŠA KOČICA

AUTHORSHIP STATEMENT

The undersigned Gruša Kočica a student at the University of Ljubljana, Faculty of Economics, (hereafter: FELU), author of this written final work of studies with the title An analysis of transfer pricing adequacy in a selected company, prepared under supervision of prof. dr. Mitja Čok.

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INTRODUCTION

The importance of multinational enterprises (hereinafter: MNEs) has increased dramatically in last decades, which led to a higher integration among them, and consequently among whole countries, which caused technological expansion, mostly in field of communication but also in areas of business operations and trade.

Nowadays, therefore substantial volume of global trade comprises of international transfers of goods and services, capital (e.g. money), and intangibles (such as intellectual property) within a multinational group of companies. According to evidence, intra-group trade is still increasing steadily and accounts approximately to more than 70 % of all international transactions (Bobek-Gospodarič, 2016c, p. 81).

Such growth is considered to be huge challenge for international taxation, since MNEs should be treated in international context rather than in isolation. This trend of interconnectedness and increased cross-border trade makes it interesting and important to understand how MNEs approach the issue of pricing their internal transfers, in order to increase the competence and efficiency of their operations and at the same time act in accordance with legislation.

This is also referred to as transfer pricing. The choice of transfer pricing method in transactions among related parties, affects the amount of profit that is shown by individual companies in the group of these related parties.

As Simmons (2016, p. 1) says, the process of globalization has a lot of advantages, but with higher integration, MNEs easily exploit “blurred borders among countries” which enables them to operate in a way that they shift profits from higher-tax countries to lower-tax countries, which is also known as tax avoidance technique. This happens due to different tax rates in countries where enterprises operate.

Bloomberg house recently announced the news that multinational enterprise Google, has saved at least two billion dollars in taxes in three years. They were able to reduce the tax base by using tax avoidance technique, called the “double Irish with a Dutch sandwich”, which allowed most of the profits to be channelled through Ireland and the Netherlands into a tax haven in Bermuda. Analysts calculated that the company paid tax at an effective rate of 2.4 %, although it carries most of its activity in countries with a high tax rate above 20 % (the tax rate in the United States was 35 %, and in the United Kingdom, which was the second largest market 28 %) (Finančna uprava Republike Slovenije, 2015, p. 8).

According to the guidelines, prepared by Organisation for Economic Co-operation and Development (hereinafter: OECD), so called Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, hereinafter: OECD TPG (OECD, 2017b, pp. 15, 16),

the problems for MNEs arise from the need to comply with different tax jurisdictions and requirements, which creates additional costs and higher burden for companies operating internationally in comparison with companies operating within one tax jurisdiction.

For tax authorities, the problems appear from practical perspective as well as from procedural perspective. From procedural perspective, countries have to resolve taxation of profit of taxpayers based upon income arising on their territory and at the same time avoid taxing companies in more tax jurisdictions (double taxation). From practical perspective, the problem for countries arises from troubles in acquiring appropriate information on enterprises placed outside its tax borders.

With accomplishing all the activities related to transfer pricing, one of the most important tax regimes in the world of transfer pricing has been established, aiming at reducing administrative burdens on one hand, and ensuring fair taxation of MNEs in different tax jurisdictions on the other. However, due to huge volume of transaction and constant technological development, there is still plenty of room for improvement.

In this master's thesis, I will present transfer pricing in broader context, as well as provide a practical example of determination of transfer pricing method for the purpose of testing transactions in a selected company. Therefore, the master's thesis is compilation of two parts, namely theoretical and practical analysis of transfer pricing.

In the introduction, the research problem, purpose and aim of master's thesis are presented. First chapter is composed of theoretical background, including overview of basic terminology such as associated enterprises, transfer prices, and the arm's length principle (hereinafter: the ALP). These terms are of a crucial importance for further understanding of topic and continuation of a research.

Next on, second chapter covers legal framework for transfer pricing and guidelines, which multinational enterprises and tax administrations pursue to address economic challenges of globalization.

Summarized in Overview of the OECD work on transfer pricing (OECD, 2012, p. 1), the development of transfer pricing policies goes back to 1979 when OECD has prepared guidance for the application of the ALP. As stated by Bobek-Gospodarič (2016b, p. 1), later on, in 1995 the OECD TPG were released and since then, they are being constantly reviewed (lastly in July 2017) and adjusted based on relevant legislation, in order to comply with increasing demands of administrations and companies and are consistent with more integrated economies, which are consequence of globalization process.

Generally, transfer pricing is subject to national laws. Slovenian legislation regarding transfer pricing follows OECD TPG, which are incorporated in national legislation and are

presented in chapter 2 of the master's thesis. According to OECD TPG (2017b, pp. 15, 16), there are two different systems of taxations, namely the residence-based system or source-based system. In certain cases, both of the systems are applied.

In residence-based tax system, the country determines the tax base of a taxable entity (which is a resident in this tax system) based on all of the earned revenue, even if it has source outside the tax system.

In source-based tax system, tax base involves income arising within country's tax jurisdiction, even if the taxable entity is not resident of this particular country. OECD member countries chose this approach as the most realistic and practical to achieve fair results and minimize the risks of unrelieved double taxation. This means that each member of a group of companies is taxed individually, based on the income attributed to this entity.

In Slovenia, the system of taxation is source based, which means that resident companies pay taxes on all of their worldwide income and non-resident companies pay taxes on their Slovenian source income.

To be able to treat companies as separate entities, transactions within the group of companies should be taxed under the assumption that they act in line with the ALP, meaning that transactions which are concluded on a group level are compared with transactions which occurred among independent companies under similar conditions, to establish acceptable transfer prices.

Part of chapter two are also tax actions called Base erosion and profit shifting ("BEPS") Action plan, which were released by OECD in 2015 to avoid manipulating with tax rules in order to artificially shift profits from higher to lower or even no-tax countries. Action 8-10 of BEPS deals with "Aligning Transfer Pricing Outcomes with Value Creation", and action 13 deals with "Transfer Pricing Documentation and Country-by-Country Reporting" (OECD, 2015d). Since then, they have constantly been developing and coordinating according to current legislation obligations.

Next part of chapter two deals with transfer pricing documentation. As described by Jain and Gubta (2016, p. 9) in order to be in line with laws in the field of transfer pricing, entities have to provide transfer pricing documentation which obliges taxpayer to adopt a transfer pricing method after in-depth analysis. Besides that, it helps in creating a culture of self-compliance among taxpayers, to avoid penalties.

Transfer pricing documentation is composed of two main files. General documentation – master file, provides overview of group of companies with intention to position the described transfer practices in the global perspective. Detailed documentation – local file in contrast to master file, provides more detailed information in connection to specific

transactions within group of companies (OECD, 2015c, pp. 14, 15). Besides that, companies where consolidated revenues exceed EUR 750 million will also have to provide a so called Country-by-Country report, which will be exchanged for the first time in 2018 for tax year 2016.

In Slovenian legislation, documentation regarding transfer prices is covered in Article 382 of Tax Procedure Act. In conclusion, of chapter two, the of transfer pricing in Slovenia is described, where irregularities and penalties for incompliance with legislation are presented.

In third chapter, directions for applying ALP are described. Chapter starts with comparability analysis, where factors and steps in determining comparability are presented. This is then followed by the explanation of how the real transactions are identified, effect of losses incurred within associated enterprises, effect of policies set by different governments, customs valuations and its effects on transfer pricing, effects of location savings and influence of assembled workforce as well as synergies among group of MNEs.

Chapter four covers the methods for setting transfer prices. According to OECD TPG (OECD, 2017b, pp. 97–145) they are divided into traditional and transactional profit methods, and the purpose of using them is to determine whether the circumstances in transactions among associated enterprises are consistent with ALP, meaning the conditions imposed in transactions are similar to those, imposed in transactions among independent entities. Traditional methods are Comparable Uncontrolled Price Method, Resale Price Method and Cost Plus Method. Transactional Profit Methods are Transactional Profit Split Method and Transactional Net Margin Method. Next on, the process of choosing the most suitable transfer pricing method is described and their strengths and weaknesses presented accordingly.

Chapter five is intended to answer the research question, regarding issues related to transfer pricing, and some of the implications made, in order to reduce them. According to United Nations (2017), problems regarding transfer pricing are overall divided in basic and special issues, which are then further broken down to more specific problems.

In the second part of master's thesis, more precisely in chapter six, which is based on practical case, the selected company (from Slovenia), its organizational structure and the industry in which they operate are described. After that, transactions with related companies are identified and the ALP is tested by performing functional and economic analysis where comparable companies are determined and conditions in a controlled transaction (meaning the transaction which is concluded between related companies) are compared with circumstances established among unrelated companies.

In the next step, method for setting transfer prices is chosen and profit level indicator selected and tested with data on comparable companies gathered from database Amadeus.

In conclusion, the results are presented, analysed and described. Chapter six also provides the answer to the first research question, provided below.

Purpose of this master's thesis is to determine the appropriate method for testing transfer prices with analysis of a practical example, and check whether the ALP is met. By that, the basis for effective and efficient business operations is set, and the company is compliant with Slovenian legislative rules.

Aim of the master's thesis is to examine current legislation and directives regarding transfer pricing applicable to associated enterprises, to analyse methods for setting transfer prices, and to demonstrate assessment of ALP on a selected company. Therefore, the aim is to answer following research questions of master's thesis:

1. Is the transfer pricing policy used by the company effective and in compliance with the ALP and national legislation? Which method for testing transfer prices is the most suitable and why?
2. What are the challenges and issues identified in dealing with transfer pricing?

1 BASIC TERMINOLOGY

“Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises” (OECD, 2017b, p. 17).

Throughout the history, transfer pricing has become a very important tax issue, which is mainly consequence of globalization that improved communication and led to continues trade among entities. Besides that, globalization facilitated creation of new subsidiaries, which is why the interconnectedness among companies around the world is currently the highest.

Transactions within group of MNEs are formed with respect to market situation, as well as in relation to group synergies and dynamics, and as such can differ from conditions which are imposed between unrelated companies in an open market. And since the interconnectedness nowadays is so high, and MNEs are spread around different tax jurisdictions, conducting enormous international transactions are sustaining their joint interests. Therefore, it is important that the right price for intra-group, cross-border transactions is set, to avoid profit shifting from countries which charge high taxes to countries charging low taxes. These kind of transactions are called “controlled” in contrast to transactions between independent companies, which are “uncontrolled” and operate according to an “ALP”, which is described below.

So, transfer pricing is a normal part of MNEs operations. However, if the pricing of intra-group transactions is not compliant with global norms in this context and with ALP according to legislation of countries subjects to transactions, the problem of tax avoidance or evasion can arise (United Nations, 2013, p. 2).

Therefore, economic purpose for setting prices within associated enterprises is to evaluate performance of individual entity in a group of MNEs, as would be done for independent company.

Even though concept of transfer pricing appears logical and easy to understand, setting an appropriate price could be challenging, especially in case of transactions including intangible assets (such as brands or trademarks) or services, because they are difficult to value.

According to Clements and Price (2007, p. 5), there are three objectives of transfer pricing in intra-group transactions:

- “To preserve or maintain divisional autonomy.
- To encourage divisions to achieve central management optimal results.
- To allow or provide a measure of divisional (product) performance that would lead to long run optimal decisions.”

In order to avoid opportunistic behaviour (which can result from encouraging optimal result for central management, while demanding autonomy from divisions), the goal is to implement structure where companies use practices to increase the effectiveness of the whole network where they perform activities.

Due to more and more complicated policies to guide pricing decisions on one hand, and companies’ ways to avoid rules on the other, transfer pricing is becoming a substantial issue in international supply chains.

Next term, already used in text above but very important in context of transfer pricing is term “**associated enterprises**”.

As defined in Article 9 of OECD Model Tax Convention on income and capital 2014 (OECD, 2015b, pp. M-25, 26), associated enterprises are where:

- a) “an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other

Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

- Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.”

Basically, the associated enterprises exist when one individual participates in management or control of more enterprises, directly or indirectly. The importance of this term comes from the fact that such companies may exploit their connections and use it for purposes of tax avoidance or evasion. Slovenian legislation in field of transfer pricing and double treaties follow OECD Model Tax Convention.

Next important definition in relation to transfer pricing is **ALP**, which is a standard, used in an international context and was adopted by OECD countries with aim to successfully determine prices charged within group of associated enterprises for tax related purposes. The principle is defined as: “where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.” (OECD, 2017b, p. 23).

In other words, it means that transactions between related parties should be taken into account and evaluated like if they were performed between companies which are not related and, of course work for their own interests.

To put it simple, in order to achieve ALP, the circumstances among associated enterprises in their business and economic interactions, should not be different from conditions imposed by independent enterprises, which are determined by market forces.

Since the market runs the majority of transactions within economy, the transactions within group should be comparable to transactions between independent companies - summarized, the ALP uses “marketplace as the norm” (United Nations, 2013, p. 11).

From a geographical point of view, this principle is neutral since it treats profits realized in different places, similarly.

The ALP was “established” in 1963, when it was described in Article 9 of the OECD Model Tax Convention document and later in 1980 the United Nations also accepted the ALP, which is revealed in Article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries. Today, it forms the basis for transfer pricing between OECD member countries and between OECD member countries and non-OECD members (OECD, 2012).

As well as transfer prices, ALP is easy to understand, while practical application is quite complicated, as it requires comparable transactions. Application of ALP and its components are described more in detail in chapter 3 of this master’s thesis.

2 LEGAL FRAMEWORK FOR TRANSFER PRICING

Transfer pricing rules have been developed mainly among members of OECD (i.e. developed countries), because of their historical and economic background.

Back in 1915, the first rules regarding transfer pricing were introduced in United Kingdom and in 1917 in United States. However, until 1960s, transfer pricing as such was not a big issue for countries (United Nations, 2013, p. 59). Later on, in 1963, when transactions increased in scope and geographical context, OECD released OECD Draft Convention, which later (in 1977) resulted in the publication of a new Model Convention and Commentaries. In 1979, OECD published practical instructions for applying the ALP. Since then, OECD TPG are constantly being revised and updated, lastly in July 2017.

Moreover, in 2015, OECD has released BEPS tax actions that deal with problems of base erosion, profit shifting and general tax avoidance. In connection to BEPS, OECD has also organized four events called “Global Forum on Transfer Pricing”, where the problems of transfer pricing were discussed among participants. These preventive actions are further described in chapter 2.2.2. of this master’s thesis.

As mentioned in introduction, the transfer pricing is primarily subject to national laws. Slovenia, as well as other member and non-member countries of OECD, incorporate guidelines in their national legislation, while tax administrations around the world pay special attention to this topic.

Next chapter describes legislation in Slovenia regarding transfer pricing.

2.1 Legislation in Slovenia in the field of transfer pricing

Slovenian legislation regarding transfer pricing is largely harmonized with OECD TPG, since Slovenia has been a member country of OECD from 21 July 2010.

The following laws govern transfer pricing rules in Slovenian legislation:

- Article 16 – 19 of Slovenian Corporate Income Tax Act (CITA). *Official gazette of the RS*, no. 117/06, 56/08, 76/08, 5/09, 96/09, 110/09 – ZDavP-2B, 43/10, 59/11, 24/12, 30/12, 94/12, 81/13, 50/14, 23/15, 82/15, 68/16 and 69/17.
- Articles 14, 248 – 255 and 382 of Tax Procedure Act (TPA). *Official gazette of the RS*, no. 13/11 – official consolidated text, 32/12, 94/12, 101/13 – ZDavNepr, 111/13, 25/14 – ZFU, 40/14 – ZIN-B, 90/14, 91/15, 63/16 and 69/17.;
- Article 11, paragraph 1 of the Financial Administration Act (*Official Gazette of the RS*, no. 25/2014) (FAA);
- Rules on transfer pricing. *Official gazette of the RS*, št. 141/06 in 4/12.;
- Personal Income Tax Act (PITA). *Official gazette of the RS*, no. 13/11 – official consolidated text, 9/12 – odl. US, 24/12, 30/12, 40/12 – ZUJF, 75/12, 94/12, 52/13 – odl. US, 96/13, 29/14 – odl. US, 50/14, 23/15, 55/15, 63/16 and 69/17
- Rules on the recognized interest rate (Interest rate Rules). *Official gazette of the RS*, no. 141/06 and 52/07.

In Slovenian legislation, definition of associated enterprises is provided in Articles 16 and 17 of the CITA. The two definitions differentiate, with respect to whether the transactions are cross-border or domestic.

Cross-border transactions (which are determined in Article 16) are transactions carried out between a resident taxpayer and a foreign enterprise (non-resident), where these entities are related. The conditions that determine when the two entities (resident and non-resident) are related are given in Article 16 of CITA.

Furthermore, the domestic inter-company transactions are carried out between resident taxpayers. The conditions that determine when the two enterprises (residents) are related are given in Article 17 of CITA.

According to the Article 16 of PITA, a related person is a family member or any person who is controlled or usually controlled by a taxpayer.

2.1.1 Legally permitted methods and procedures for setting transfer prices

As stated in Article 16 of CITA, legally permitted methods for setting transfer prices, compliant with ALP are:

- Comparable Uncontrolled Price Method;
- Resale Price Method;
- Cost Plus Method;
- Transactional Profit Split Method;
- Transactional Net Margin Method.

They can be used separately or in combination. The rules for their implementation are revised in Rules on transfer pricing, which besides methods for setting transfer prices, emphasises the importance of comparability analysis. Furthermore, it provides rules on evaluation of individual and combined transactions and use of range of comparable market prices. It also includes rules on cost sharing agreements, exceptions in determining comparable market prices for services and intangibles, and business connections (Rules on transfer pricing, 2006).

To prevent double taxation, Ministry of Finance of Republic Slovenia is involved in preparation of negotiating positions, establishing the facts and circumstances for the assessment of the reality and eligibility for elimination of double taxation.

2.1.2 Determination of tax base

In determining the tax base of taxpayers, the same procedure applies for related parties - residents and non-residents. According to Article 16 and 17 of CITA, in determining the revenue of the taxpayers, transfer prices between related parties (considering also intangible assets and services) should be taken into account. Revenue shall be at **least** up to the amount, which is determined in a way that the prices of such comparable assets or services are considered, which in identical or similar conditions, would be achieved on the market between unrelated enterprises.

When determining the expenses of a taxpayer, the transfer pricing of associated enterprises for assets (including intangible assets and services), shall be considered, but the expenditure should **not be higher** than the amount established by reference to comparable market prices.

However, the taxpayers may be obliged to adjust their tax base in case the irregularities are detected, in order to ensure that taxes are paid correctly in country where the income is achieved. (Deloitte, 2015, pp. 229–230)

But if the transactions are carried out among resident taxpayers, the tax base does not have to be increased or decreased, because they will all pay the taxes in one country, where transactions happen. But there is one exception to that rule, namely according to Article 17 of CITA, which deals with transfer prices among related parties – residents, the tax base may increase or decrease if one of the parties involved in transaction:

- discloses an unutilized tax loss from preceding periods,
- pays tax according to this law at a rate of 0 % or at a specified rate, which is lower than general rate of 19 %, determined in Article 60 of CITA – 19 %, or
- is exempt from paying corporate tax under CITA.

This rule is applicable for cases, where the resident taxpayers try to exploit the system, through financing each other and at the end not paying the taxes accordingly, due to losses incurred or due to other exceptions.

The Slovenian legislation in this field originates from, and is compliant with OECD and its main publications, which are of a crucial importance for tax administrations. They are presented in the following chapter.

2.2 Organization for Economic Co-operation and Development (OECD)

In the field of transfer pricing, the OECD plays very important part, since the majority of countries who have adopted regulation regarding transfer pricing, follow OECD guidelines and rules. Officially, it was established on 30 September 1961, when new Convention entered into force and Canada and US joined former OEEC (Organisation for European Economic Cooperation). The key purpose of OECD is ensuring cooperation among countries in order to achieve better results.

Slovenia has joined OECD on 21 July 2010, and today, there are 35 OECD member countries worldwide that regularly cooperate with each other, identify and analyse problems and set policies. They jointly work on achieving development and growth in economy, increasing employment levels in participating countries, regulating and encouraging world trade and implementing ways to decrease irregularities that appear in the process. In this respect, their main goal is to enable an improved and appropriate standard of living for the residents of the countries involved (PricewaterhouseCoopers-PwC, 2016, p. 25).

Since its establishment, OECD has released different studies and guidelines for countries regarding business operations among associated enterprises and methods for determining transfer pricing.

In continuation of the master's thesis are described two main documents regarding regulation of transfer prices, OECD TPG and OECD BEPS Action Plan, both issued by OECD.

2.2.1 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

OECD TPG is a document, intended to offer satisfactory solutions in transfer prices cases, for reducing disputes, appearing between tax administrations and MNEs. The OECD TPG were created as amendment and compilation of OECD Report - Transfer Pricing and Multinational Enterprises (1979) and accepted in their original version in 1995 by the Committee on Fiscal Affairs, on 27 June 1995 and by OECD Council for publication on 13 July 1995 (OECD, 2017b).

Great influence on OECD TPG had "Regulations for specific types of inter-company transactions", which were released in 1968 by US Treaty. The OECD TPG have been updated in 1995 and 2010, and lastly in July 2017.

In 2013 revision, the guidance on safe harbours (Chapter IV) was revised, and it was acknowledged that correctly determined safe harbours (legal provisions) are important from the perspective of relieving compliance liabilities and assuring higher certainty to taxpayers. In Slovenia, "safe harbours" with regards to transfer pricing exist in relation to the interest rate on loans between associated enterprises and thin capitalization rules, which are, however not topics included in this master's thesis.

In 2016, OECD TPG has been revised again, in order to reflect clarifications and revisions agreed in below described 2015 BEPS Reports on Action 8-10 "Aligning Transfer Pricing Outcomes with Value Creation", and action 13 "Transfer Pricing Documentation and Country-by-Country Reporting", which can be observed in chapters I, II, V, VI, VII and VIII.

Last revision, namely the review and modification of Chapter IX, was done in 2017 and related to guidance on business restructurings from the perspective of transfer pricing (OECD, 2017b).

In the Table 1 below, changes of OECD TPG are briefly described, and divided according to chapters.

Table 1. Changes of OECD TPG

Change of OECD TPG	Topic	Changes
Chapter I.D (new version)	Arm's Length Principle	Consideration of risk, non-recognition of transactions
Chapter II (additions)	Transfer Pricing Methods	Commodity transactions (clarification of application of CUP method), current guidance on profit split
Chapter IV. E (revision)	Safe Harbours	To relieve some compliance burdens and to provide greater certainty for cases involving smaller taxpayers or less complex transactions.
Chapter V (new version)	Transfer Pricing Documentation	Implementation of three-tiered approach to transfer pricing documentation (CbCR, Master/Local file)
Chapter VI (new version)	Special Considerations for Intangible Property	New guidance on intangibles, hard-to-value intangibles (HTVI)
Chapter VII (new version)	Special Considerations for Intra-Group Services	Low value-adding intra-group services
Chapter VIII (new version)	Cost Contribution Arrangements	Substantial tightening with respect to control over risk and measurement of contributions (market value vs at cost)
Chapter IX	Transfer pricing Aspects of Business Restructurings	Adaption to BEPS-findings

Source: C., Nowotny, M., Seiler, T., Kiesenhofer, & R., Blahova, *International Tax Law – Introduction to the Law of Double Conventions*, 2017, p. 93.

The OECD TPG is a document that links directives for transfer pricing, into a unified whole. It covers ALP and guidance for its application, describes methods for determining transfer prices in detail, provides rules on performance of comparability analysis and describes approaches to avoid and resolve disputes in relation to transfer pricing.

Furthermore, it covers documentation required in connection to transfer pricing, deals with special considerations for transfer pricing in the field of intangibles, services provided (in the group of MNEs) and business restructurings, and provides guidance and explanations for cost-contribution agreements (hereinafter referred to as CCA). These are the arrangements that allow the companies of the group to share their contributions related to acquiring or developing the assets or services, and consequently share their benefits proportionately to the costs incurred.

There are two types of CCAs, namely the “development CCAs” relating to producing or developing intangible or tangible assets and “services CCAs” for obtaining services. The main difference between them is that “development CCAs” are intended to generate future benefits for the participants in the transactions, while “services CCAs” bring current benefits to participants. (OECD, 2015a, pp.163, 164)

In Slovenian legislation, CAAs are regulated Article 23 of Rules on transfer pricing. (Rules on transfer pricing, 2006)

According to 2017 edition of OECD TPG, permitted methods for determining transfer prices are (OECD, 2017b, pp. 97–145):

- “Comparable Uncontrolled Price Method;
- Resale Price Method;
- Cost Plus Method;
- Transactional Profit Split Method;
- Transactional Net Margin Method.”

The most appropriate methods for defining whether conditions between associated enterprises are in line with ALP, are traditional transaction methods. This is because if there are any differences in prices when comparing controlled transaction (i.e. between two related parties) and prices determined in comparable uncontrolled transaction (between two independent entities), the distinctions in prices are directly correlated to relations enacted between enterprises. Therefore, the ALP conditions may be achieved simply by replacing the price in transaction between related parties by the price set by independent entities. This means that traditional transaction method is preferable choice in case that traditional transaction method and transactional profit method can be applied with equal reliability.

Next on, according to OECD, the most preferable method for determining transfer pricing is comparable uncontrolled price method (CUP), because it compares prices among associated enterprises most directly (OECD TPG 2017, p. 98). However, important implication in this regard is that the companies should choose the method, most suitable to their business operations, since there is not always an option to choose traditional transaction methods and achieve preferable results.

2.2.2 Base erosion and profit shifting tax avoidance strategies (BEPS)

Another vital document in relation to pricing related parties' transactions was created in response to increased tax problems and avoidance by multinational organizations in recent years. The OECD released an action plan, in 2013, to restructure international tax rules for countries, the BEPS (PwC, 2015b, p. 1). This was sponsored by the G-20 governments, a coalition of countries that produce around 80 percent of global economic output in terms of gross domestic product (GDP). BEPS were approved in November 2015.

“When designing their domestic tax rules, sovereign states may not sufficiently take into account the effect of other countries' rules.” (OECD, 2013, p. 9). Main goal of BEPS is ensuring that profits are taxed in countries, where the economic activities are being

completed and where the value creation takes place. The international economy demands that countries cooperate on tax issues, in order to be able to protect their tax sovereignty.

BEPS provide countries with domestic and international instruments that will better align rights to tax with economic activity. This action plan recognizes actions required to address base erosion and profit shifting, sets deadlines to apply these actions and identifies the resources needed and the methodology to implement these actions (OECD, 2015d).

There are 15 actions to equip governments with domestic and international instruments to address tax avoidance (OECD, 2015d):

- “Addressing the tax challenges of the digital economy;
- Neutralising the effects of hybrid mismatch arrangements;
- Designing effective controlled foreign company (cfc) rules;
- Limiting base erosion involving interest deductions and other financial payments;
- Countering harmful tax practices more effectively, taking into account transparency and substance;
- Preventing the granting of treaty benefits in appropriate circumstances;
- Preventing the artificial avoidance of permanent establishment status;
- Aligning transfer pricing outcomes with value creation (Actions 8.-10.);
- Measuring and monitoring BEPS;
- Mandatory disclosure rules;
- Transfer pricing documentation and country-by-country reporting;
- Making dispute resolution mechanisms more effective;
- Multilateral convention to implement tax treaty related measures to prevent BEPS.”

Actions 8 – 10 and 13 deal with transfer pricing issues. More detailed, Action 8 is engaged in developing transfer pricing rules for transfers of hard-to-value intangibles. Its purpose is to prevent associated enterprises from shifting intangibles in more favourable tax environments (BEPS, 2013, pp. 20–23).

Among other things, the OECD has defined the concept of ownership of intangible assets in relation to activities carried out by individual entities in a related parties’ transaction. The determination of who is the legal and who is the economic owner of these assets is the key to understanding the involvement of intangible assets in related party transactions. Chapter VI. of the OECD TPG links the ownership of intangible assets with the activities performed by individual parties, involved in transactions, which is evident from so called DEMPE analysis that will have to be submitted by taxpayers. This analysis will disclose which companies in the group carry out functions related to development, enhancement, maintenance, legal protection and exploitation of the intangible assets, and only these

companies will be entitled to compensation from the use of these assets. (Bobek-Gospodarič, 2016c, p.81)

Before the DEMPE concept, the owner of an intangible asset was entitled to all of the income arising from it, which meant that he could have a company in Slovenia and at the same register an intangible asset (e.g. trademark) in a low-tax jurisdiction and charge royalties to Slovenian company. Therefore he would pay taxes in low-tax jurisdiction and avoid paying taxes in Slovenia, even if the operations in relation to this asset would be performed in Slovenia.

Action 9 develops rules to prevent base erosion and profit shifting by transferring risks among, or allocating capital to group members that actually control the risks and are financially able to bear them. Tax planning schemes often included transactions that provided large profits to companies in favourable tax environments, although these companies did not perform any functions or possess assets and capital. (Bobek-Gospodarič, 2016c, p. 82)

Action 10 deals with other high-risk transactions, and Action 13 provides rules in connection to transfer pricing documentation to improve transparency for tax administration, considering the compliance costs for business (BEPS, 2013, pp. 20–23).

2.3 General documentation regarding transfer pricing

Documentation regarding transfer pricing is described in Action 13 of BEPS document provided by OECD. It is also included in OECD TPG as Chapter V.

In Slovenian legislation, supporting transfer pricing documentation has been required since 2005 and is covered in Article 382 of TPA. It is compliant with OECD TPG requirements. It requires MNEs to deliver the information on their international business operation and transfer pricing policies to tax administrations in a document, called “**master file**”. This document should be available to all relevant tax administrations and should be grouped into five categories:

- Organizational structure of the MNE;
- Description of business or businesses that MNE is engaged into;
- MNE’s intangibles;
- Intercompany financial operations of MNE;
- Tax and financial position of MNE.

Next on, MNEs have to provide detailed transfer pricing documentation (from perspective of transactions) in document called “**local file**”, which is specific for each country and identifies material transactions among related parties, the amounts of transactions and

company analysis of determination of transfer pricing, regarding transactions stated in the document. Local file is supplement to master file and its purpose is for the taxpayer to assure that he is compliant with arm's length principle. Local file is focused on transactions among local country group member and associated enterprises in other countries, which are of a material importance with respect to local country's tax system. It includes information regarding financial transactions, comparability analysis and selection and application of transfer pricing method (OECD, 2015c, pp. 9–16).

Finally, yet importantly, large MNEs have to provide also a document called **Country-by-Country (CbC) Report**, which is provided annually to each tax jurisdiction in which they operate and includes "amount of revenue, profit before income tax and income tax paid and accrued". Furthermore, they have to provide "number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction." Additionally, it requires MNEs to "identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in" (OECD, 2015c, p. 9).

CbC report is submitted only by MNEs with consolidated revenue of EUR 750 million and is part of their master file. It will be exchanged for the first time in year 2018 for the tax year 2016. Based on the publicly available data from year 2014, there are 7 Slovenian entities that will be required to submit the CbC report. (Bobek-Gospodarič, 2016d, p. 87)

The exchange of CbC reports will be held annually by parent companies in international groups of MNEs, which will submit a report to their local tax authority, that will further forward CbC reports to the jurisdictions in which this multinational group operates. The information provided will show the global allocation of profits, taxes paid in different jurisdictions, information on entities operating in different jurisdictions and business activities carried out. CbC reports will enable tax authorities to provide a comprehensive insight into the operating structure of a certain group of companies in different countries.

In cases where the competent authority will have a reason to doubt the correctness or completeness of the reported information, it will inform the competent authority of the State of the party, affected by such irregularity or incompleteness of the reported information (PwC, 2016).

Provision of these documents, enables tax authorities to find out whether enterprises are engaging in inaccurate transfer pricing and other practices through which they artificially shift income into more favourable tax environments.

Tax authorities are therefore provided with useful information and are able to assess transfer pricing risks and audits. The advantage of widely accepted documentation rules is the reduction of compliance costs that would otherwise appear.

Master file and local file should be delivered by MNEs to local tax administrations, while Country-by-Country report should be provided in jurisdiction of tax residence of parent entity and later on shared between jurisdictions through automatic exchange, in accordance with government-to-government mechanisms.

Timing regarding preparation of documentation differs between countries. In Slovenia, for example as of 2006, the information on cross-border inter-company transactions must be prepared concurrently (by the time the tax return is filed).

However, documentation for domestic transactions needs to be submitted only upon request from the tax authorities in the course of a tax audit. This means that documentation should be prepared for cross-border transactions, and in case of request posed by tax authority, also for domestic transactions.

Generally, the documentation should be submitted immediately, though if the taxpayer is unable deliver documents straightaway, the tax authority shall determine the period within which the documents should be provided. This period may vary from 30 and up to 90 days, depending on the size and complexity of the data.

If transactions are not significantly different, a taxpayer may also provide documentation for two or more transactions by making adjustments for differences between them, if any (382 Article of TPA). An important thing to notice with regards to transfer pricing documentation is that not all transactions that occur among associated enterprises are adequately material in their nature to require full documentation in the local file (OECD, 2015c, p. 17).

Materiality can be measured in relative terms, for example transactions not exceeding a certain percentage of revenue, or in absolute terms, e.g. transactions not exceeding a fixed amount. The materiality rules are established individually by countries, based on local requirements. The documentation regarding transfer prices should generally be reviewed and updated annually.

Next on, the rules regarding language of transfer pricing documentation should be established under the local laws. Countries are encouraged to permit the documentation in commonly used language, in order to avoid time and costs incurred if translating documents. In Slovenia, a master file might be in a foreign language. If the master file is not prepared in the Slovenian language, a taxpayer must, at the request of the tax authorities, translate it within a deadline determined by the Financial Administration but not before 60 days pursuant to Article 382(7) of the TPA. Translation may also be submitted to the tax authority before the deadline. Country-specific documentation must be prepared in the Slovenian language pursuant to Article 382(7) of the TPA. Even if

documentation is prepared in a foreign language, it must be prepared according to the Slovenian legislation.

In order for MNEs to follow rules and efficiently provide transfer pricing documentation, many countries have also adopted penalties. The regimes regarding penalties are governed by the laws of each individual country. Penalty for inadequate TP documentation or documentation, which is not prepared according to the terms imposed by the tax authorities and does not comply with the size of the company, is EUR 1,200 to EUR 30,000 for the legal entity and EUR 600 to EUR 4,000 for the responsible person of the legal entity. (PwC, 2015a, p. 913) Another way to encourage taxpayers to fulfil transfer pricing documentation are compliance incentives, such as penalty protection. Penalties are further described in following chapter.

Last important point in relation to transfer pricing documentation is principle of confidentiality, meaning that there should be no public disclosure of confidential information and other commercially sensitive information.

2.4 Tax audit of transfer pricing

To minimize violation of laws in relation to transfer pricing, tax audit of this field is carried out. In Slovenia, the Financial Administration of the Republic of Slovenia has recognized importance of transfer pricing and transferred responsibility for tax audit of transfer pricing to the General Financial Office on 1 January 2014. Regarding the exercise of tax audit of transfer pricing, Slovenian control mechanisms are consistent with OECD TPG directives.

The Transfer Pricing Department operates within the Financial Supervision Department, which is under the control of the General Financial Office. By carrying out the transfer pricing control centralized within one department, a greater specialization of inspectors is ensured and better exchange of practices in this field, which is relatively complex.

The last available data regarding control of transfer prices are from February 2015. From the Table 2 below, it is evident that the number of controls carried out in years 2010 – 2014 was 73, and the amount of additionally identified tax obligations EUR 5.4 million.

Table 2. Tax audit of transfer prices

Transfer prices	2010	2011	2012	2013	2014
Total number of controls carried out	31.0	105.0	75.0	32.0	73.0
Additionally identified tax obligations, in EUR million	8.3	3.7	3.8	4.8	5.4

Source: Finančna uprava Republike Slovenije, *Finančni inšpekcijski nadzor – Nadzor transferenceh cen*, 2015.

The most common irregularities in previous years in the field of transfer pricing, which influenced the additionally charged tax obligations were the following:

- inadequate use of transfer pricing methods in the light of the facts and circumstances of the case, and consequently the inadequate amount of compensation received by the taxpayer for pursuing of the activity;
- irregularities in connection with the attribution of profits to permanent establishments;
- irregularities in connection with the payment of fees for the use of intangible assets;
- irregularities in relation to credits and debits with which taxpayers adjusted the tax base;
- irregularities in relation to services between associated enterprises.

In addition to the aforementioned irregularities, in practice it can also be observed (Šivic, 2015):

- incorrect selection of transfer pricing methods that a taxpayer should use considering the risks assumed and functions undertaken by a taxpayer for his parent company;
- transfer prices of individual transactions are not in accordance with the ALP;
- incorrect definitions of permanent establishment in terms of Articles 6 and 7 of CITA (performing economic activity in the Republic of Slovenia and attribution of profits of parent companies to these units);
- with the question of recording the costs for which the taxpayer does not have the relevant credible documents;
- misdemeanor in case of tax deductions in the payment of dividends, interest, rights to use intangible assets.

The failure to be in line with ALP in transactions among associated enterprises has legal consequences and may result in penalties, already mentioned above in chapter 2.3.

Firstly, the tax base may be adjusted (tax charge increased or tax loss decreased) and secondly the following penalties in accordance with the Article 397 of TPA can be applied in case there is a failure to submit a tax return taxpayer sets out false or incorrect or incomplete data and thereby misleads financial administration (PwC, 2015a, p. 913).

- Penalties range from EUR 1,200 to 15,000 for the small legal entity and EUR 3,200 to EUR 30,000 for the medium to large legal entity.
- In addition, responsible person of the company may be subject to a fine from EUR 600 to EUR 4,000 for small company and EUR 800 to EUR 4,000 for the medium and large company.”

In the case of a serious offence (Article 398 of the TPA), the prescribed penalty is:

- Between EUR 4,500 and EUR 100,000 for a taxpayer that according to the Companies Act is treated as a micro or small company; or
- Between EUR 10,500 and EUR 150,000 for a taxpayer that according to the Companies Act is treated as a medium-sized or large company.

If taxes are not paid up to determined dates, there is also late payment interest levied according to daily interest rate. In addition to performing tax audits, the activities of inspectors in the transfer pricing department also aim at preventive action. Thus, since 2009, Financial Administration of the Republic of Slovenia has been acquiring data from newly registered international companies. In this procedure, the inspector carries out a visit to the taxpayer with purpose to inform the taxpayer with the Slovenian transfer pricing legislation.

Through targeted inspection of transfer pricing and visits to taxpayers, in the context of obtaining data from newly registered international companies and subsidiaries, taxpayers are becoming increasingly aware that their operations are monitored and actions taken, in cases where analyses show that there is a possibility of profits being illegitimately shifted abroad.

Generally, the tax legislation of countries with regard to the taxation of international transactions was established for an economic environment characterized by a lower level of economic integration across national borders. That is why the OECD encourages countries to devote more attention to international taxation, implement measures in their legislation and increase control over taxpayers who are assumed to carry out transactions with which they transfer profits from the state (Finančna uprava Republike Slovenije, 2015).

3 GUIDANCE FOR APPLYING ARM'S LENGTH PRINCIPLE

The official definition of ALP is stated Chapter 1 of this master's thesis and is taken from paragraph 1 of an Article 9 of the OECD Model Tax Convention. This definition matches with definition of associated enterprises defined in Article 9 of 1963 Draft Convention, which was adopted by OECD Council on 30 July 1963. Article 9 was designated as paragraph 1 in Model Convention, released in 1977 and adopted by OECD Council on 11 April 1977 (OECD, 2015b, p. M-26).

ALP treats associated enterprises as separate entities, in order to adjust profits to the conditions which would be imposed among independent entities in equivalent transactions and under comparable conditions. With this approach, the nature of transactions among

these associated enterprises is taken into consideration, and whether the conditions imposed differ from conditions that would be achieved in comparable uncontrolled transactions. This is referred to as “comparability analysis”.

The objective of ALP is to promote growth and development of international trade and investment and at the same time reduce irregularities, which in today’s world of technology and interconnectedness, is a necessity.

OECD countries fully support ALP and believe that there is no legitimate and realistic alternative to it. They have adopted ALP for several reasons. A key reason is that it puts associated enterprises and independent enterprises on more equal position for tax purposes. With this, creation of tax advantages or disadvantages that could distort competition is avoided.

Furthermore, it works efficiently in majority of cases and determines real taxable profits. It reduces an artificial price distortion, which is a consequence of shifting profits from high tax countries to low tax countries. Besides that, it minimizes double taxation, because when transfer prices are adjusted in one tax jurisdiction, they have to be adjusted in another tax jurisdiction as well.

ALP also ensures that economic contribution of associated enterprises involved in transactions is accurately measured, meaning that income is attributed to where is earned. There are also some drawbacks of ALP. The problems and difficulties in application of ALP arise in transactions where highly specialized goods or unique intangibles are traded, or specific services provided.

Moreover, problem could be that associated enterprises may be involved in transactions that independent enterprises would not participate in. Application of ALP can also present an administrative burden for both, the taxpayers and tax administrations. This is due to evaluating many cross-border transactions. In connection to that, it can be also difficult to obtain appropriate information, since information that is available could be incomplete, hard to interpret or even hard to obtain (OECD, 2017b, pp. 36, 37).

3.1 Comparability analysis

As mentioned above, the ALP is applied by comparing conditions in a controlled transaction with conditions in transactions between independent enterprises. This is referred to as comparability analysis, which is the first step in determining ALP.

To assure that comparison of conditions is valuable and beneficial, economically relevant characteristic of the compared situations should be appropriately comparable (OECD, 2017b, pp. 43–44). This means that if there are any differences which could materially impact examined conditions, they should be eliminated with accurate adjustment.

Characteristics that need to be acknowledged in commercial or financial relations among associated enterprises to determine transaction are following (OECD, 2017b, p. 45):

- Contractual terms of transaction;
- Functions performed by each of the participants, assets used and risks assumed (containing also circumstances of transaction, industry practices and how functions relate to broader generation of value by MNE group to which entities belong);
- Features of property transferred in transactions or services delivered;
- Economic environment of enterprises and of market where they operate;
- Business strategies followed by the enterprises.

This information should be presented as part of the local file. The degree to which these factors will matter in determining comparability, depends on the nature of controlled transaction and transfer pricing method adopted.

The aforementioned **contractual terms of transactions** are useful because they generally define how responsibilities, obligations, risks and benefits should be divided among parties.

The **functional analysis** provides information on what parties involved in transactions do and competences they provide in the process. Here, it is vital to recognize how value is created in the group as a whole, how the companies are organized and structured, how interdependent are functions performed by associated parties with rest of the group, and what is contribution of each of associated parties to creation of the value (OECD, 2017b, p. 51).

Besides functions performed by each party, also the assets used in transactions should be taken into consideration. Functional analysis takes into account type of assets (e.g. intangibles, plant and equipment...) and nature of assets (e.g. market value, the age of assets...). Last, but not least, functional analysis considers also the risks borne by each party. This analysis of risks in commercial and financial relations is done in six steps, namely (OECD, 2017b, 53–73):

- “Identification of economically significant risks with specificity;
- Contractual assumption of risk;
- Functional analysis in relation to risk;
- Interpretation of steps 1-3;
- Allocation of risk;
- Pricing of the transaction, taking account of the consequences of risk allocation.”

Features of property transferred or services delivered is another important aspect in determining comparability of controlled and uncontrolled transactions. The characteristics that could be taken into account are the following: in case of transfer of tangible property - physical characteristics (such as quality, reliability, volume of supply, etc.), in case of services - the nature and level of services. And when intangible property is involved - form of transaction (e.g. licensing or sale), type of intangible property, its benefits from the use, duration and degree of protection (OECD, 2017b, pp. 73, 74). Depending on the transfer pricing method chosen, more or less importance is attributed to this factor.

Economic environment of enterprises and of market where they operate is important part of defining market comparability. The relevant factors are geographic location, size of markets, competition, supply and demand levels, purchasing power of consumers, regulation imposed by different governments and so on. With help of these factors, the differences and potential material effects on price will be determined, which could then be accurately adjusted to eliminate such effects (OECD, 2017b, pp. 74, 75).

Lastly, **business strategies followed by the enterprises** must be observed in determining comparability for transfer pricing purposes. Under business strategies it is taken into account for example innovation, development of new products, level of variation, risk aversion, extent of arrangements, labour laws attributed, market penetration and so forth.

In order to effectively perform comparability analysis, there are 9 steps to follow according to OECD TPG (OECD, 2017b, pp. 147–149), which are supposed to be a good practice, for determining reliable comparables. These steps are the following:

- Decision on years to cover;
- Extensive analysis of taxpayer's conditions;
- Understanding controlled transactions that are subject of analysis, with the purpose of being able to determine the tested party (when appropriate), transfer pricing method, financial indicator, etc.;
- Assessment of internal comparables, if there are any;
- Finding the accessible sources to gather information on external comparables;
- Selecting most suitable transfer pricing method and based on that also relevant financial indicator;
- Identification of characteristics to be met by uncontrolled transaction – for it to be potentially comparable;
- Performing comparability adjustments if needed;
- Interpreting data gathered and determining arm's length compensation.

3.2 Recognition of actual transactions undertaken

Next step in determining the ALP is recognition of actual transactions between parties. There are two situations when tax administration can disregard structure adopted by taxpayer.

Under the first one, the actual transactions are assumed from written contracts. If economically significant characteristics of transactions are inconsistent with written agreement, then the actual transactions are identified, based on actual transactions in the conduct of parties.

The second one arises when arrangements of transaction observed in totality are different from those, which would have been assumed by independent enterprises that behave rationally in comparable circumstances. Main question in analysis of transaction is whether there exist a commercial rationality behind arrangement and whether these conditions could be imposed between independent enterprises under comparable economic circumstances.

There can also be a situation in which the transaction among associated enterprises is not recognized, which happens in cases, when the transaction is commercially irrational and there exists no market for such transactions (for example, if one party offers insurance to another party, which is exposed to significant uncertainty due to exposure to large claims, and there exists no market for such insurance).

Since non-recognition can lead to double taxation, it is very important that actual nature of transaction is determined and arm's length pricing is applied to accurately defined transaction. The non-recognition should not be "used" only due to difficulty in applying arm's length (OECD, 2017b, pp. 77–80).

3.3 Losses

If entity consistently experiences losses, while at the same time group of MNEs as a whole is profitable, this could mean that there is a problem with regard to transfer pricing of their internal transactions and would demand special examination of transfer pricing policies. Independent enterprise would not be willing to accept incurring losses on long term. In contrast, associated enterprise, which suffers losses, might stay in the business, if MNE group finds this situation beneficial for the whole group.

There are, however different types of losses, namely the commercial losses that are consequence of external circumstances or losses incurred due to internal non-arm's length pricing. Commercial losses can appear due to: start – up losses, business strategies (e.g. new product development, diversification, market penetration), economic downturn –

recession, foreign exchange losses or other reasons such as product specific losses, R&D failure, competition etc. (Jain, 2015, pp. 236–239).

But losses can as well arise from non-arm's length pricing within group of associated enterprises. In such case, it is possible that enterprise incurring losses, is not compensated appropriately from the MNE group in relation to benefits resulting from its activities. An independent enterprise would perform such loss making activities, only if compensation would be high enough. Therefore, one way to tackle this problem is to "deem the loss enterprise to receive the same type of service charge that an independent enterprise would receive under the arm's length principle." (OECD, 2017b, p. 81).

3.4 The effect of government policies

Next type of circumstances, in which the ALP should be adjusted, is for government policies, namely price controls, controls over payments for services or management fees, interest rate controls, controls over the payments of royalties, exchange controls, anti-dumping duties, or exchange rate policies (OECD, 2017b, p. 81).

Generally, these government interferences should be treated as situations of a certain market in a country and should be considered when evaluating transfer price of the taxpayer in that market. When government interventions are taken into consideration, the doubt presented is whether the transactions between associated enterprises are consistent with transactions between independent enterprises.

Firstly, it is important to determine the phase at which price controls affect prices of products or services. Here, it depends whether the impact will be on final price to customer or if the prices in earlier stages of supply of goods would be impacted. In this point, it is obvious that an independent enterprise would not produce or distribute a product under circumstances that would not allow any profit realization.

Next issue arises if country blocks payment owed by one associated enterprise to another (e.g. exchange controls could prohibit transaction of interest payments on loan made by an associated enterprise stationed in another country). If such intervention is applied to transactions among associated enterprises and transactions among independent enterprises, the procedure for tax purposes is the same in both cases. But when the intervention is applied only on transactions among associated enterprises, such situation should be viewed as circumstance affecting terms of transaction. The problem here, however is that independent enterprises would probably not engage in transactions where the country would impose intervention.

In both situations, a taxpayer should treat payments from associated enterprise in the same manner as payments from independent party (OECD, 2017b, pp. 82, 83).

3.5 Use of customs valuations

The ALP applies in order to compare value of goods imported by related parties, with value of goods imported by independent entities. This has to be done, because the related parties may have a relationship with different conditions imposed, which affects the price of goods imported. According to OECD TPG, the valuation methods for customs purposes may not be aligned with OECD's recognized methods. Namely, two tests are used for determining if transfer price is acceptable: "the "circumstances of sale" test to determine whether the relationship influenced the price, and the "test values" test which is used to determine whether the transaction value closely approximates one of three types of "test" values." (Ping & Silberztein, 2007).

The "circumstances of sale" test analyses the way in which the commercial relationship between seller and buyer is organized and the process of determining the price for the product in question. With these two steps, it is determined whether the relationship between seller and buyer has affected the price set for imported product.

The alternative "test value" is used for the same purpose. It compares the price of the product to three test values, namely:

- the transaction price of the same or similar product when sold by unrelated parties (in a country where the sale takes place);
- the so called "deductive value or computed value" for identical or similar product;
- these two values can be taken into consideration for comparison only if these prices relate to products that have been imported in certain country about the same time as the tested merchandise (U.S. Department of homeland security, 2007).

Taxpayers may be interested in setting low price for imported goods, so that customs duties imposed are lower. On the other hand, for tax purposes, the higher price paid would mean higher deductible costs in importing country (but also higher revenue realized in country of export). Therefore, the collaboration among income tax and customs administrations is becoming very important for evaluation of transfer prices, in order to reduce inappropriate customs valuations (OECD, 2017b, pp. 83, 84).

3.6 Location savings and other local market features

Another important aspect, noted in context of an ALP is that features of geographic area where a company operates, can affect the comparability and the prices in line with ALP. These issues may occur in connection with so called location savings - costs savings attributable to performing business in a particular market. There are two types of such savings, namely the location savings and other local market features.

Location savings enable companies to achieve better financial result when providing the same product as companies on other locations. These saving relate to costs of operations (lower real estate prices, lower cost of labour).

If location savings exist, they should be divided among associated enterprises regarding their contribution, which is determined in OECD TPG paragraphs 9.126–9.131. Generally, few things should be determined in connection to location savings in case that local comparables cannot be identified, namely whether location savings even exist, what is their amount, and are they retained by one member or more members of associated enterprises or are they passed on to unrelated parties. Adjustments should be based on analysis of relevant facts (functions performed, assets used, risks undertaken). If local market comparables are available for determination of arm's length prices, there is no need for adjustments for location savings.

Other local market features relate to other characteristics of geographic areas where goods are sold or produced. These characteristics are for example purchasing power of people there, product preferences, degree of competition, if the market is in expansion or contraction phase, country infrastructure, availability of personnel and so on. These features create advantages or disadvantages for companies operating there.

Therefore, as with location savings, also here the rule is that if local market comparables are not present, adjustments should be based on analysis of relevant facts. These are whether the advantage exists, what is decrease or increase in revenue in comparison to profits realized from comparables on other markets and degree to which these benefits and drawbacks are passed on independent costumers or suppliers. If local comparables are available for determination of arm's length prices, there is no need for adjustments for other market features (OECD, 2017b, pp. 84, 85).

3.7 Assembled workforce

Some businesses are beneficial due to employing unique and highly skilled workforce, which may affect the arm's length price for goods or services provided by this group of employees. In some cases, the transfer of assembled workforce may present savings for transferee, in the form of expenses of hiring and training new employees. However, in other cases, transfer of employees may cause lower flexibility and potential liabilities, in case of dismissal of workers.

If possible to determine benefits of assembled workforce in comparison to workforce of comparable transactions, the comparability adjustments should be made to assess the influence that assembled workforce has on prices for goods and services. It is important to note that this factor should be considered in cases, where transfer of employees, means

transfer of valuable intangibles and “know-how”. For example, if an employee from a company A, transferred to Company B possesses a certain “know-how”, which will now be available to company B. In such cases, the suitable price must be paid by company B for the right to operate with newly acquired intangibles (OECD TPG, 2017, pp. 88, 89).

As with other concepts, the issue of assembled workforce is understandable in theory, however it is very demanding to include it in determination of the ALP of prices, since a lot of factors need to be considered and additionally, it is hard to evaluate the intangible asset such as the “know-how” of workforce.

3.8 MNE group synergies

Lastly, comparability issues may occur because of presence of MNEs group synergies. Under certain circumstances, when being a part of MNEs group, a company can experience benefits from interactions that would generally not be available to comparably positioned enterprises.

These synergies are favourable to the whole group and can increase its consolidated profits. Generally, they arise from economies of scale, combined purchasing power, integration in communication or computer systems, higher capacity for borrowing funds etc. It can also happen that synergies are negative, if for example, the group is very big and complex and the companies face bureaucratic problems when performing transactions.

General rule here is that if the synergies among related companies are incidental (not consequence of deliberate actions for reaching synergies), such benefits do not have to be individually compensated or allocated between members of group. However, if the benefits are consequence of intentional moves to provide a member of group with certain advantage (or disadvantage), the nature, amount and how this advantage (or disadvantage) will be divided among MNEs of a group should be decided. The decision, whether synergies are incidental (appear only because certain company is a part of MNE group) or deliberately made, is determined with functional and comparability analysis (OECD TPG, 2017, pp. 89–92).

Rules regarding location savings and other local market features, assembled workforce and MNE group synergies, are part of 2017 revised OECD TPG where they are described more in detail. Even though these concepts are very hard to implement in practice, due to their complexity, it is important that they are constantly being studied and reviewed, so that steps are taken towards better approaches in determining ALP, and that at the same time it is being assured there is less room for tax avoidance.

4 METHODS FOR SETTING TRANSFER PRICES

Transfer pricing methods are used to “establish whether conditions imposed in the commercial or financial relations between associated enterprises are consistent with arm’s length principle.” (OECD, 2017b, p. 97).

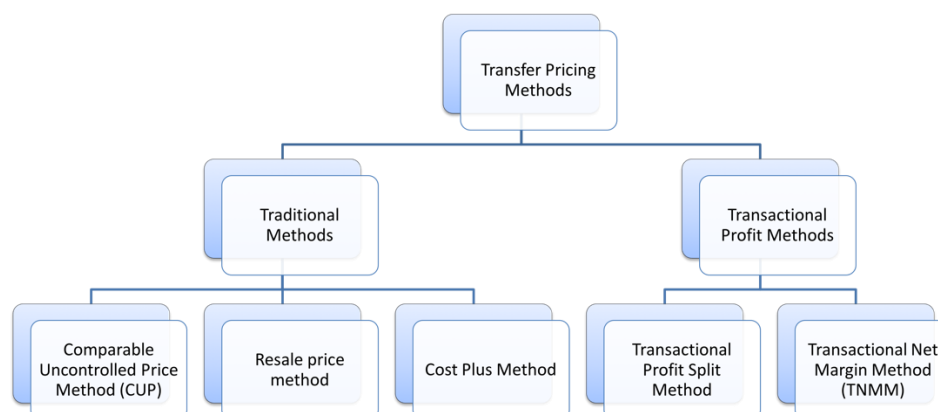
According to Slovenian legislation (which is in accordance with OECD TPG), the determination of a comparable market price should be carried out by using the most appropriate method according to the circumstances of the case. The most appropriate method for determining a comparable market price must be selected among the transfer pricing methods, which are specified in the fifth paragraph of Article 16 of the CITA and subject to the following criteria (Rules on transfer pricing, 2006):

- the advantages and disadvantages of each particular method;
- the suitability of each method according to the nature of the related transactions; determined on the basis of an analysis of the functions performed by each person in the related transaction (taking into account the assets used and the risks assumed);
- the availability of reliable data, required for the use of chosen method, and
- the degree of comparability between transactions among associated enterprises and transactions among independent enterprises and the reliability of adjustments.

Furthermore, legislation determines that internal comparisons are more appropriate than external comparisons (explained in continuation) and if a comparable market price can be determined with the same reliability using traditional transaction methods or transactional profit methods, the use of traditional transaction methods is preferred.

For greater clarity, the following Figure 1 hierarchically presents the transfer pricing methods:

Figure 1. Transfer pricing methods



Generally, the methods are sorted according to whether we compare the individual transactions and their prices (traditional transaction methods), or perform comparison among enterprises based on data regarding achieved profit (transactional profit methods).

4.1 Traditional transaction methods

Traditional transaction methods are supposed to be the most accurate when determining whether the financial and commercial relations among associated enterprises are at arm's length. This is due to the fact that differences in prices can be located directly to financial or commercial relations agreed between associated enterprises, and arm's length conditions can be determined by replacing price in transaction among related parties for the price in transaction between unrelated parties.

In some cases, where comparable transactions do not exist or are not sufficiently comparable, we need to use a more indirect approach to assess compliance and instead of prices, compare the gross margins achieved or mark up on costs incurred. Traditional transaction methods include:

- Comparable uncontrolled price method (referred to also as “CUP method”);
- Resale price method (referred to also as “RP method”);
- Cost plus method (referred to also as “CP method”).

4.1.1 Comparable uncontrolled price method

According to definition of OECD TPG (OECD, 2017b, p. 101), the CUP method “compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.”

If differences among prices are noticed, this might suggest that the ALP is not met in commercial and financial conditions, imposed between associated enterprises and that the price in the uncontrolled transaction may need to be substituted for the price in controlled transaction.

Two conditions have to be satisfied in order to be able to compare an uncontrolled transaction to a controlled transaction for the purpose of transfer pricing:

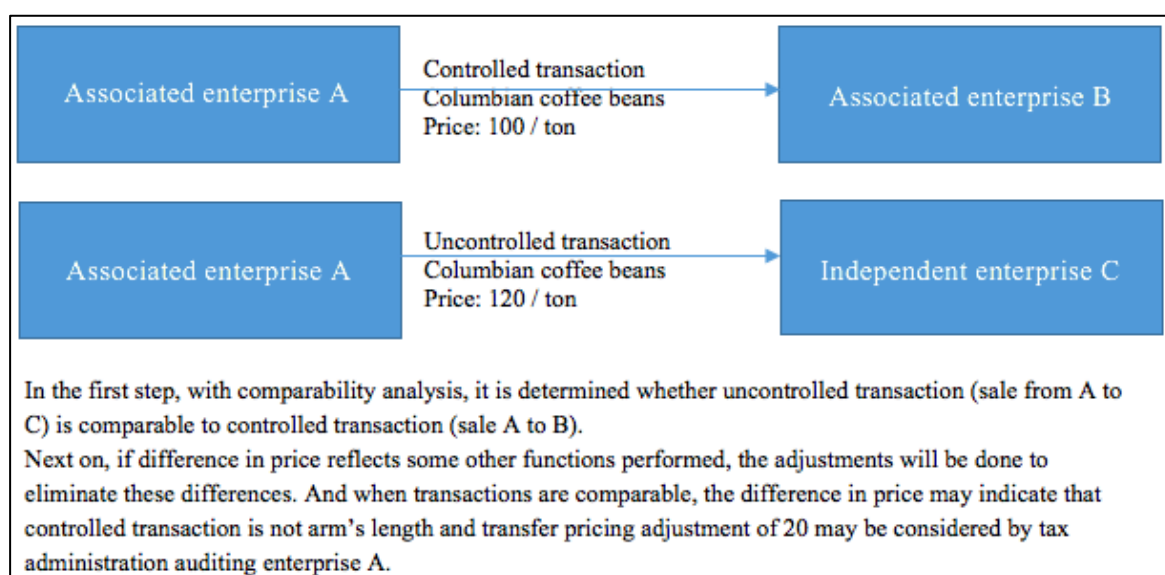
- None of the differences (if any) between transactions which are subject to comparison should not have a material impact on the price;
- If, however there are material effects of such differences, they should be eliminated with appropriate adjustments. Adjustments may be possible for differences concerning the source of the products, delivery terms, volume discounts, product

modifications, and risk incurred. Nevertheless, reliable adjustments may not be possible for trademarks and their effects on prices, effects of geographical differences, and significant product differences (United Nations, 2011).

The CUP method can be applied on the basis of “internal comparables” (which are the transactions between taxpayer and unrelated enterprises), or on the basis of “external comparables” (i.e. transactions between other unrelated enterprises).

Example of use of CUP method is presented in Figure 2:

Figure 2. Illustration of CUP method



Source: OECD, *Transfer pricing methods*, 2010, p. 3.

The application of this method is most appropriate when product comparability is high, since any difference in product, could materially affect the price of the transaction, and often it is not feasible to perform adjustments for that kind of differences in comparability. If internal comparables are not available, the CUP method is most useful for establishing an arm's length price for (OECD, 2010, p. 3):

- the sales of commodities which involve the same level of the business chain (e.g. sale to a secondary manufacturer, to a distributor, to a retailer, etc.), and
- some transactions which relate to financial field, for example money lending.

Also the market prices for these kinds of transactions (e.g. prices of commodities, interest rates) might be publicly accessible.

4.1.2 Resale price method

The resale price method, as is apparent from the name, starts with the price at which a product bought from a related party is then resold to an unrelated party. From this resale price, appropriate gross margin is subtracted, representing the amount, a reseller would demand in order to cover its operating expenses and regarding its functions provided, make an appropriate profit. This gross margin is determined with respect to gross margins from comparable uncontrolled transactions.

The remaining amount (when adjusted also for other costs), can be considered as arm's length price for the transfer of goods or services between related parties. "Thus, in a resale price method, the resale price margin (i.e. the gross margin) that the reseller earns from the controlled transaction is compared with the gross margin from comparable uncontrolled transactions." (OECD, 2010, p. 4).

Figure 3. Illustration of Resale price method

Sales price to independent customers	1,000	Tested in the resale price method; determined from uncontrolled comparables
Resale margin (i.e. gross margin) (e.g. 40%)	400	
Cost of goods sold: transfer price	(600)	(i.e. purchase price from associated enterprise)
Selling and other operating expenses	(300)	
Operating profit	100	

Source: OECD, *Transfer pricing methods*, 2010, p. 4.

As is evident from the Figure 3 above, the transfer price to associated enterprise is 600 units and represents the reduced price of a product charged to independent enterprises (1000 units).

This method is most suitable for applying to sales and marketing operations, usually carried out by a distributor or reseller. There are two ways to determine the resale price margin. The first one is with "internal comparable" meaning the resale price margin of the reseller in the transaction with related enterprises is set by reference to the price margin that the same reseller receives on items bought and sold in transactions performed with independent entities. And the second way is with "external comparables" (which is usually performed where dependable internal comparables are not available), meaning the resale price margin is defined based on the resale price margin received by independent entities in comparable uncontrolled transactions (OECD, 2010, p. 4).

Under resale price method, less product comparability is required, as with comparable uncontrolled price method, but of course higher comparability gives better results.

In case when reseller does not add significantly to the price of product, resale price margin is easiest to determine. If the products are further incorporated into more complex goods, or if reseller contributes substantially with including intangible property in creation of product, the resale price margin is harder to determine. It also depends if reseller has an exclusive right to resell the goods.

4.1.3 Cost plus method

Final traditional transaction method is the cost plus method. As evident from the name, this method starts with costs incurred by supplier of goods and services to associated enterprise and then appropriate mark-up is added, to result in proper profit, depending on functions performed. This mark-up can be again determined by “internal comparable” (same supplier earns in comparable uncontrolled transactions), or by “external comparable” (mark-up received in comparable transactions between independent enterprises).

Mark up in cost plus method is generally computed after deduction of direct and indirect costs and before subtraction of operating expenses (e.g. overheads). Therefore, in the cost plus method mark-ups on costs from controlled transactions are compared with those in comparable uncontrolled transactions.

In cost plus method (as well as with resale price method), less product comparability is required, than with CUP method, but of course higher comparability gives better results.

For better understanding, illustrative example is given in a Figure 4 below:

Figure 4. Cost plus method

Cost of raw materials	200	
Other direct and indirect production costs	100	
Total cost base	300	
Mark-up on costs (e.g. 20%)	60	Tested in the cost plus method; determined from uncontrolled comparables
Transfer price	360	(i.e. sale price to associated enterprise)
Overheads and other operating expenses	(40)	
Operating profit	20	

Source: OECD, *Transfer pricing methods*, 2010, p. 5.

It is most useful in following cases (OECD, 2010, p. 5):

- property sold by manufacturer or provider who does not undertake some special risks or contribute unique intangible assets (e.g. sale of semi-finished goods, long-term buy-and-supply agreements, provision of services).

The problems with this method are accurate determination of costs, application of comparable mark up to comparable cost basis and consistency in accounting (same type of costs should be used in each situation) (OECD, 2017b, pp. 111–115).

4.2 Transactional profit methods

In contrast to traditional transaction methods, transactional profit methods “examine the profits that arise from particular transactions among associated enterprises.” (OECD, 2017b, p. 117).

Profit realized in a particular transaction between related enterprises is a relevant indicator if conditions imposed for transactions between them differ from those that would be imposed by unrelated enterprises. In practice, transactional profit methods are used because there is a lack of publicly available benchmarking data with information on prices set in open-market comparable transactions (Hughes & Nicholls, 2010). Besides that, they are typically applied in cases when one of the parties involved in transaction uses valuable intangible assets and the proper return for the usage of this asset should be determined. (United Nations, 2011)

Transactional profit methods include:

- Transactional net margin method (referred to also as “TNMM”);
- Transactional profit split method (referred to also as “TPS method”).

4.2.1 Transactional net margin method

Transactional net margin method “examines a net profit indicator, i.e. a ratio of net profit relative to an appropriate base (e.g. costs, sales, assets), that a taxpayer realises from a controlled transaction (or from transactions that are appropriate to aggregate) with the net profit earned in comparable uncontrolled transactions.” (OECD, 2010, p. 6). Also in this method, the net profit indicator which resembles the ALP could be determined by internal or external comparables.

The net profit indicator weighted to costs is used when dealing with a production and service activity, and the net profit indicator weighted to sales when dealing with the companies involved in sales operations. The net profit indicator weighted to assets is used in asset-intensive activities (Bobek-Gospodarič, 2016b, p. 10).

Usually, “the net profit indicator that is tested in a TNMM is the operating profit (before interest, extraordinary items and income taxes).” (OECD, 2010, p. 6). Selected financial indicator should reveal the functions accomplished by the tested party and their value (i.e. the enterprise, included in transaction for which the financial indicator is tested), in a way that the value is determined in consideration of assets used and risks assumed. Furthermore, the financial indicator should be based on relevant data (for example, sale to independent parties), rather than on transactions performed among associated enterprises. Lastly, it should be reliable and consistent.

The illustration of TNMM method in comparison to cost plus method is presented in Figure 5 below.

Figure 5. Difference between cost plus method and a TNMM on an example

Cost of raw materials	200	
Other direct and indirect production costs	100	
Total cost base	300	
Mark-up on costs (e.g. 20% of costs)	60	Tested in a cost plus method
Transfer price	360	
Overheads and other operating expenses	(45)	Tested in a TNMM
Operating profit (e.g. 5% of costs)	15	

Source: OECD, *Transfer pricing methods*, 2010, p. 7.

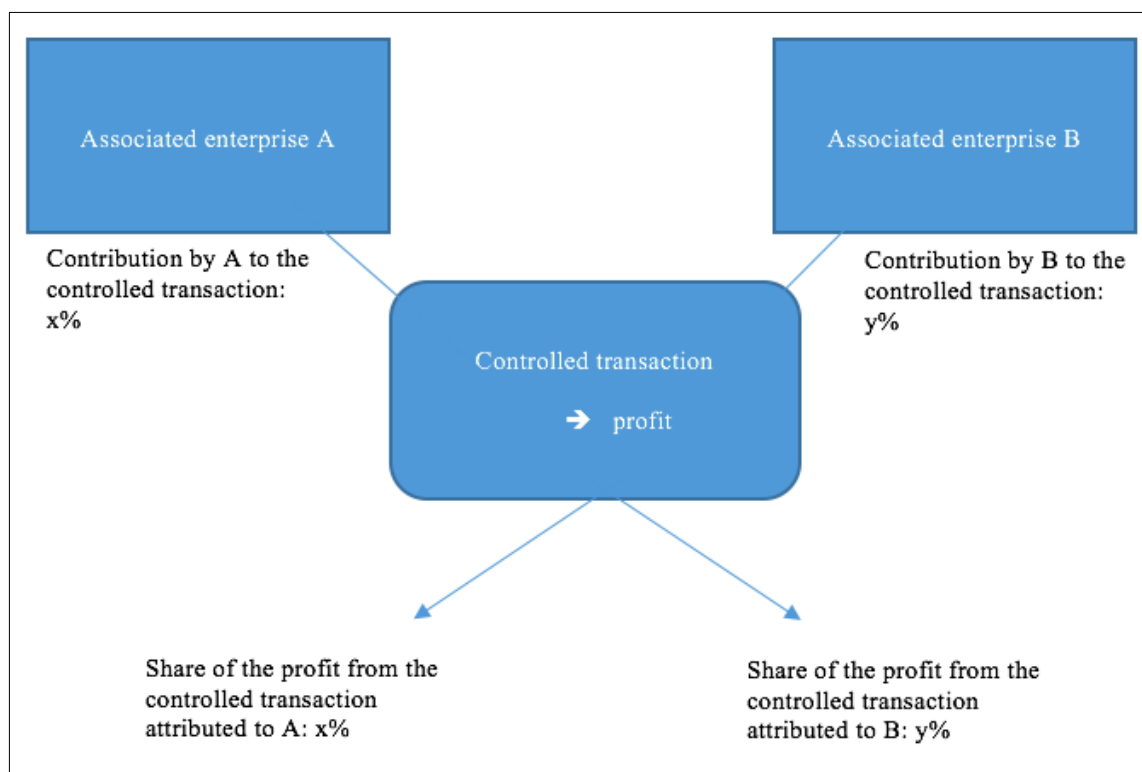
Normally, when TNMM is being applied, broader functional comparability is more important than the product comparability, since net profit margins are less affected by differences in products (OECD, 2010, p. 6). However, they could be affected by other factors, for example business strategies of companies, position on market, different cost structures, management productivity or the level of business experience (United Nations, 2011).

4.2.2 Transactional profit split method

The last method is transactional profit split method, which “identifies combined profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged.” (OECD, 2010, p. 8). These profits are then divided among related parties, in such manner that it approximates the division of profits which would occur between unrelated parties.

The illustration of transactional profit split method is given in a Figure 6 below.

Figure 6. Transactional profit split



Source: OECD, *Transfer pricing methods*, 2010, p. 8.

This method offers solution for highly integrated operations, where one-sided method would not be suitable, or for cases where both participants in transaction offer valuable and unique contributions. However, it is not used in cases when one party performs just simple functions, and does not contribute significantly.

If it is possible, the basis for this method should be acquired from external data (for example how profits were divided in uncontrolled joint venture agreement, although in majority of cases, it will be supported by internal data) (OECD, 2010; OECD, 2017b).

How the profits are split, should be based on contributions of the enterprises to the creation of revenues. Generally, there are two methods for allocation of profits between the parties involved in the transaction, namely the contribution analysis and residual analysis.

Under the contribution analysis, the combined profits from the controlled transactions are divided between related parties on the basis of the functions performed by them. This is performed with the help of external data, which reflect how independent enterprises allocate their profits depending on the circumstances of the case.

Under the residual analysis, there is a two-step approach used for allocation of the profits between related parties:

- In the first step, there is a portion of profit allocated to enterprises in order to compensate for their routine contributions. This amount is determined with the review of external data on comparable transactions and this part can be done with using traditional transaction methods.
- In second step, the residual profit is further distributed between related parties of MNE group (the profit that is still available after the first step).

This kind of approach is usually used in cases where valuable intangible assets are owned by all of the parties involved in the transaction, and the residual profit is distributed correspondingly to the value of their contributions (OECD, 2017a).

In practice, profit split method is least used due to its complexity, since the problem arises when measuring combined revenue and costs for all related parties. Furthermore, in many cases such transactions involve valuable intangibles which are hard to value, or the functions performed are very interrelated and it is therefore hard to determine the individual contributions of the parties involved.

4.3 Selection of the most appropriate transfer pricing method

In process of selecting the most appropriate transfer pricing method, the four criteria should be taken into account (OECD, 2017b, p. 97):

- Strengths and weaknesses of OECD transfer pricing methods;
- Appropriateness of method regarding the nature of the controlled transaction – determined through functional analysis;
- Accessibility and availability of trustworthy information (especially from uncontrolled comparables);
- Degree of comparability between controlled transactions and transactions among independent entities (uncontrolled).

In connection to the appropriateness of method regarding the nature of the controlled transaction, it is important to know which party is being tested in different methods.

In the Table 3 below, the methods with corresponding tested parties and financial indicators are presented:

Table 3. Tested parties and financial indicators

Method	Tested party	Financial indicator
Comparable uncontrolled price method	No tested party-the price of goods is compared	/
Cost plus method	Usually the seller or service provider	Mark-up on costs of the seller
Resale price method	Buyer (often distributor)	Resale margin (i.e. Gross margin)
Transactional net margin method	Seller or	Net profit on costs or net profit on assets
	Buyer	Net profit on sales
Transactional profit split method	Both	/

Source: Summarized and edited according to the OECD, *Transfer pricing methods*, 2010, p. 13.

In the transactional profit split method, both enterprises, involved in transaction are tested. Therefore, the transactional profit split method is known as a “two-sided method”, while the cost plus method, resale price method and TNMM are “one-sided methods” (OECD, 2010, p. 13).

Some of the strengths and weaknesses of transfer pricing methods are already mentioned above in descriptions of transfer pricing methods. In order to make it more legible, this chapter sums up main advantages and disadvantages of OECD transfer pricing methods.

Comparable uncontrolled price (CUP) - CUP method is the most accurate and reliable transfer pricing method to apply ALP and should be used whenever it is probable that data on comparable uncontrolled transactions are available. The advantage of this method is that there is no confusion in choosing which party to the transaction should be tested, since the prices of the products are compared (United Nations, 2011).

In practice, it is very hard to find so similar transactions between unrelated enterprises where there is no difference with material effect on price. However, if the adjustments are made, they distance the comparable uncontrolled price from what was agreed in the open market. For example, if two transactions of certain product are compared, with assumption that in one transaction, the seller has monopoly power, while in the other the purchaser has monopoly power, this can result in very different price for what seems the same transaction (Hughes & Nicholls, 2010).

So this method is useful when independent enterprise is selling the same product as two associated enterprises (e.g. commodities, such as coffee beans) and it is possible to be sure

that tested and uncontrolled transaction happened under comparable circumstances (OECD, 2010, p. 9).

Resale price method - This method is the most appropriate to be applied to marketing operations, which involve purchase and resale of tangible assets. There are fewer adjustments needed than in CUP method, because the difference in product does not have a material effect on gross profit margins (OECD, 2010, p. 10).

The problem here arises, if the reseller contributes significantly to creation of product with use of intangible property (e.g. licence, trademark). The presence of such intangibles may offer comparable entity higher level of profitability in comparison to companies who do not possess such intangibles (Bobek-Gospodarič, 2016b).

Besides that, the issue here appears if the accounting practices differ, in connection to ensuring that the same type of costs are used to determine gross margin.

Last problem here is when small differences in products lead to high differences in gross margins that companies earn. In case that a seller has to make great marketing efforts to sell certain product, it can be expected that he receives a higher gross margin to cover his selling costs (Hughes & Nicholls, 2010).

Cost plus method - This method is most appropriate for sales of semi-finished goods among associated enterprises, when joint facilities or long-term buy-and-supply agreements are concluded between related parties or when services are provided in controlled transaction.

The clear advantage of cost plus method is that it is simple to comprehend and easy to implement for most accounting systems, because once the mark-up is determined there is no need for complex determinations of profit allocations or margins (Hughes & Nicholls, 2010).

The companies in many cases use this method to set prices for internal, as well as external transactions.

As with the resale price method, less adjustments are required for product differences under the cost plus method than the CUP method in defining whether a transaction is a comparable uncontrolled transaction.

The problem of this method is proper determination of costs. Some companies may record costs under costs of goods sold, and other companies under operating expenses. To overcome this problem, some companies determine mark-ups based on total costs (meaning costs of goods sold plus operating expenses) (Hughes & Nicholls, 2010).

Another important aspect of comparability is accounting consistency, as is the case with resale price method (OECD, 2010).

Transactional net margin method - One plus of this method is that net profit indicators are less affected by transactional differences than the price (CUP method). They may as well be less affected by functional differences than gross profit margins (Resale price). Next on, financial data only for tested party should be examined, which is useful when data is hard to obtain or when one of the parties involved performs a lot of interconnected activities. Besides that, the data on net profits realized by comparable independent enterprises are more often publicly available, which makes TNMM easier to apply (Bobek-Gospodarič, 2016b, pp. 11, 12).

The weakness of this method is potential difficulty in acquiring reliable information of uncontrolled comparable transactions, which may not be available or a taxpayer may not have access to enough data. It can also be hard to determine whether comparable companies are truly comparable to tested party (Hughes & Nicholls, 2010). Next problem is determining revenue and operating expenses to establish net indicators taken as profit measure. There is also a problem of adjusting profits for appliance of TNNM (OECD, 2017b, pp. 117–120).

Transactional profit split method - Key advantage of this method is that it is the only one of the methods that offers solution for highly integrated operations, where one-sided method cannot be applied.

Next on, it is the most appropriate when both sides included in transaction provide valuable contributions, but would not be used when one party provides simple functions to transaction.

Furthermore, under this method, both parties are examined, which delivers better outcomes regarding profit results, and besides that, the allocation of profits may be based more on division of functions (considering risks undertaken and assets used) within associated enterprises than on external data.

The drawback of this method is its application. It can be hard to gather data from foreign members of MNE group, and it can be difficult to measure joint profits and costs of all associated enterprises (OECD, 2017b, pp. 133–136). Firstly, profits are sometimes the result of operations performed many years ago, and secondly, by including all costs in profit to be shared gives chance to some participants to transfer costs (which may be result of their failure) to others (Hughes & Nicholls, 2010).

For the conclusion on transfer pricing methods, in Figure 7 below, there is an illustration of the selection of most appropriate method, depending on a situation (OECD, 2010, p. 16).

Figure 7. Illustration of the selection of most appropriate TP method

If CUP and another method can be applied in an equally reliable manner.	→ CUP	
If not		
Where one party to the transaction performs “benchmarkable” functions (e.g. manufacturing, distribution, services for which comparables exist) and does not make any valuable, unique contribution (in particular does not contribute a unique, valuable intangible)	→ One sided method → Choice of the tested party (seller or purchaser): generally, the one that has the less complex functional analysis	
If tested party is the seller (e.g. contract manufacturing or provision of services)	→ Cost plus → Cost-based TNMM (i.e. testing the net profit / costs) → Asset-based TNMM (i.e. testing the net profit / assets)	➤ If cost plus and TNMM can be applied in an equally reliable manner: cost plus.
If tested party is the buyer (e.g. marketing / distribution)	→ Resale price → Sales based TNMM (i.e. testing the net profit/sales)	➤ If resale price and TNMM can be applied in an equally reliable manner: resale price.
Where each of the parties makes valuable, unique contributions to the controlled transaction (e.g. contributes valuable unique intangibles)	→ Two-sided method ○ Transactional profit split	
MNEs retain the freedom to use “other methods” not listed above, provided they satisfy the arm’s length principle. In such cases, the rejection of the above described methods and selection of an “other method” should be justified.	→ Other methods	

Source: OECD, *Transfer pricing methods*, 2010, p.16.

In relation to the last row, mentioning “other methods”, it should be noted that CITA, which is valid in Slovenia after 2007 deleted this provision, which means that use of other methods in Slovenian legislation is no longer allowed.

4.4 Use of more than one method

According to OECD TPG, there is no need for a taxpayer to perform analysis under more than one method, because this could create additional burden. Where the selection of one method is not straightforward, and there are more methods considered, it is advisable to choose the one method that provides the best estimation of arm's length price. However, in cases when it is not possible to arrive at satisfactory results with one method, flexible approach is allowed, with evidence of various methods used in combination. In such situation, the arm's length price has to satisfy practical viewpoint of all parties involved, considering facts and circumstances of the situation, available evidence and dependability of methods used (OECD TPG, 2017, p. 100).

5 ISSUES RELATED TO TRANSFER PRICING

After examining and studying literature regarding transfer pricing, this chapter is intended to provide an answer to research question, raised in the beginning of this master's thesis:

- What are the challenges and issues identified in dealing with transfer pricing?

According to United Nations (2017, pp. 27–29), the problems regarding transfer pricing are divided into two categories. The first one is **basic** issues underlying transfer pricing, namely jurisdictional issues, allocation issues and valuation issues. The main reason for the emergence of these issues is that MNE groups are trying to avoid or minimize their worldwide taxation, through different practices.

The second category of issues is **special** issues, which refers to transfer pricing issues connected to documentation requirements, business restructuring, cost-contribution agreements and use of “secret” comparables.

The main jurisdictional issue is profit shifting from countries charging higher taxes, to countries with lower tax obligations, through non-arm's length transfer pricing. Profit shifting is the process where companies transfer profits from their subsidiaries where the economic activity is performed, to other subsidiary companies operating in lower-tax countries. This is usually achieved by the MNE group, organizing an internal trade through which they exploit international tax rules, to move taxable profits between different jurisdictions (Turner, 2017). If such transactions are performed legally, but in contrast to the purpose of legislation, this can be addressed as aggressive tax planning. It is a relatively new concept, which has developed due to more and more sophisticated tax-planning structures where the major international tax-consulting companies have played an important role undoubtedly (Bobek-Gospodarič, 2016a, p. 71). This problem is tackled by BEPS Actions, OECD TPG and by measures of national legislation of countries, participating in the field of transfer pricing.

The next jurisdictional issue is related to question which of the governments engaged in transactions between associated enterprises of a MNE group should tax the income, and how should they “divide it”. This issue is mitigated with signing international agreements on the avoidance of double taxation of income and wealth, which eliminate tax obstacles to international trade and investment and reduce the possibility of tax evasion (Slovenia has signed treaties with 59 countries as of year 2018).

International treaties, through various mechanisms, enable the elimination of double taxation, increase the security of taxpayers and, through the information exchange mechanisms, enable the control of income received by foreigners. Furthermore, they prevent tax discrimination and facilitate the settlement of fiscal disputes. Such bilateral tax agreements are the most important part of the international legal tax framework in the field of direct taxes of multinational enterprises operating in several countries. Equally important sources of international tax law are the European Union directives implemented in national tax legislation, especially in the area of related companies from different EU Member States. In accordance with the adopted OECD TPG, however, it is necessary to use the so-called arm’s length prices for all transactions among associated enterprises.

Finally, yet very importantly, is the issue of exploitation of tax benefits (e.g. tax loss carried forward) connected to jurisdictions of countries. The “tax loss carry forward” means that the company can use realized tax losses to avoid the taxation in future. For example, in Slovenia, according to Article 36 of CITA, under certain circumstances tax losses can be carried forward for indefinite period, and each year, 50 % of taxable profit can be reduced with accumulated loss from previous periods. In some cases, an international enterprise takes advantage of an associated company’s tax losses before they shut down, in circumstances where losses can be carried forward for a certain number of years. Therefore, it artificially lowers its tax obligation.

Second category of basic transfer pricing issues are allocation issues. The MNE groups around the world are trying to allocate their resources with maximum efficiency and in the most optimal way, in order to operate profitably. Trade or taxation barriers increase transaction costs of MNEs and at the same time cause distortion in allocation of resources. On the other side, governments are trying to allocate costs and income from the MNEs’ resources to determine the tax to be paid. This can consequently lead to a dispute between countries in the allocation of costs and resources, in relation to their goal of maximizing the tax base in their respective jurisdictions.

Next problem arises with allocation of common resources, which represent a basis of competitive advantage to an MNE, namely intangibles and service-related intra-group transactions, and are hardly separated from the revenue of the MNE’s group members for tax purposes.

Third category of basic issues, related to transfer pricing are valuation issues. The fundamental issue here is how to value intra-company transfers, since it is hard to determine, whether the prices set in a group of associated enterprises are the same, as independent parties would negotiate. This is mainly issue with intangibles and services, which are often hard to value, due to their uniqueness, individuality and exceptionality. This issue is further discussed under special issues.

In addition to above described issues, there is another category of problems connected to transfer pricing, so-called special issues. The one that can pose a huge pressure to MNEs, is the documentation requirements. This represents a problem because, if demanded too broadly, it can put high burden on a taxpayer, causing him very high costs in exchange for information required. If the country is viewed as being extremely demanding regarding documentation provided by MNEs, this may negatively affect the foreign investment into it.

The solution for this issue is uniform documentation standard. This was done in 2015, when the OECD/G20 BEPS Project released guidance on a standardized three-tier approach to transfer pricing documentation (this refers to aforementioned and described Master file, Local file and Country-by-Country reports) (United Nations, 2017, pp. 41–43).

Next issue, already mentioned in category of valuation issues is issue with valuing and determining ALP in case of intangibles. According to Slovenian accounting standards (The Slovenian Institute of Auditors, 2016), intangible asset is an identifiable non-monetary asset, usually without physical substance. Usually, it appears as an intangible long-term asset. In OECD TPG (OECD, 2017b, p. 252) they are divided into two categories. The first one is “trade intangibles” which include patents, know-how, designs, rights (e.g. computer software) and models, used for production of goods. The second one is “marketing intangibles” and includes trademarks, trade names, customer lists, distribution channels etc. The problem of transfer pricing connected to trading with intangibles, is that firstly, it should be determined whether the trade with intangibles happened at all, and besides that, it is hard to value and compare them due to their uniqueness. Furthermore, from tax perspective very important issue is the legal and economic ownership of intangibles and the compensations that parties involved in transaction receive in relation to respective intangible asset. These problems and solutions are tackled by BEPS Action plan, namely Action 8 (United Nations, 2017, pp. 27–29) and very comprehensive Chapter VI of OECD TPG (OECD, 2017b, pp. 247–318).

Following issue, also mentioned in category of valuation issues, is intra-group services. There are three main issues connected to intra-group services, which are very similar to issues with intangibles. The first one is whether the service has actually been provided in the group of related enterprises, the second one is how to value the service provided (what

the intra-group charge for these services should be according to ALP), and the last one is whether the service provided brings economic benefits to the recipient. The instructions on how to proceed in such cases are described in Chapter VII of OECD TPG (OECD, 2017b, pp. 319–344). However, it is important to treat each transaction subject to tax audit individually.

Next special issue is represented by business restructurings, which is considered as “cross-border redeployment of functions, assets and risks to which a profit/loss potential may be attached.” (United Nations, 2017, p. 45). The main problem here is whether the reallocation of profits, and more generally the whole process of restructuring follows the ALP. The fact that the enterprises undertake business restructurings to achieve business synergies at a group level, does not answer question whether the ALP is met from the viewpoint of each of the restructured entities. This is covered in Chapter IX of OECD TPG (OECD, 2017, pp. 365–411).

Next problem is connected to so called cost-contribution agreements (CCAs) which are agreed among associated enterprises to mutually develop, produce or obtain rights, assets or services. Each of the parties involved, takes on a portion of the costs and in return is expected to obtain proportionate share of benefits without payment from developed property. The problem here appears, when the “contributions of the participants are inconsistent with their share of expected benefits.” (United Nations, 2017, p. 47). The CCAs issues are covered in Chapter VIII of OECD TPG (OECD, 2017b, pp. 345–364).

The last issue connected to transfer pricing is so called use of “secret” comparables and it refers to the usage of information about a taxpayer by the tax authorities in order to assess the potential risk or perform transfer pricing audit of another taxpayer. That second taxpayer does not receive the access to that information, since it may reveal confidential information about a competitor’s operations. The use of secret comparables is argumentative, but in practice, there is a difference if they are used for the purpose of risk assessment (to evaluate the possibility of performing tax audit) or if they are used for making adjustments of transfer pricing. It is argued that using the secret comparables for adjustment of transfer pricing is in principle unfair, unless if data are shown to the taxpayers affected in this process taking into the account the confidentiality, so that they are able to defend themselves in case if the adjustments are needed (United Nations, 2017, p. 48).

The rules and guidelines imposed by countries and international associations are clearly essential for countries to protect their tax base, remove double taxation and to increase cross-border trade. In transfer pricing, as in every legislative practice, referring to such a global context, there are many issues that need to be removed or at least further reduced, so that the companies, tax jurisdictions and, at the end, also countries will develop in right and fair manner.

This chapter has provided the answer to my research question regarding issues in transfer pricing. It is difficult to determine which of the problems represents the biggest “danger” to tax authorities and countries in general, but I think that they could all be threatening if the countries did not work on reducing them. However, I believe that, in addition to the listed problems, there exist many of those that have not yet been discovered and sanctioned by the states, due to the complexity of this field and bureaucratic restraints. Therefore, I think it is important that countries deal with these problems and their solutions, since preventive actions are always better than curative ones.

6 TRANSFER PRICES IN A SELECTED COMPANY

Second part of master’s thesis is devoted to practical example of disclosure and adequacy of transfer pricing in a selected company.

Since the data exposed in continuation are confidential in nature, the company is anonymized and referred to as the “Company”.

The Company is part of the complex group of associated enterprises, however, in order to display the transfer pricing procedure, only three companies are taken into consideration, i.e. the companies that are included in transactions with Slovenian subsidiary (the Company).

Therefore, the following abbreviations are used for better understanding and transparency for the purpose of this master’s thesis:

- Parent company, originating from Germany is referred to as the “Parent”;
- Subsidiary company acting as subscriber for services from the Company, referred to as the “Buyer”.

Data, provided in this part of master’s thesis are internally acquired.

The aim of this part is to turn theory described in the first segment of master’s thesis, into practice, in order to be able to understand the topic more thoroughly.

The analysis is prepared for year 2015, for which I was able to gather necessary documentation.

The purpose of this part of master’s thesis is to:

- identify all significant transactions carried out between the company and its associated enterprises;

- perform an analysis of the comparability of the functions performed, the assets employed and the risks undertaken for the most significant transactions identified;
- define the method used for testing the transfer prices for each identified transaction and
- establish a comparable market price for identified transactions.

The transfer pricing documentation in this master's thesis was prepared in accordance with Article 382 of TPA, Articles 16-19 of CITA, the Rules on transfer pricing and the OECD TPG.

6.1 Presentation of a selected company

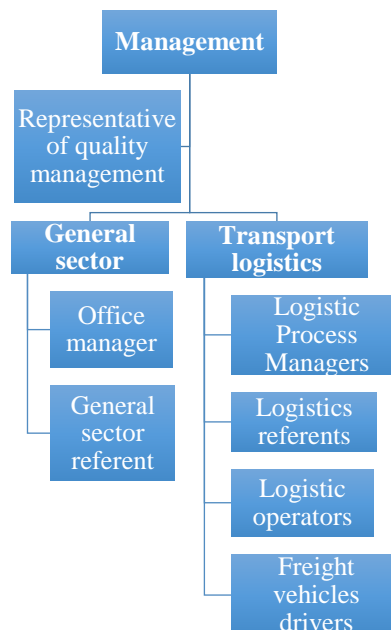
The Company has been registered in Slovenian Business Register on 8.5.1997. It is run by Slovenian director and is in 100 % ownership of Parent company, which has its headquarters located in Germany. In accordance with the Companies Act, Company is a limited liability and micro-capital company. The Company is an agency offering and organizing logistics services for the transport of vehicles and is considered as a driving force for the development of automotive logistics.

The main activities of the AEO-certified forwarding Company are:

- Processing of export and import vehicles
- Purchase of capacity for freight vehicles
- Customs clearance
- Organization of storage areas
- Organization of further transportation
- Container handling
- Transport coordination by truck, ship, and rail
- Other logistics services tailored to the individual needs of customers
- Coordination services
- Ship-owner's agent
- Railroad agency
- Fiscal representation
- Organization of technical services (vehicle maintenance, repairs ...)

In business year 2015, the Company employed 20 people on average in terms of working hours. In 2015, the Company did not have seconded workers to or outside Slovenia.

Figure 8. Organizational structure of the Company



Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for the Company* (internal material).

The Table 4 below presents important business categories of the Company for business years 2011 to 2015.

Table 4. Overview of the company's operations for period 2011-2015 (in EUR)¹

Categories	2011	2012	2013	2014	2015
Assets	296,036	372,674	257,866	410,918	368,925
Capital	93,784	155,783	159,759	201,148	221,225
Revenues	1,240,683	1,172,343	1,284,926	1,311,902	1,491,381
Operating profit / EBIT	44,831	83,881	75,906	55,227	33,016
Net profit / loss	29,023	62,001	60,124	41,389	20,078

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

6.2 Taxes

The Company has a tax period equal to a calendar year. In 2015, the Company has achieved a tax base of EUR 31,484.72 and tax liabilities of EUR 5,352.40 (calculated at 17 %, which was tax rate at that time) and had no uncovered tax loss.

¹ To ensure anonymity, the numbers are covered in a way that they are all multiplied by the same factor.

In the corporate income tax return for business year 2015, the Company did not adjust the tax base (increased revenues or reduced expenses) due to transactions with associated enterprises.

6.3 Market conditions and competitors

The Company is specialized in the field of motor transport as a provider of logistics services. The automotive logistics industry includes processing, storage, transportation, logistics and technical services. Globalization in terms of procurement, production and distribution of goods has led to an increasing international division of labour, which has a direct impact on the global logistics market, which is growing faster than the world economy itself. Automotive logistics is heavily dependent on the development of automobile imports and exports or the development of the automotive industry itself. Since 2011, the automotive industry is still growing, of which the Slovenian automotive logistics industry also benefits. For the Company, there are important markets for the **logistics of finished cars** and **contract logistics services**. Both markets are characterized by strong price competition.

An important factor in the development of the entire group of associated enterprises is globalization, which is further responsible for the increase in international division of labour in the field of procurement, production and sales of products and goods. This is reflected in the fact that annual growth rates in the global logistics market are significantly higher than the global economy.

However, there are also some significant challenges identified, in connection to logistics business, namely demographic development, availability of highly qualified personnel, investments in infrastructure and consequences of energy-political changes. The main factors for the further development of industry are increasing demands of customers in terms of efficiency and quality and ensuring sustainable goals. Moreover, due to innovative and modern techniques of communication, also consumer behaviour is changing as well as costs and margin pressures, which leads to the need for further process improvements and costs reduction. Key drivers of profitability in the industry are process optimization and low fundamental costs.

The Company faces the following risks in the business:

- demographic changes and, consequently, constraints on access to a well-educated personnel;
- cost pressures;
- increased demand for performance and durability; and
- changes in consumers' behaviour due to new communication systems.

Buyers - the only buyer of the company is an associated enterprise from Germany, hereinafter referred as the “Buyer”.

Suppliers - Most important supplier of the Company is joint stock company Port of Koper, which represents an 80 % share in terms of turnover. Other important suppliers are hauliers and other suppliers to support the administration.

Price policy - The Company is briefly involved only in the design and implementation of its business policy. The price policy is defined at the group level. In accordance with the Agreement, the Buyer has to pay a monthly lump sum to the Company, for services provided. The amount of the lump sum is calculated for each calendar year based on planned costs of the Company.

In case that the actual costs in a given period deviate from the planned costs for the percentage specified in the respective contract, the Company issues an invoice / credit note. In year 2015, the Company has issued a credit note in amount of EUR 36,000.

Key competitors - The Company has four main competitors in Slovenia in field of forwarding and transport services.

Since these competitors operate within international groups, they cannot be considered for the purposes of assessing transfer-pricing adequacy of analysed Company. The reason for this is that comparison among prices should be made with independent companies in comparable circumstances, so the price charged in a transaction is determined in open market, not within a group of companies.

6.4 Transactions between associated enterprises

In Table 5 below are shown the main transactions among associated enterprises in year 2015.

Table 5. Major transactions with associated enterprises in 2015

Type of transaction	Beneficiary	Supplier	2014 in EUR	2015 in EUR
Intermediary services	The Buyer	The Company	1,164,134	1,323,000
Advisory services - IT	The Company	Parent company	n.a.	n.a.

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

In the year 2015, the Company operated only with the associated company Buyer, while there were no transactions with Parent company.

According to data provided, there are imposed contractual terms for calculation of provision of advisory services-IT, however, there is no transaction recorded. From the perspective of Slovenian tax authority, this does not present any issue, since the Company is in position to pay (they are beneficiary), which means that if they are not paying services, they are not lowering their tax base.

On the other hand, this could be a problem if the Company would be a supplier of the services, for which they would not receive compensation, meaning their tax base would be lower.

Business transactions with associated enterprises in relation to the income achieved are shown in the following table.

Table 6. Volume of related party transactions in business year 2015 compared to 2014

Business transactions with associated enterprises			
in EUR	2014	2015	% change
Net sales	1,164,294	1,323,000	13.63%
Sales - associated enterprises	1,164,134	1,323,000	13.65%
Sales - Revenue - unrelated enterprises	160	0	0.00%
Operating expenses (labour costs, write-offs and depreciation are not included)	328,533	479,000	45.80%
Operating expenses - associated	n.a.	n.a.	n.a.
Operating expenses - unrelated	n.a.	n.a.	n.a.

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

The main types of transactions between associated enterprises in year 2015 are given in tables below.

Table 7. Types of sales transactions with associated enterprises in year 2015

Services sold to associated enterprises - consolidated on the basis of the type of service	Associated enterprise	Amount in EUR	Description of the calculated price	Transfer pricing method used
Intermediary services (logistics services, customs offices and other agencies)	Buyer	Approximately 1,300,000	The basis is the planned costs; Annual adjustments if the differences > 5%	Cost plus method, mark up 3%

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

The cost plus method with mark-up of 3 % is used for determination of prices charged to Buyer for the intermediary services provided.

Table 8. Types of purchasing transactions with associated enterprises in 2015

Services purchased by associated enterprises - consolidated on the basis of the type of service	Associated enterprise	Description of the calculated price	Transfer pricing method used
Advisory services - Contract for IT services for an unlimited period. Starting on 1.1.2012.	Parent company	The price is calculated according to the total IT costs of Parent company. The share of Company depends on the number of users and is changed annually.	Division of costs between Parent company and Company

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

The method, according to which the prices are charged for advisory IT services by Parent company are determined on the basis of division of costs between Parent company and Company. In analysed period, there were no transactions with respect to advisory IT services.

6.5 Functional analysis

The analysis presented in continuation describes the economically essential functions performed by companies in purchasing and sales transactions, an overview of the risks to which companies are exposed and the assets used or needed by companies to carry out their functions.

Functional analysis is therefore an important tool for defining and organizing facts about a business. It identifies how the activities performed by MNEs are divided between each member involved in the examined transaction, for which respective enterprises should be rewarded. This analysis forms the basis and provides a framework for comparability study intended for applying ALP and subsequently for determination of the most appropriate transfer pricing method (Bansal, 2014).

As evident from the Table 9 below, the main functions borne by the Company are acquisition of customers, invoicing, sales and distribution, administrative, legal and financial function, and administration services.

Table 9. Functions borne by companies included in the transaction in 2015

Functions	The Company	Parent company	Buyer company
Acquisition of customers	**	**	**
Determination of prices for services	-	**	**
Invoicing	**	*	*
Marketing and promotion activities	-	-	**
Sales and distribution	**	**	**
Guarantees for quality of provided services	-	***	***
Administrative function	*	*	*
Legal function	**	**	**
Financial function	**	**	**
Administration services	**	**	**

Legend - key to symbols to be used

Symbol	Comparative Functional Level Standards
-	No functions.
*	Least functions.
**	Lesser functions.
***	Highest functions.

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

Furthermore, the Table 10 below presents the risks undertaken by the Company and as can be observed from the respective table, the Company does not bear any risks.

Table 10. Risks undertaken by companies involved in the transactions in 2015

Risks	The Company	Parent company	Buyer company
Market and price risk	-	**	**
Risk of preoccupied capacities	-	**	**
Investment risk	-	**	**
Warranty risk	-	**	**
Risk of poorly performed services by subcontractors	-	**	**
Damage to personal vehicles	-	**	**
Exchange rate risk	-	**	**
Risk of default	-	**	**

Legend - key to symbols to be used

Symbol	Comparative Risk Level Standards
-	No risk exposure.
*	Lowest risk exposure.
**	Medium risk exposure.
***	Highest risk exposure.

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

And finally, from Table 11 below, it can be observed that the main assets employed by the Company for performing its operations successfully are trademarks, land and buildings, other devices and equipment and employees.

Table 11. Assets employed by companies involved in the transactions in 2015

Assets	The Company	Parent company	Buyer company
Intangible assets			
Trademarks	**	**	**
Tangible assets			
Land and buildings	***	***	***
Other devices and equipment	***	***	***
Employees	**	**	**

Legend - key to symbols to be used

Symbol	Comparative Assets Employed
-	No assets employed.
*	Least assets employed.
**	Medium assets employed.
***	Highest assets employed.

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

6.6 Economic analysis

6.6.1 Choice of a transfer pricing method

This chapter is devoted to analysis of the possibilities of using the transfer pricing method in transport and logistics.

Comparable uncontrolled price method (CUP) - The comparable uncontrolled price method compares the absolute price charged for the service in the transaction and the price charged in a comparable transaction between unrelated parties in comparable circumstances. When analysing the possibility of using the CUP method, both the internal and the external comparables must be taken into account.

External comparison - The Company carries out a specific car logistics service, so it is not possible to find completely comparable services on the market between unrelated parties and, in addition, there are no standardized price lists for their services on the market. Therefore, it is not possible to use an external comparables in the CUP method to determine the relevance of transfer pricing.

Internal comparison - The Company does not provide similar services to unrelated parties (or purchases similar services from unrelated parties), therefore, it is not possible to use an internal comparison of the CUP method to determine the relevance of transfer pricing.

Due to constraints described above, the CUP method cannot be used to prove the adequacy of transfer pricing in transport and logistics transactions neither in internal nor external version.

Resale price method - In cases where a transfer price cannot be determined based on a CUP method, the resale price method shall be used. It is usually used to determine transfer pricing in transactions where assets purchased from an associated enterprise are resold to an independent entity. Since the car logistics service is not such case, the resale price method was not considered appropriate.

Cost plus method - Cost plus method is the last of the traditional transaction methods and is used in cases where the transfer prices cannot be determined based on the aforementioned methods. According to OECD TPG, it is the most appropriate method for determining the market prices of services. The cost plus method is derived from the costs of the supplier of services related to the transaction, covering both direct and indirect expenses associated with the transaction. The company then adds appropriate mark-up on this cost.

Given that there is no available data for comparable services, the described method was not applied for testing purposes.

Transactional profit split method - Transactional profit split method identifies profits/losses to be split among associated enterprises in controlled transactions, in which they participate.

In case of a selected Company, this method is straightaway excluded, because it offers solution for companies that are highly integrated in their operations or if both parties included in a transaction make unique contributions, which here is not a case.

Transactional net margin method (“TNNM”) - TNNM method compares net profit earned from a controlled transaction (among associated enterprises) with the net profit earned in comparable uncontrolled transactions (between independent enterprises).

The basis for a TNNM may be costs, sales, assets or other accounting categories. The net profit margin method therefore works in a similar way as cost plus method or the resale price method.

One of the advantages of this method is that the differences in transactions have less impact on the levels of net profit than on the price, which is used under CUP method. Net

profitability of sales is therefore not as sensitive to functional differences between transactions among associated enterprises and transactions between independent parties, as profitability of sales. By using available databases, this method in practice represents the most common way of determining the arm's length of transactions between associated enterprises.

In general, the method can be used with different indicators. The indicator must reflect the primary activity (and therefore the profitability on the market). In the case of selected Company, the TNMM method is used.

6.6.2 Comparability analysis

Methodology - With the help of the Amadeus database and web resources, the companies that carry out forwarding and logistics activities were identified. Amadeus is an online database that contains comprehensive information on around 21 million companies across Europe. It can be used to research individual companies, companies with specific profiles and it provides different types of analysis. It is European subset of ORBIS database, which is provided by Bureau van Dijk. Orbis database covers detailed and comparable information on nearly 250 million companies globally (Leitner + Leitner d. o. o., Transfer pricing – Use of database studies on the basis of Amadeus (interno gradivo), 2009)

In further step, the economic analysis and selected criteria, which is described below were considered. The data were available up to year 2013, therefore the analysis was done with data from 2011-2013.

Choice of comparable data - In the search for comparable companies, the following criteria was used:

- the legal status of the company;
- type of activity (NACE Codes);
- words contained in the description of the activity;
- independence criterion (ownership);
- independence criterion (subsidiaries);
- types of financial data;
- availability of financial data;
- year of incorporation;
- geographic criterion;
- operating profit or loss (EBIT);
- total assets of the company.

Legal status of the company - Only active companies are selected (companies that are not liquidated and have not ceased their business activities), as well as companies with unknown activity status. In this way, companies that have ceased their business activity are eliminated from the sample.

Following this criteria, 3,181,898 potentially comparable companies are identified.

NACE (Nomenclature generale des activites economiques dans les communautes Europeennes) Codes - NACE Rev. 2 (statistical classification of economic activities in the European Community) was selected for the purpose of the analysis. This decision is justified by the fact that NACE Rev. 2. statistical code numbers are the same in the countries of the European Union, which allows the same search based on the type of activity.

In relation to forwarding, logistics and transport services, the following codes are selected (European Commission, 2008):

- 52.29 - Other transportation support activities
- 49.20 - Freight rail transport
- 49.41 - Freight transport by road
- 50.20 - Sea and coastal freight water transport
- 52.10 - Warehousing and storage
- 52.21 - Service activities incidental to land transportation
- 52.22 - Service activities incidental to water transportation
- 52.24 - Cargo handling

After applying this criterion, 3,126,769 companies are excluded. Therefore, there are 55,129 potentially comparable companies left in the sample.

The words contained in the description of the activity - In the description of the activities of individual companies, following words are determined for search purposes: "cars", "carriage", "logistics", "transport", "distribution" and "agent".

After applying this criterion, 6 companies are excluded, meaning there are still 55,123 potentially comparable companies.

Independence criterion (ownership) - In order to ensure that the results derived represent ALP, it is important to eliminate those potentially comparable companies, which are part of groups, meaning they are not independent, to ensure that the final set of companies does not include controlled transactions. Therefore, only those companies that have less than 25 % of direct or complete ownership by a single shareholder in the company (Category A +, A, A -) can be selected.

After applying this criterion, 53,262 companies are excluded, so there are 1,861 potentially comparable companies available.

Independence criterion (subsidiaries) - Companies without subsidiaries are chosen, to ensure independence.

After applying this criterion 659 companies are excluded and there are 1,202 potentially comparable companies.

Types of financial data - Companies that have unconsolidated statements are selected for better comparison.

Following this criterion, 91 companies are excluded and 1,111 potentially comparable companies are available.

Availability of financial data - Companies with available data for years 2011, 2012 and 2013 were chosen in order to be able to calculate weighted average of operating margins and to eliminate influence of fluctuations in a particular year on the final result.

After applying this criterion, 466 companies are excluded. There are 645 potentially comparable companies left available.

Year of incorporation - Due to the fact, that companies who start their business operations may have large fluctuations in business results in initial phase of operating, only companies that were established before or in 2011, and companies whose year of establishment is unknown are selected for the sample (to avoid start-ups having an impact on the final results of the research).

With this criterion, 20 companies are excluded and 625 potentially comparable companies are available.

Geographic criterion - This criterion is used to include companies, which operate in similar economic conditions as the companies in the tested transaction. Selection included companies in the European Union (28 countries), Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia.

After applying this criterion, 156 companies were excluded and 469 potentially comparable companies still present in the sample.

Operating profit (EBIT) - Companies with positive results from operating are selected, for higher degree of comparability.

After applying this criterion, 265 companies were excluded and there are 204 potentially comparable companies.

Total Assets - Under this last criterion, companies with maximum value of EUR 2.5 million of assets are selected, to prevent too high variations in value.

After applying this criterion, 104 companies are excluded 100 potential comparable companies available for further analysis.

Furthermore, companies without public access to financial information, active website, or about which it is not possible to obtain the relevant information (to determine comparability to selected Company) are eliminated from sample.

Therefore, final sample includes 44 companies, which are shown in Appendix 1 (with webpages).

6.6.3 Selection of profit level indicator

For the analysis of market prices, the "TNMM method" was selected. Generally, profit level indicators are classified as rates of return, measuring profit as percentage of an asset (most common measure is return on assets – ROA) and margin/mark-up ratios measuring profit as a percentage of another flow.

The profit level indicators are used to compare the financial results of the tested customer (in this case the Company) with those of comparable companies. Margin ratios are more acceptable because they are more transactional in nature (meaning they divide a flow by a flow) and, in many cases less sensitive to differences between the accounting and economic measures of profits and assets than rate of return measures.

The chosen transfer pricing method is based on the profitability of operating income (operational margin), which is calculated as shown in equation (1):

$$\text{Operating margin (OM)} = (\text{operating profit} / \text{operating revenues}) \times 100 \% \quad (1)$$

The calculation of three-year average of OM ratio is shown in equation (2) below:

$$\text{Average OM} = \frac{OM_{2011} + OM_{2012} + OM_{2013}}{3} \quad (2)$$

Table 12. List of comparable companies

No.	Name of the company	Operating margin (%) 2013	Operating margin (%) 2012	Operating margin (%) 2011	Average 2011 to 2013
1	PRACTICOS DE VALENCIA SLP	10.20	17.76	14.20	14.05
2	UAB ACE LOGISTICS	7.23	5.98	5.42	6.21
3	COMPASS TRANSIT SIA	8.24	5.74	3.97	5.98
4	LOTREX	6.65	3.41	5.55	5.20
5	CTD EXPRESS	1.44	0.05	0.22	0.57
6	ALCOTRANS - AGENTES TRANSITÁRIOS, LDA	1.16	0.94	1.06	1.05
7	TRANSSUPREME FRACHTENVERMITTLUNGS, HANDELS, LAGEREI U. INT. SPEDITION GMBH	0.53	0.58	0.48	0.53
8	EXTRA - TRANSPORTES INTERNACIONAIS, LDA	1.89	2.02	2.11	2.01
9	CROMM INTERNATIONAL S.R.L.	3.70	3.44	0.98	2.71
10	GPS GENOA PORT SERVICE - S.R.L.	1.79	1.62		4.53
11	GRANELS I VOLQUETS SL	1.30	2.45	1.25	1.67
12	MAX - TRANS SP. Z O.O.	2.71	3.17	3.48	3.12
13	FINNFREIGHT OY	6.72	6.43	2.65	5.27
14	UAB EKSEA	7.67	7.35	6.44	7.16
15	STORI PODJETJE ZA STORITVE, ORGANIZACIJO IN TRGOVINO, D.O.O., LJUBLJANA	0.64	0.16	0.28	0.36
16	BOCDO TRAFIC SL	0.94	-2.15	-3.01	-1.41
17	CORPORACION DE PRACTICOS DEL PUERTO DE PALMA SLP	6.25	6.65	12.00	8.30
18	DAUNIS MASO Y FONT SA	0.90	0.80	0.00	0.56
19	MOLDTRANS PORTO, LDA	0.89	-2.16	0.62	-0.22
20	DOGE SPEDIZIONI S.R.L.	0.54	0.36	0.50	0.47
21	TRANSPORTE INTERPENINSULAR DE EXTREMADURA SL	1.08	2.75	0.68	1.50
22	СИГМА ШИПИНГ ООД	3.77	4.21	0.71	2.90
23	EXPORTMAR SOCIEDAD ANONIMA LABORAL	9.39	10.75	16.77	12.30
24	NET - CARGO SP. Z O.O.	1.41	-2.03	1.04	0.14
25	E.S.C. - EUROPEAN SHIPPING COMPANY S.R.L.	1.86	3.51	7.05	4.14
26	T.P.T. - TRÂNSITOS E SERVIÇOS ADUANEIROS, LDA	5.98	3.65	12.88	7.51
27	CENTRO SPEDIZIONIERI DOGANALI SERVICE SRL IN SIGLA CSD SERVICE SRL	2.00	3.37	10.56	5.31
28	PIETRO BALENA & FIGLI S.R.L.	6.09	4.15	7.25	5.83
29	GARURTRANS GASTEIZ SL	5.02	-0.60	6.12	3.51
30	IMPREPORT - IMPRESA PORTUALE S.R.L.	1.60	4.25	2.18	2.68
31	INTERSEA CONTAINER SERVICES E.I.E.	1.63	4.00	0.76	2.13
32	АПИС КАРГО ООД	9.07	15.59	4.55	9.74
33	ALPHA INTERNATIONAL S.R.L.	2.36	4.51	8.30	5.06
34	EWALS CARGO CARE SA	4.42	4.26	3.82	4.17
35	+ CARGA - TRÂNSITOS, COMÉRCIO E SERVIÇOS, LDA	1.11	1.16	1.40	1.22
36	EFFE TRASPORTI S.R.L.	1.31	-0.90	0.71	0.37
37	VEIRAT COVER TRANS SL	1.83	0.83	0.96	1.21
38	PATINTER DEUTSCHLAND GMBH	0.30	1.10	2.09	1.16
39	RICCHI INTERNATIONAL S.R.L.	4.09	3.02	2.48	3.20
40	FRACASSI WORLDWIDE SHIPPING S.R.L.	40.42	29.44	14.68	28.18
41	ESATRANS JIHLAVA, S.R.O.	1.89	0.88	-0.86	0.64
42	ARGO LOGISTICKÉ CENTRUM, S.R.O.	3.81	4.31	11.97	6.70
43	FERNANDO FLORES BARCELONA SL	8.08	9.14	4.56	7.26
44	TRANŠPED D.D.	2.33	3.31	4.76	3.47

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

In the next step, we have to determine arm's length range, which is done with interquartile range.

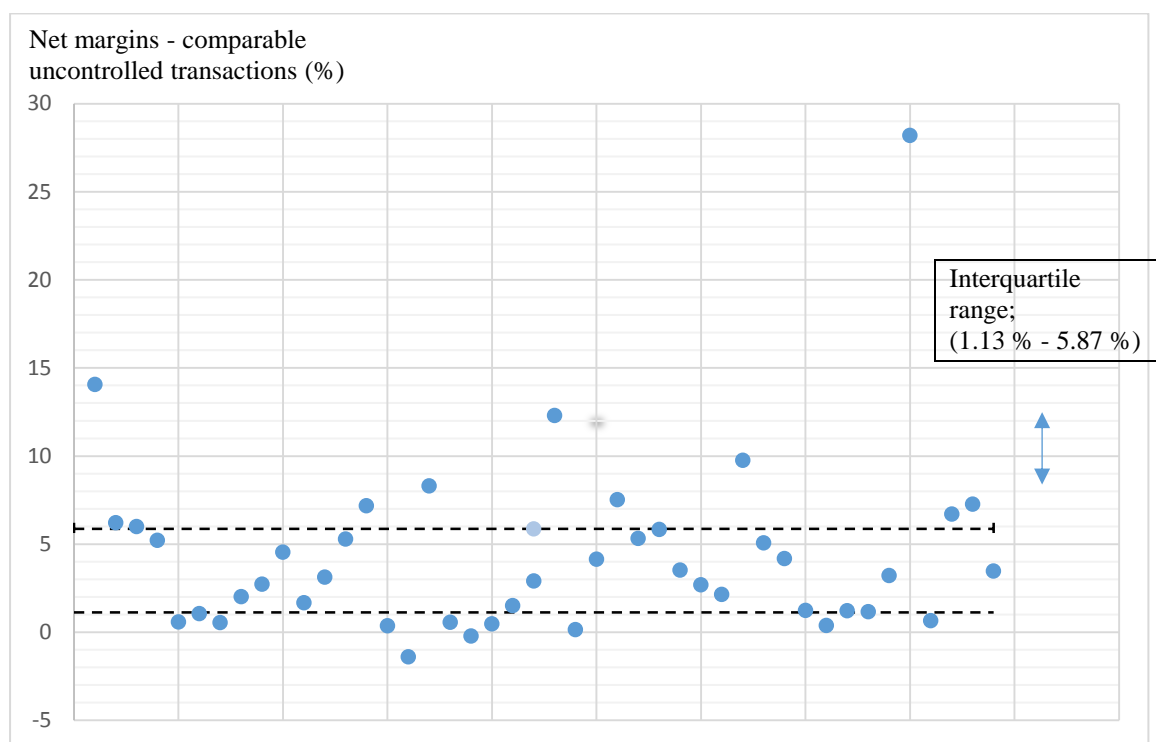
Firstly, we calculate minimum, maximum, first and third quartile. For analysis, only values between first and third quartile are relevant. Through this, extreme values that significantly

influence the final range of results are excluded and, therefore, a conclusion whether a transfer prices applied in a given inter-company transaction are within the arm's length.

Using the financial data of the final set of 44 comparable companies engaged in forwarding and logistics activities, operating margins and average operating margins in the analysed period are calculated. Results allow determination of adequate statistical values (quartiles) within a chosen set and determination of the inter-quartile range, which shows a range of operating margin values, which is considered arm's length.

In the Table 13 below, the net margins observed in comparable uncontrolled transactions are presented in scatter plot, with interquartile range, which determines arm's length transactions.

Figure 9. Illustration of arm's length range



Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material); own calculations.

The arm's length price was calculated according to following rule: The upper 25 % and the lower 25 % results are eliminated in order to calculate an inter-quartile range; the median of inter-quartile range is then applied as the arm's length price.

Table 13. Calculation of marginal values

Marginal value	2015 (Average OMin period 2011 – 2013)
Minimum	-1.41
First quartile (Q1)	1.13
Median	3.16
Third quartile (Q3)	5.87
Maximum	28.18

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material); own calculations.

The Company has generated an operating margin of 2.21 % in 2015, as can be seen from the table below:

Table 14. Calculation of operating margin for 2015²

Year	Revenues	Operating profit	Operating margin (%)
2015	1,491,299	33,016	2.21

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material); own calculations.

6.7 Presentation of results

From results, obtained after the marginal results are abandoned (the value between the lowest value and first quartile and the third quartile and the maximum value), it can be concluded that the interquartile range of the operating margin of the comparable companies in 2015 ranges from 1.13 % to 5.87 % with median value of 3.16 %.

In the year 2015, the Company had an operating margin of 2.21 %, which is in line with the interquartile range of the results achieved by comparable companies in the period 2011-2013, i.e. in line with the arm's length.

This means that terms imposed in transactions between the Company and associated enterprises are in line with terms imposed among comparable independent companies operating on open market, which reflects in operating margins.

² To ensure anonymity, the numbers are covered in a way that they are all multiplied by the same factor.

CONCLUSION

The main players in today's economy are international companies that are global taxpayers and enjoy most of the benefits of free trade. It enables them free movement of goods and capital across borders, which simultaneously triggers huge challenges for countries to retain the same taxable revenues and prevent base erosion and profit split. The presence of international companies and their investments are essential for employment and economic growth, but countries should not allow gains to be unjustifiably transferred from the countries in which they are created.

From previous experiences, it is evident that the rules with which individual countries wanted to prevent the transfer of profits from countries have not achieved the desired effect, and therefore the OECD emphasizes that the key to achievement of satisfactory results is in coordinated international action, which will have wide political support in most countries of the world.

Therefore, in recent years there has been an intensification of the legislation governing transfer pricing. Organizations such as OECD and European Union believe that transfer pricing will be one of the most important topics in the future, both for tax administrations and for international companies. Countries throughout the world are incorporating guidelines from OECD TPG in their legislation and emphasize the importance of transfer pricing documentation for higher clarity and overview of transactions among companies.

The primary goals of the selected Company in the field of transfer pricing are business transparency and compliance with ALP. In my analysis, the transfer pricing method used for testing was a transactional net margin method, which is used between an enterprise unit in the role of an internal point of sale and sales units.

The method used is one of the allowed methods according to CITA. Given the factors affecting the comparability of transactions (incomplete competition in the market, the results of functional analysis), TNNM is the best choice.

Furthermore, I found out that the transactional net margin method used, determined on the basis of comparability analysis based on independent enterprises, corresponds to the functions performed and the risks undertaken by the participants in the transaction. At the same time, the conditions in transactions are comparable to terms that would be agreed between independent enterprises in a comparable uncontrolled transaction, thus fulfilling the basic condition for ALP. On the first part of research question, namely "Is the transfer pricing policy used by the company effective and in compliance with the ALP and national legislation?" I can answer affirmatively.

To the second part of the question, " Which method for testing transfer prices is the most suitable and why?" however, the answer is provided in the chapter six of master's thesis. To summarize, the most appropriate method is TNMM, since firstly, other methods cannot be used with such certainty, and secondly, TNNM is applicable because it uses margin ratios, which are more acceptable because they are more transactional in nature (meaning they divide a flow by a flow). And in many cases margin ratios are less sensitive to differences between the accounting and economic measures of profits and assets than rate of return measures.

Therefore, the Company's business is in line with regulations in the field of transfer pricing.

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APPENDICES

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APPENDIX 2: List of abbreviations.....2

APPENDIX 1: Sample of comparable companies

Table. Final sample of comparable companies

No.	Company name	Country	Webpage
1	PRACTICOS DE VALENCIA SLP	ES	www.practicosdevalencia.com
2	UAB ACE LOGISTICS	LT	www.ace.lt
3	COMPASS TRANSIT SIA	LV	www.compass-transit.com
4	LOTREX	FR	lotrex.fr
5	CTD EXPRESS	FR	www.ctdexpress.net
6	ALCOTRANS - AGENTES TRANSITÁRIOS, LDA	PT	www.alcotrans.pt
7	TRANSSUPREME FRACHTENVERMITTLUNGS, HANDELS, LAGEREI U. INT. SPEDITION GMBH	DE	www.transsupreme.de
8	EXTRA - TRANSPORTES INTERNACIONAIS, LDA	PT	www.extratransportes.pt
9	CROMM INTERNATIONAL S.R.L.	IT	http://www.cromm.it/
10	GPS GENOA PORT SERVICE - S.R.L.	IT	www.gps-ge.it
11	GRANELS I VOLQUETS SL	ES	www.gra-vol.com
12	MAX - TRANS SP. Z O.O.	PL	www.maxtrans.pl
13	FINNFREIGHT OY	FI	www.finnfreight.fi
14	UAB EKSEA	LT	www.exespedition.com
15	STORI PODJETJE ZA STORITVE, ORGANIZACIJO IN TRGOVINO, D.O.O., LJUBLJANA	SI	www.stori.si
16	BOCDO TRAFIC SL	ES	www.bocdotrafic.net
17	CORPORACION DE PRACTICOS DEL PUERTO DE PALMA SLP	ES	www.practicosdepalma.com
18	DAUNIS MASO Y FONT SA	ES	www.dmf.es
19	MOLDTRANS PORTO, LDA	PT	www.moldtrans.pt
20	DOGE SPEDIZIONI S.R.L.	IT	www.dogespedizioni.it
21	TRANSPORTE INTERPENINSULAR DE EXTREMADURA SL	ES	www.tiex.es
22	СИГМА ШИПИНГ ООД	BG	www.sigma-shipping.com
23	EXPORTMAR SOCIEDAD ANONIMA LABORAL	ES	www.exportmar.net
24	NET - CARGO SP. Z O.O.	PL	www.net-cargo.pl
25	E.S.C. - EUROPEAN SHIPPING COMPANY S.R.L.	IT	http://www.esceuropean.com/chisiamo.htm
26	T.P.T. - TRÂNSITOS E SERVIÇOS ADUANEIROS, LDA	PT	www.tpt.pt
27	CENTRO SPEDIZIONIERI DOGANALI SERVICE SRL IN SIGLA CSD SERVICE SR L	IT	http://www.centrospedizionieri.com/
28	PIETRO BALENA & FIGLI S.R.L.	IT	http://www.pietrobalena.it/en/about-us
29	GARURTRANS GASTEIZ SL	ES	www.garurtrans.com
30	IMPREPORT - IMPRESA PORTUALE S.R.L.	IT	http://www.impreport.it/eng/company.html
31	INTERSEA CONTAINER SERVICES E.I.I.E.	GR	www.intersea.com.gr
32	АРНС КАРГО ООД	BG	http://www.ariscargo.bg/about-en.php
33	ALPHA INTERNATIONAL S.R.L.	IT	http://www.alpha-international.com/homepage-international/
34	EWALS CARGO CARE SA	ES	www.ewals.com
35	+ CARGA - TRÂNSITOS, COMÉRCIO E SERVIÇOS, LDA	PT	www.carga-lda.pt
36	EFFE TRASPORTI S.R.L.	IT	http://www.effetrasporti.com/it/index/home-4.html
37	VEIRAT COVER TRANS SL	ES	www.covertrans.com
38	PATINTER DEUTSCHLAND GMBH	DE	www.patinter.com
39	RICCHI INTERNATIONAL S.R.L.	IT	ricchiinternational.it
40	FRACASSI WORLDWIDE SHIPPING S.R.L.	IT	http://www.fracassishipping.com/
41	ESATRANS JIHLAVA, S.R.O.	CZ	www.esatrans.cz
42	ARGO LOGISTICKÉ CENTRUM, S.R.O.	CZ	www.argogroup.cz
43	FERNANDO FLORES BARCELONA SL	ES	www.cargoflores.com
44	TRANŠPED D.D.	CR	www.transped.hr

Source: Leitner + Leitner d.o.o. (2015). *Transfer pricing documentation for Company* (internal material).

APPENDIX 2: List of abbreviations

ALP – Arm’s length principle

BEPS – Base erosion and profit shifting Action plan

CCA – Cost-contribution agreement

CITA – Slovenian Corporate Income Tax Act

EBIT – Operating profit

MNE – Multinational enterprise

FAA – Financial Administration Act

NACE – Nomenclature generale des activites economiques dans les communautes Europeennes

OECD – Organisation for Economic Co-operation and Development

OECD TPG – OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

PITA – Personal Income Tax Act

TPA – Tax Procedure Act