UNIVERSITY OF LJUBLJANA
SCHOOL OF ECONOMICS AND BUSINESS

MASTER'S THESIS

AN ANALYSIS OF TRANSFER PRICES FOR THE COMPANY M

Ljubljana, September 2020 JERNEJ SCHWARZMANN

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LIST OF ABBREVIATIONS

sl. – Slovene

en. – English

ALP – (sl. Neodvisno tržno načelo); Arm's length principle

BEPS – (sl. Erozija davčne osnove in preusmeritev dobička); Base erosion and profit shifting

CFC – (sl. Nadzorovana tuja družba); Controlled foreign company

CUP – (sl. Primerljiva prosta cena); Comparable uncontrolled price

D.O.O. – (sl. Družba z omejeno odgovornostjo); Limited

EU – (sl. Evropska unija); European Union

FOB – (sl. Franko ladja); Free on board

GmbH – (sl. družba z omejeno odgovornostjo); Gesellschaft mit beschränkter Haftung (en. Limited)

HRM – (sl. Upravljanje s človeškimi viri); Human resource management

INC. – (sl. Delniška družba); Incorporated

IP – (sl. Intelektualna lastnina); Intellectual property

KStG – (sl. Davek od dohodka pravnih oseb); Körperschaftsteuergesetz (en. Corporate income tax act - Austrian)

LTD – (sl. Družba z omejeno odgovornostjo); Limited

MNE – (sl. Multinacionalno podjetje); Multi-national enterprise

NACE – (sl. Statistična klasifikacija gospodarskih dejavnosti); Statistical classification of economic activities in the European community

OECD – (sl. Organizacija za gospodarsko sodelovanje in razvoj); Organisation for economic co-operation and development

ÖNACE – (sl. Nacionalna klasifikacija dejavnosti); Austrian national classification of activities

ROE – (sl. Donos na kapital); Return on equity

R&D – (sl. Raziskave in razvoj); Research and development

SKD – (sl. Standardna klasifikacija dejavnosti); Standard classification of activities

TNMM – (sl. Metoda stopnje čistega dobička); Transactional net margin method

U.S. – (sl. Združene države); United States

VAT – (sl. Davek na dodano vrednost); Value added tax

ZDavP-2 – (sl. Zakon o davčnem postopku); Tax procedure act (Slovenian)

ZDDPO-2 – (sl. Zakon o davku od dohodkov pravnih oseb); Corporate income tax act (Slovenian)

ZDoh-2 – (sl. Zakon o dohodnini); Personal income tax act (Slovenian)

ZGD-1 – (sl. Zakon o gospodarskih družbah); Companies act (Slovenian)

INTRODUCTION

In the recent years, profit shifting to low or no-tax countries has been a hot issue for multinational companies and tax authorities. Base erosion and profit shifting (BEPS) specifies strategies that exploit gaps to avoid taxes and discrepancies in tax legislation to unnaturally move profits to countries with more favorable taxation for companies (OECD, 2017a).

Tax avoidance is directly connected to transfer pricing, which is an international fiscal problem. To tackle it, Organisation for Economic Co-operation and Development (OECD) directives have established the "Arm's length" principle as the basic principle of transfer pricing affiliated companies. The principle implies the following circumstances: when two people who are close meet, they have a natural inclination to hug. In theory, these two people should behave indifferently to strangers, who would shake hands. So, when doing business, the relationship between the two companies should not affect their transactions, and must therefore remain at an arm's length (Cazacu, 2015).

In order to closely monitor a company's financial reports, transfer pricing documentation is of great help to both companies and tax authorities. In 1995, OECD announced the Transfer pricing guidelines for multinational enterprises and tax administrations to help companies form the documentation correctly. Probably the most challenging problem is to set the transfer prices properly. Transfer prices are important for tax administrations and taxpayers. In the end, they determine the amount of taxable profits for affiliated enterprises in various tax jurisdictions. Problems with transfer prices primarily began only in transactions among affiliated companies, who operated within the same tax jurisdiction, but OECD's Transfer pricing guidelines are recently focusing on the international aspect of transfer pricing. (OECD, 2017b).

Selecting the most suitable transfer pricing method is a vital part of transfer pricing. As I chose to observe a small and medium-sized company (SME) with a complex product completely tailored to customers' needs, it was difficult to find comparable data. If equivalent information is not available, then the data that is available should be examined. When the price or costs of an individual product are accessible, the resale or cost-plus method can be used (Kumar & Sosnoski, 2011). Companies can use transfer prices to their advantage, as in the business practices, the companies generally identify tax payment as an expense, so they will always try to minimize it in order to optimize net profits (Sundari & Susanti, 2016). While transfer pricing documentation is mainly prepared to reduce the risk of being audited and consequently potentially penalized, cleverly chosen transfer pricing methods can help companies achieve corporate goals. However, these methods need to be acceptable from the tax authority's point of view (Cools, 2005).

The unit of this analysis is a group of associated companies. M d.o.o. and S d.o.o. are tax residents of Slovenia and company H GmbH is a tax resident of Austria. S d.o.o. provides turn-key solutions for spatial problems in the form of steel structure industrial building - halls for companies from various industries. Products and services offered include project documentation, steel structures, PVC fabric or panel sheet covers, and assembly. Halls are tailor-made according to customer specifications and needs from the very beginning; thus, every project is one of a kind. Companies will be further described in detail in the transfer pricing documentation chapter. I have been working in the company S d.o.o. for the past three years and have seen it grow from a small to a medium-sized enterprise. According to Companies act (ZGD-1) OG. 1. RS, no. 65/2009, two out of three conditions have to be met to be classified as a medium-sized enterprise in 2017. When the average number of employees during the financial year exceeds 50, the net sales revenue exceeds 8,000,000 EUR and the asset value exceeds 4,000,000 EUR. S d.o.o. recorded net sales revenue and asset value which exceeded the threshold to be classified as a medium-sized enterprise. With increasing number of the ingroup transactions, the company decided to prepare transfer pricing documentation in case of being audited and to make operating between the companies smoother. Following the OECD Transfer Pricing Guidelines and examples from best practices should be sufficient.

The purpose of this thesis is to analyse and attempt to solve the problems that have emerged as the group of associated companies grows. One of them is to understand and use transfer prices correctly. This thesis will focus on examining how the company sets the prices for transactions occurring within the group and, by providing feedback, helping the company understand the importance of appropriate methodology in determining the transfer prices.

One of the objectives of this thesis is to study the theory behind transfer prices. I will examine the rules and legislation regarding transfer prices in Slovenia. I will also research the competition and the position of the company in the market. Every transaction between the companies in the group will be analysed. On the company's behalf, I will prepare the transfer pricing documentation, which will be used for the purposes of the audit and will help avoid any unnecessary penalties from the tax authorities. Finally, I will recommend improvements and point out important findings relevant to the company. The aim of the thesis is to answer the following research questions:

Are transactions between the observed associated companies compliant with the national legislation and the arm's length principle?

Which transfer pricing methods do the observed companies apply to the transactions? Are those methods the most suitable?

This thesis uses a case study as a research strategy. The case study observes, through various data sources, an event in its natural background. Its purpose is to contront the theory with the empirical world (Piekkari, Welch & Paavilainen, 2009). As there is only one unit of

analysis, this is a single case study. A single case study is appropriate when the case is special, unique or it provides a test to a well-established theory (Rowley, 2002). The data collected is both primary and secondary. The Research on the theory is based on secondary data, mainly from scientific journals and local legislation. The practical part of the thesis is based on a combination of primary and secondary data. Primary data usually consists of an interview, but in my case, there would be no additional benefit in conducting it, as through the course of my training and work in the Finance and Controlling department of one of the case study companies, I have acquired in-depth knowledge on how it operates. The secondary data that I used are documents, annual reports and archived material, which is typical for single case studies (Piekkari, Welch & Paavilainen, 2009).

The theoretical part consists of research on transfer prices, base erosion and profit shifting, the "arm's length" principle, associated enterprises and a comparability analysis. In the practical part of the thesis, I used the company's data to prepare the Transfer pricing documentation, consisting of two parts, a Master and a local file. The Master file is a general overview of the group and its economic environment. In the local file, all types of transactions are systematically analysed. The most important part of the documentation is the functional analysis. Recommendations to the company will be presented in the recommendations chapter.

1 LITERATURE OVERVIEW

For easier understanding of the topic, I will explain basic concepts like transfer prices and the arm's length principle. The concepts tightly connected with the previously mentioned two are base erosion and profit shifting. The last two are associated with enterprises and comparability analysis. It will be easier to connect theory to practice after clearing up the most important concepts.

1.1 Base erosion and profit shifting

Base erosion is the use of monetary procedures and planning the taxes to decrease the company's taxable profits. Income structure can be modified to have more favorable tax treatment. Another option would be to find a process to lower several expenses against taxable profits. That way, a company's tax bill is redused below the expected amount (Healy Consultants Group Plc, 2017).

Profit shifting includes paying to companies in the group, moving earnings from high-tax zones towards low-tax ones. This functions as an instrument, increasing the ready to use profits for the group shareholders. In most cases, these transactions between associated companies occur as royalties or other expenses that can be discounted before taxing the profits. These kind of payment types have additional benefit, as in some jurisdictions lower

tax rate applies to this type of income. One of those would be Luxembourg (Healy Consultants Group Plc, 2017).

Profit shifting is easily illustrated with a simple example. A company positioned in a country with a 30 percent tax rate makes $1000 of income at home, where it would normally be subject to tax at 30 percent, but the company has the opportunity to transfer $500 of that income to its foreign associated firm in a jurisdiction with a 20 percent tax rate. In case that the home country does not tax foreign income, then the reallocation decreases domestic tax liabilities by $150 and increases foreign tax liabilities by $100, for a net saving of $50. Income reallocation is unlikely to be costless, but if the tax saving of $50 exceeds the after-tax cost of income reallocation, then it will be in the interest of the company to transfer taxable income from the high to the low-tax jurisdiction (Hines, 2014).

Groups of multinational enterprises are optimaly positioned to benefit from tax evading strategies. Nature of international processes allows the funds to flow through the network of firms in the group. Using their capital, entities used solely for tax reduction purposes are set up and maintained easily. With income large enough to afford taking professional advice on how to structure taxes, it is easier to follow changes in the legislation annually (Healy Consultants Group Plc, 2017).

1.1.1 Techniques used in base erosion and profit shifting

Companies, especially big multinationals, use different techniques to shift profits to jurisdictions with lesser income taxes. Below are some methods usually used to increase a company's overall profits (Healy Consultants Group Plc, 2017).

Trademark and technology licensing/transfer pricing - Guiding trademark of the group, their patents and designs in such way, that the intellectual property (IP) gets the lowest tax rate applied possible. Other group enterprises are then being charged royalties for brand usage. As royalties are often affected by withholding taxes, it is important to prioritize the IP holding company's tax treaty relationship with the countries where the other group companies are. By reducing the intellectual property royalties from usual tax rate to 20%, Luxembourg is a popular destination for an IP holding company in Europe (Healy Consultants Group Plc, 2017).

Thin capitalization – Subsidiaries that are set up with lowest share capital allowed, help groups utilize debt to fund operations of the newly established enterprise. Interest is attracted by the extensive debt load, which is treated differently in some jurisdictions. If it is structured correctly, it can cut total tax bill of the group (Healy Consultants Group Plc, 2017). Opportunities to efficiently relocate can be determined by the tax code specifics and tax implementation of home and also host countries. Rules on thin-capitalization and transfer pricing documentation can prevent the profits to be shifted away (Heckemeyer & Overesch, 2013).

1.1.2 Putting assets into entities without substance

Trying to attract new businesses, countries establish advantageous tax regimes. In order for this to work, real companies need to situate them inside the country. The biggest problem is that businesses establish the so called shell corporations and exploit special regimes which is still allowed too many times (Healy Consultants Group Plc, 2017).

1.1.3 Main difficulties for countries in determining taxable income for companies

With rapid progress of digital economy, services are not limited only to the host country. The European Union (EU) tried to tackle the problem by updating legislation concerning value added tax (VAT) for digital services. Since it is challenging to regulate where and how it is supposed to be taxed, cooperation on the international level is necessary (OECD, 2017a).

1.1.4 OECD's proposed solutions to address base erosion and profit shifting

BEPS is all about the arbitrage among national taxation legislation. In order to provide transparency worldwide and collaboration on matters regarding taxes, it is important to tackle the unfavourable consequences of BEPS. The next few paragraphs are describing the actions proposed by the OECD (Healy Consultants Group Plc, 2017).

Focusing on the digital economy and its challenges. A concept to "neutralize the consequences of the hybrid twin arrangements and arbitrage". The solution is to introduce consistency in the tax systems of the countries, and at the same time granting countries to keep their supremacy over national tax rules. Next action proposed is trying to negate the consequences of hybrid mismatch arrangements by preventing tax exemption on tax deductible revenues for the payer (Healy Consultants Group Plc, 2017).

The OECD is planning to establish their instructions on implementing enhanced controlled foreign company (CFC) rules, imposing liabilities on parent firms for profits of the subsidiaries. The OECD claims that CFC rules behave positively in the origin nation, as it reduces the motivation of taxpayers to move profits to jurisdictions with lower tax rates (Healy Consultants Group Plc, 2017).

BEPS techniques and advantageous tax rules in some jurisdictions are being reviewed to cut back rateable financial gain. The primary goal of those reviews is to limit and reduce base erosion through different monetary payments and deductions of the interest (Healy Consultants Group Plc, 2017).

In situations involving at least two countries, adaptations will be made to rules related to advantageous regimes by making the exchange of information mandatory. This will increase the transparency and efficiency of countering bad operations regarding taxes. With global value chains being so complex, it is crucial to consider upgrading tax plans, currently being

solely bilateral. The main objective is to thoroughly coordinate allocation of the revenue generating financial activities. This should cut down a portion of the abuses on treaties (Healy Consultants Group Plc, 2017).

Next two OECD propositions are based on re-defining an extensive but more clear definitions in the rules. First set will reformulate perpetual organisations status to prevent artificially avoiding it and consequently unreasonably evade the local taxes. The second will try to better regulate the benetifts of the intangibles transferred between the companies in the group. They will design clear-cut estimation rules that apply to intangibles. The main focus will be on setting transfer prices of intangibles with unknown value, while inspecting plans of cost contributions (Healy Consultants Group Plc, 2017).

Similar to intangibles with unknown value, it is difficult to evaluate transactions inside the group that involve high risk. This kind of transactions are usually not taking place bar between associated companies, which means it is sometimes impossible to be in line with the arms-length principle. The rule's main objective is to explain how to apply the profit split method to the challenging global value chains. On the other hand, it should also protect versus management fees, and alternative base eroding transactions like head office expenses (Healy Consultants Group Plc, 2017).

1.2 Transfer prices

In the Slovenian Rules on transfer prices OG. 1. RS, no. 141/2006 there is no definition of transactions between affiliated companies, therefore some are described in Table 1.

Table 1: Definitions of transfer prices

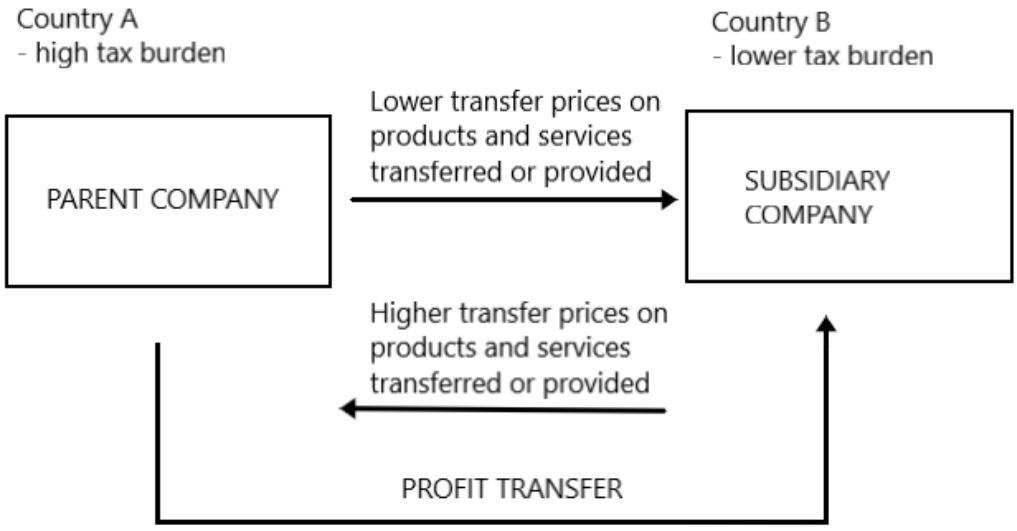
Author (year)	Definition
Cambridge Dictionary (n.d.)	An amount of money charged by one department in a company to supply goods or services to another department within the same company, or from one company to another in a group.
OECD (2003)	A transfer price is a price, adopted for book-keeping purposes, used to value transactions between affiliated enterprises under the same management at artificially high or low levels to affect an unspecified income payment or capital transfer between those enterprises.
Guzina (2005)	A transfer price is any price at which two or more related parties (or related parts of those parties) charge each other for a particular good or service.
Eden & Smith (2001)	A transfer price is the price charged in transactions between firms that are related, for example, trade between a parent company and its foreign subsidiary or between two foreign affiliates.

Source: Own work.

Microeconomic theory separates prices into transfer and market prices. While market prices are created on the market and are a result of contradictory interests of offer and demand, transfer prices are typically an outcome of multinational or affiliated company's pricing policy (Guzina, 2012). When business between associated companies is made, prices set are called transfer prices. However, there are two types: adapted or non-adapted. The latter is very similar, sometimes even the same as the market price. When the prices are different than those set by the market, the fact that companies are affiliated affected the price, that is why they are called adapted (Sikka & Willmott, 2010).

The main problem of transfer prices is that they can be misused. By using transfer prices and structuring the costs and income, companies can artificially shift taxable revenue to a jurisdiction with lower tax rates. Groups of companies that do business in different tax jurisdictions, will always try to reduce the profits in high-tax and accumulate them in low-tax ones, as can be seen in Figure 1. Practically every multinational corporation is shifting their profits all aroung the globe at their will by using transfer pricing (Sikka & Willmott, 2010).

Figure 1: Profit transfer using transfer prices



Source: Perčević (2011).

Sometimes it is challenging to recognize the companies exploiting transfer pricing and to decide when to set an audit in motion. The features usually connected with a serious risk related to transfer pricing include relocation of taxable income and transactions with associated companies in jurisdictions with lower tax rates. Restructuring of the business and transactions regarding intangible assets between associates are generally also questionable. The risk is usually also present in companies with successive years of losses or excessive debt. A similar risk applies to those with poor or non-existent transfer pricing documentation. Royalty payments, insurance premiums and other similar types of payments between associates have the capability to deteriorate the company's tax base (Clauser, 2014).

1.3 Associated enterprises

Owners, the Supervisory board, the Management board, managers and their closest relatives have a major influence on business management. In such case, when a legal person or an individual have the control and influence on the business decisions in associated enterprises, it is a must to study the actions of the associated enterprises and tax consequences that come with it (Šešok, 2001).

Before determining if the transfer prices are correctly set, the relationship between the enterprises should be defined. Tax authorities must figure out how the enterprises are connected, if at all, as specified in the Slovenian Corporate income tax act (ZDDPO-2), OG. 1. RS, no. 117/2006. Only after that can they start analysing the transfer prices and then make the assessment of the tax base. Transfer prices cannot be determined between enterprises who otherwise are associated, but do not make any business. Associated enterprises are the essential ingredient in determining the transfer prices (Šešok, 2001).

Definitions of associated or affiliated enterprises can be found in few Slovenian laws and regulations. First is the Corporate Income Tax Act (ZDDPO-2), which is very important for tax issues connected to transfer prices. The Companies Act (ZGD-1) focuses mainly on companies in general, while also describing affiliated enterprises. The Personal Income Tax Act (ZDoh-2), OG. 1. RS, no. 117/2006 concentrates on income of natural persons and the Tax Procedure Act (ZDavP-2), OG. 1. RS, no. 13/2011 on legal procedures regarding taxes.

1.3.1 Associated enterprises as defined by the Corporate Income Tax Act (ZDDPO-2)

Associated enterprises in the Corporate Income Tax Act are defined in two ways. Article 16 defines the relationship among a resident and a non-resident taxpayer while Article 17 defines the relationship between two residents.

Division of transactions into those between two residents and those between residents and foreign enterprises is meaningful because of the adaptation of the tax base. In the case of transactions between residents and non-residents, transfer prices are reviewed according to the arm's length principle. Transfer prices between residents are not reviewed, unless the tax position of one of the enterprises is more favorable: Not liable for the payment of corporation tax, is paying tax equal to 0% (or displays uncovered tax loss). The enterprise is in both cases obliged to provide the required documentation, while resident to resident business only after a request from the tax authorities (ZDDPO-2).

1.3.1.1 Associated enterprises: resident – non-resident

Written in Article 16 of the Corporate Income Tax Act, a resident or non-resident taxpayer and a foreign legal entity or a foreign person without legal personality who is not a taxpayer (hereinafter: foreign person) shall be deemed an associated enterprise in the following cases:

When the taxpayer directly or indirectly holds at least 25% of the value or number of shares or equity holdings, shares in management or control or voting rights of a foreign person, or controls the foreign person on the basis of a contract or the transaction conditions differ from the conditions that have been or would be reached between non-associated enterprises in equal or comparable circumstances (ZDDPO-2).

When the foreign person directly or indirectly holds at least 25% of the value or number of shares or equity holdings, shares in management or control or voting rights of the taxpayer, or controls the taxpayer on the basis of a contract or the transaction conditions differ from the conditions that have been or would be reached between non-associated enterprises in equal or comparable circumstances (ZDDPO-2).

In case where the same person at the same time directly or indirectly holds at least 25% of the value or number of shares or equity holdings, shares in management or control of the taxpayer and the foreign person or of two taxpayers, or controls them on the basis of a contract or the transaction conditions differ from the conditions that have been or would be reached between non-associated enterprises in equal or comparable circumstances (ZDDPO-2).

The same individuals or their family members are considered associated when they directly or indirectly hold at least 25% of the value or number of shares or equity holdings, shares in management or control of the taxpayer and foreign person or of two residents, or control them on the basis of a contract, or the transaction conditions differ from the conditions that have been or would be reached between non-associated enterprises in equal or comparable circumstances (ZDDPO-2).

A family member under this Act shall be deemed to be a person's spouse or person with whom the individual lives in a long term committed relationship that has, under the Act regulating marriage and family relations, the same legal consequences as marriage; or a partner with whom the individual lives in a registered same-sex partnership under the Act regulating civil partnership registration; children, adopted children and step-children or children of the person with whom the individual lives in a long term committed relationship that has, under the Act regulating marriage and family relations, the same legal consequences as marriage; or children of a partner with whom the individual lives in a registered same-sex partnership under the Act regulating civil partnership registration; and parents or adoptive parents of an individual (ZDDPO-2).

1.3.1.2 Associated enterprises: resident - resident

Residents shall be deemed to be associated enterprises if they are associated in capital, management or control in such a way that one resident directly or indirectly holds at least 25% of the value or number of shares or equity holdings, shares in management or control

or voting rights of other resident or controls the other resident on the basis of a contract in a manner that differs from relations between non-associated enterprises (ZDDPO-2).

Residents are considered associated when the same legal entities or individuals or their family members hold in two residents directly or indirectly at least 25% of the value or number of shares or equity holdings, shares in management or control or voting rights or control the two residents on the basis of a contract in a manner that differs from relations between non-associated enterprises (ZDDPO-2).

A resident and an individual performing business shall also be deemed associated enterprises if the same individual or their family members hold in the resident at least 25% of the value or number of shares or equity holdings, shares in management or control or voting rights or controls the resident on the basis of a contract in a manner that differs from relations between non-associated enterprises (ZDDPO-2).

According to this Article, family members shall be deemed to be the person's spouse or person with whom the individual lives in a long-term committed relationship that has under the Act regulating marriage and family relations the same legal consequences as marriage; or a partner with whom an individual lives in a registered same-sex civil partnership under the Act regulating civil partnership registration; children, adopted children and step-children or children of the person with whom the individual lives in long-term committed relationship, that has under the Act regulating marriage and family relations, the same legal consequences as marriage; or children of a partner with whom the individual lives in a registered same-sex civil partnership under the Act regulating civil partnership registration; and parents or adoptive parents of an individual (ZDDPO-2).

1.3.2 Associated enterprises according to the Companies Act (ZGD-1)

It is stated in Part IV of Article 527 of the Companies Act, that Affiliated companies shall be legally independent companies that are in a mutual relationship in which one company has a majority interest in the other company (a majority-owned company and a company with a majority interest) or one company is dependent on the other (the subsidiary and the parent company). Companies are also considered associated when they are concern companies, when the two companies have mutual equity participation, or the companies are affiliated through business agreements (ZGD-1).

1.3.3 Associated enterprises according to the Personal Income Tax Act (ZDoh-2)

Associated enterprises are defined in the Personal Income Tax Act, Paragraph 3 of the Article 16. According to this Act, an affiliated person shall be a family member or any person, under the control of the taxpayer or usually under the control of the taxpayer. A family member shall be a spouse of the taxpayer, lineal ascendant or descendant of the

taxpayer or of the spouse, the spouse of the lineal ascendant or descendant of the taxpayer or of the spouse, brothers, and sisters and half-brothers and half-sisters, as well as adoptees and adopters. A family member shall also be a partner with whom the taxpayer lives together in a registered same-sex partnership, pursuant to the Act governing civil partnership registration (hereinafter: partner in same-sex partnership). It shall be deemed that a person supervises another person, if the person has an ownership share or the right to an ownership share in the amount of at least 25 percent in the form of the value of all shares or in the form of a voting right, based on ownership shares in a real person. For the purpose of determining control, it shall be deemed that a specific person is in possession of all ownership shares owned directly or indirectly by any person affiliated with this specific person (ZDoh-2).

1.3.4 Associated enterprises according to the Tax Procedure Act

The Tax Procedure Act also defines affiliated persons in Article 148, paragraph 3. According to this Article, family members shall be deemed to be the person's spouse or person with whom the individual lives in a long-term committed relationship that has under the Act regulating marriage and family relations the same legal consequences as marriage; or a partner with whom an individual lives in a registered same-sex civil partnership under the Act regulating civil partnership registration; children, adopted children and step-children or children of the person with whom the individual lives in long-term committed relationship, that has under the Act regulating marriage and family relations, the same legal consequences as marriage; or children of a partner with whom the individual lives in a registered same-sex civil partnership under the Act regulating civil partnership registration; and parents or adoptive parents of an individual (ZDavP-2).

Besides the entities from the previous paragraph, affiliated entities are also a legal entity that is affiliated in equity, management or control so that one legal entity holds, directly or indirectly, at least 25% of the value or the number of shares or interests in equity, management or control, or voting rights in another legal person or controls another legal entity person on the basis of a contract in a way that is different from those of unrelated parties (ZDavP-2).

1.4 The Arm’s length principle

The Arm’s length principle is used to make transfer prices proportionate to transactions of independent enterprises in comparable conditions. OECD defines the Arm’s length principle in Article 9 of the OECD Model Tax Convention (2017) as:

In case the conditions between the two affiliated companies in the business are different from those among unaffiliated companies, then any hidden profits which stem from those conditions may be contained in the company’s profits and taxed appropriately (OECD, 2017b).

Cazacu explains the concept of the arm's length principle in the following example: when two people who are close meet, it is natural for them to hug. The theory precludes that the friendship and conduct among these two people is the same as between two strangers that would only shake hands upon concluding a transaction, thus remaining at an arm`s length (Cazacu, 2015).

In an effort to better explain this principle: If two companies, with existing commercial ties, perform a transaction, it will generally have a market price as a result. This is a so called "arm`s length" transaction, since it represents a real market negotiation for a product. Tax authorities consider the arm`s length price acceptable. However, when two enterprises are affiliated, they might try to unnaturaly alter the real price of the transaction to minimize the aggregate tax bill (Cazacu, 2015).

The arm's length principle is effectively working in the larger part of cases. In numerous cases, an appropriate comparison of transactions can be made with financial indicators for instance mark-up on cost, net profit or gross margin pointers. On the other hand, sometimes the arm's length principle cannot be applied so simply. An example would be multinational enterprise (MNE) groups doing business in the integrated production of extremely specific products, with unique intangible assets or businesses providing specific services. The main resolution to combat these particular examples is by using the transactional profit split method. (OECD, 2017b)

As the business world is developing and changing rapidly, the importance and value of intangibles assets' is growing. This creates a possible hole in the arm's length principle, or better, an undefined area. There are transactions that associated parties engage in, when non-associated parties would not. Such example are transfers of "crown jewel" intangibles, trademarks or licenses, that can never be priced and that would never take place among unrelated parties. Therefore, these transactions should be disregarded when they occur between associated enterprises (Ernick, 2015)

1.5 Comparability analysis

The comparability analysis is essential for the application of the arm's length principle. It is built on an evaluation of the circumstances in a controlled set of transaction with the situations that would arise from two independent parties engaging in an equivalent transaction under comparable circumstances. In order to precisely define such a controlled transaction, two key aspects need to be determined. The first one is to identify the financial or commercial nature of relationship among the affiliated companies and all other economically relevant circumstances. Secondly, a comparison of those relevant circumstances of the controlled transactions with the relevant circumstances surrounding uncontrolled transaction should be made. The use of the arm's length principle thus hangs on defining what would be the conditions in which independents would have agreed on in equivalent transactions in similar circumstances. However, prior to making any comparisons

with uncontrolled transactions, any other characteristics of the financial or commercial relationships that are economically relevant must be identified (OECD, 2017b).

In determining the comparability of two or more transactions, a comparability analysis shall be carried out, considering the economically relevant factors that influence the data and conditions of individual transactions. The transferred assets' or services' characteristics of should be described in detail. The functions performed by associated and non-associated enterprises (considering used funds and risks assumed) and their business strategies provide a quick overview of which companies are actually the most important in the group and should accumulate the most profit. Economic circumstances and contractual terms in which transactions occur round up the comparability analysis. The comparability of transaction circumstances must be determined for the time when transactions were carried out or before they were carried out. Data on transactions and related conditions from past years must be examined, if it reveals facts and circumstances that may have affected comparable market prices (Rules on transfer prices).

It is slightly delicate when it comes to manufacturing companies, as it is sometimes very complex to set transfer prices to follow the comparability analysis findings, especially with highly specialized or even unique products. In such cases, it is very challenging to comply with the arm's length principle. The absence of a standardized benchmarking legislation may lead to discrepancies in the assortment of comparable data. Consequently, all these factors result in variation of transfer prices (Sulik-Górecka, 2018).

1.5.1 Characteristics of transferred assets and services

The reasons for different market prices of assets and services are their special characteristics. We use the analysis of characteristics of assets and services to identify the variances among prices in controlled and uncontrolled transactions. Special characteristics, according to Article 10 of the Rules on transfer prices, that should be analysed are found in transactions of assets which are not intangible assets. The features investigated are also physical and technical characteristics, quality, durability, reliability, availability (accessibility) and the scope of delivery, possibility of repairs, warranties, standardization, packaging, design, graphic design, additional services etc (Rules on transfer prices).

In transactions with services, the characteristics investigated are their nature and scope, availability, warranties, qualifications of operators, security, risks, additional and after sale services etc. When it comes to transactions of intangible assets, important characteristics that should be analysed are the form of transactions according to the mode of exploitation of intangible assets (sale or purchase of full rights of intangible assets, purchase or sale of a license for the right to use an intangible asset or the involvement of an intangible asset in the only asset that is sold), type of intangible assets, duration and level of protection of expected benefits from the use of these funds (for example by determining the net present value of future returns), (not) exclusive rights to use these resources, territorial restrictions, start-up

costs, costs for research and development, possibility of granting sub-licenses, additional investments in intangible assets etc (Rules on transfer prices).

The analysis of the characteristics of assets and services is more useful when equalling prices between controlled and uncontrolled transactions, while not as useful at comparing profit margins. It is mostly used with the Comparable Uncontrolled Price (CUP) method for determining transfer prices. The CUP method focuses on the product's or service's market price, while other methods focus mainly on comparing functions, that are being done by companies in comparable transaction. Bearing in mind the fact, that when comparing transactions there should be the same or at least similar products (assets) or services, the associated enterprises and tax authorities should consider five factors of differentiation (Kuhar, 2008):

Quality - When examining the properties of products, we cannot observe their quality in isolation, but the useful value they represent for consumers. Moreover, environmental acceptability, product lifecycle, security of use, etc. are becoming increasingly important for consumers, so these characteristics must be identified in determining transfer prices and comparing them with prices among independent firms. The so-called quality assurance system, on the basis of various standards and regulations on certification, checks certain characteristics and procedures in the manufacturing phase of products. The following factor affecting the formation of transfer pricing is quality assurance measures. Quality management can be active or passive (Kuhar, 2008).

Product image - In the field of production and marketing of products we distinguish between culturally bound and neutral products, which depends on their more or less strong national anchoring, as well as the differentiation in pricing and their homogeneity (Kuhar, 2008).

Culturally bound products - The parent company sells a product made in one country to another country through a subsidiary that is headquartered in that other country. Since a subsidiary in another country is confronted with a strong competition in manufactured and culturally strong products, the parent company must trade their product to a subsidiary at a lower price than the companies that originate from the other country, and lower than achieved when selling it on the domestic market (Kuhar, 2008).

Additional services - There are many products on the market, which can often be differentiated according to the services that they additionally offer or are provided by vendors. Thus, it often happens that equal products, taking into account additional services, become so different that direct price comparison is no longer possible. In the process of studying transfer pricing and prices in comparable unrelated transactions, additional services need to be identified and properly evaluated. Additional services can be divided into those that appear before the sale of the product and those only after it. The first category includes project design, technical consulting and financial services. The second category is related to post-purchase services like transportation and assembly. Also, the services usually offered for years after the installation of a product are warranty and repair. The result of additional services is higher customer satisfaction, for which they are ultimately willing to pay. Therefore, with different services, various transfer prices can also occur, which can be determined in an indirect way, when evaluating the cost of additional services (Kuhar, 2008).

Delivery and payment terms - The possibility of creating supply and payment conditions at otherwise homogeneous products leads to different transfer prices. Various content of transport clauses (Incoterms), which regulate, for example, the transition of risk and ownership, is typically reflected in the formation of transfer prices (Kuhar, 2008).

1.5.2 Functional analysis

In transactions between two unaffiliated companies, functions performed by companies are generally reflected in compensation. Consequently, functional analysis is indispensable in identifying the comparability among controlled and uncontrolled transactions or businesses. It aims to locate the economically noteworthy activities and responsibilities attempted. This includes assets used or contributed and risks assumed by the parties to the transaction. It concentrates on what the parties really do and the capabilities they offer (OECD, 2017b).

In Article 11 of the Rules on transfer prices, there are several functions mentioned that should be analysed. These are design and production or manufacturing, which are the most obvious. Less noticeable are probably assembling, servicing and distribution. Other functions that should not be neglected in the analysis are research and development, purchasing, marketing and financing. The most vital element is the economic importance of functions. The main differences are their frequency, nature and value for the companies involved in the transaction (Rules on transfer prices).

1.5.3 Contractual terms

The controlled transactions can be defined by conducting contracts. Typically, the agreements include the division of responsibilities and pricing arrangements. Equally important elements are obligations, rights and assumption of identified risks (OECD, 2017b). The contractual terms in transactions among affiliated and transactions among non-affiliated enterprises are compared using an analysis of contractual terms. Responsibilities, risks and benefits should be distributed between associated equally between non-associated parties. In case contractual terms in written form do not exist, the conditions between associated enterprises are identified on the basis of their conduct and in compliance with the economic principles that normally exist and apply in equal or comparable circumstances between non-associated enterprises (Rules on transfer prices).

1.5.4 Economic circumstances

Arm’s length prices might differ over various markets despite transactions involving similar property or service. To accomplish comparability between markets, there should be little to no difference in the major factors that effect the price. Substitute goods or services offered on the market should be accounted for when identifying the relevant market (OECD, 2017b).

The economic circumstances, according to the Rules on transfer prices, that define comparable markets are numerous. The first group could be the geographical location of the markets and their size. A further analysis can define the degree of competition in those markets and the relative competitive positions of buyers and vendors. Another group could be the existence of cycles (cyclical, economic or life cycle of the product), availability (accessibility), replacement of assets or services, level of supply and demand in the market as a whole and in individual partial markets. The elements that should be considered are also consumers' purchasing power, the nature and degree of market regulation by the state. The last of the economic circumstances are connected directly to the product. Those are production costs, labour, capital costs and transportation (Rules on transfer prices). In situations where multinational company performs comparable controlled transactions in different tax jurisdictions and the economic circumstances are comparable, the MNE can count on a multiple-country comparability analysis to justify its transfer pricing policy. However, this kind of approach may reduce reliability (OECD, 2017b).

1.5.5 Business strategies

Business strategies should as well be considered in explaining the transactions and in defining comparison for transfer pricing intentions. The main business strategy aspects according to Article 16 in the Rules on transfer prices include innovation and development of new products. Part of the business strategy are also the level of diversification, avoiding risks and market share strategies. Comparability should as well consider a company's assessment of changes in policy-making and impact of existing and planned labour legislation (Rules on transfer prices). When companies decide for the market penetration strategy, they are allowed to temporarily charge a price lower than that of comparable products offered in the market. Penetrating the market or increasing the market share may for the shorter period of time record lower profits on the account of higher costs compared to the competition (OECD, 2017b).

1.6 Advance pricing agreement

The term Advance Pricing Agreement (APA) was introduced in 1991. This procedural device in the tax system permits the taxpayer and the government to discuss and resolve tax issues voluntarily. A specialty of APAs is that the agreements are reached prior to the transactions occurring. The agreements involve foreign countries and require significant negotiation between the authorities and taxpayers. APAs are intensely factual; transactions are described in detail and usually very complex. These agreements can cover a number of years and their terms are strictly confidential (Ring, 1999).

When MNEs consider investing in the country with lower tax rates than the other country, admission from the low-tax country is required to be priced for tax purposes. In case of being audited without an APA, following the investment finish, tax authorities determine the

transfer prices. Actually, these prices are not neccesarily equivalent, which might lead to double taxation. Motivation for double taxation increases with higher revenue of firm's investments. Anticipating such scenario, companies might not fully exploit all of the investment opportunities. Signing an APA means setting the prices prior to the investment, which could help companies avoid such inefficiencies (Becker, Davies & Jakobs, 2014).

The Advance pricing agreement's purpose is to be an unbiassed tax practice which should improve the general procedure of defining an MNE's taxable income in and between tax jurisdictions. However, it can be misused by governments when trying to attract the world's biggest corporations to their tax jurisdictions. Such cases were investigated by the European Commission in 2014. The reported governments and MNEs were Apple in Ireland, Starbucks in the Netherlands and Fiat in Luxembourg. All three cases included prohibited national encouragement in form of tax benefits in the APAs (Eden & Byrnes, 2018).

The costs of APA requests vary from country to country and so do the methods to calculate them. Some countries use fixed filing and extension fees, some set it according to taxpayer's turnover and others consider which transfer pricing method was used. Secondly, many countries do not impose filing fees at all. In Slovenia for example, a filing fee is 15.000 €, while an extension fee is 7.500 €. It seems that the costs of setting APAs are the biggest factor for companies when deciding whether or not to initiate such an agreement. The other factor is definitely the strictness of the authority and the possibility of reaching compromises. APAs were successfully introduced in Belgium, with 814 APAs functioning at the end of 2017. It seems that Advance Pricing Agreements in Slovenia are not yet accepted by companies or authorities as there is not a single one in force at the end of 2017 (European commission, 2018). The factors worth considering when deciding whether or not to start conversations with tax authorities regarding an APA are the penalties for not submitting the transfer pricing documentation when inspection strikes. In Slovenia, the fee for such offense is from 1.200 € to 15.000 € for micro and small enterprises, and from 3.200 € to 30.000 € for medium and large enterprises (Guzina, 2019).

2 TRANSFER PRICING METHODS

In order to determine the transfer pricing, related enterprises must take into account comparable market prices in their interactions. According to Article 16 of ZDDPO-2, the comparable market price is the one of comparable assets and services between related enterprises, that is or would be achieved on the market between non-affiliated companies in the same or similar circumstances. In the case of inadequately set transfer prices, the related enterprise must adjust the revenue and expenditure that would have been achieved if they operated in line with the Arm's length principle. Alike adjustment would lead to the truthful tax-deductible revenues and expenses (Corporate Income Tax Act, 2006).

Transfer prices can be determined with different approaches. The determination of transfer pricing may be the subject of a market negotiation between two enterprises and is formed in the same way as the transfer prices form between two unrelated companies; the formation of transfer pricing and the selection of the method for forming them are the subject of an agreement between related enterprises, however, it can be the outcome of both factors (Guzina, 2012).

In accordance with the OECD transfer pricing guidelines, the methods for determining transfer prices are primarily split into two groups: traditional transaction methods and transactional profit methods. The main difference between the groups is based on the availability of data. Traditional transaction methods use comparable transactions on the market to determine the transfer prices, while transactional profit methods, basing on profits, use data exclusive to associated enterprises, because of lack of data from the market (OECD, 2017b).

2.1 Traditional transaction methods

Traditional transaction methods according to OECD Transfer Pricing Guidelines are comparable uncontrolled price methods recognized as the CUP method (sl. metoda primerljivih prostih cen), resale price method (sl. metoda preprodajnih cen) and cost-plus method (sl. metoda dodatka na stroške). Traditional transaction methods are the utmost straightforward measure of establishing whether circumstances in the commercial and financial relationships among affiliated companies are in line with the arm's length principle. Any variance among the price of controlled and comparable uncontrolled transaction can usually be tracked straight to the commercial and financial relationship established among the companies (OECD, 2017b). These methods allow us to substitute the prices of comparable uncontrolled transactions with those of the controlled transaction. They can be adjusted, but only with reliable adjustments as shown in Table 2. However, it is and will be demanding to govern what is reliable and acceptable by the authorities, and what not (Sporken, 2001). Even thought the traditional transaction method and the transactional profit method can be practiced in an equally trustworthy fashion, it is desirable to use the traditional transaction method over the transactional profit method (OECD, 2017b).

Table 2: Traditional transaction methods

Method	Measurement focus	Comparability requirements	Possible adjustments
Comparable uncontrolled price	Price	- Similar products - Similar conditions	- Product quality - Contractual terms - Level of market - Geographic market - Intangible property - Transaction date - Foreign exchange
Resale price method	Gross income	- Similar functions performed - Risks - Contractual terms - Similar product group	- Inventory levels - Turnover rates - Operating expenses - Contractual terms - Foreign currency risks - Accounting adjustments
Cost plus method	Gross income	- Similar functions performed - Risks - Contractual terms - Similar product group	- Operation complexity - Operation expenses - Contractual terms - Foreign currency risks - Accounting adjustments

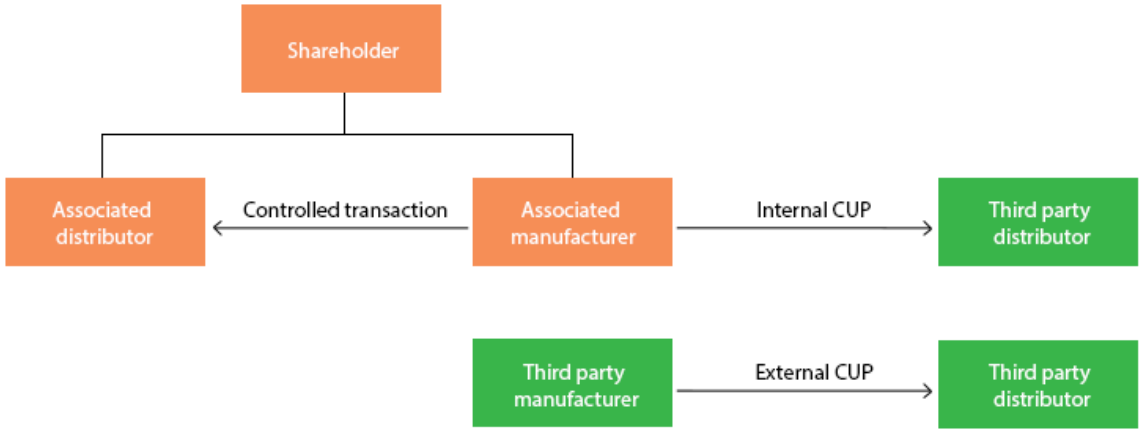
Source: Rosenberg, McLennan, Mohamed & McInnes (2003).

2.1.1 Comparable Uncontrolled Price Method (CUP)

The comparable uncontrolled price method is widely and commonly used method, while also preferred by tax administrations. The method uses the transfer price charged in controlled transaction among affiliated companies and compares it with the market price charged in same or similar transactions between unrelated companies (Perčević, 2011). Third party transactions are divided into two groups; the first is between an associated and an unassociated company, which is called the Internal CUP, and the second among two unaffiliated companies, called the External CUP (Transferpricingasia, 2017). According to regulations, the CUP method is the most trustworthy method, when all the stringent requirements are fulfilled (Rosenberg, McLennan, Mohamed & McInnes 2003).

Figure 2 shows the difference between the two types of the CUP method. The comparable uncontrolled price between unassociated enterprises should match the price in the controlled transaction among affiliated companies.

Figure 2: Comparable Uncontrolled Price method



Source: Transferpricingasia (2017).

There are many factors to consider when shaping transfer prices using the comparable uncontrolled price method. The most important is product similarity. This method will not produce a trustworthy computation of arm's length prices as long as material product inequality exists and is impossible to make reliable adjustments. For example, when either the tested enterprise or comparable company exploits trademarks in connection with the sale of the product, the comparability will be reduced. Seemingly negligible discrepancies in contractual or economic conditions might have an impact on the price, which means that comparability under the CUP method depends highly on similarity. Factors that may cause inequalities among controlled and uncontrolled transactions which would require adaptation to the data are numerous. Most common differences are in the product's quality and the contractual terms. Some factors are related to markets like its level or geograpfic location in which the transaction takes place. Factors that should not be neglected are intangible property associated with the sale, foreign currency risks and substitutes accessible to the buyer or seller (Rosenberg, McLennan, Mohamed & McInnes 2003).

When applying the CUP method to intangible property, the assets licenced to the associated and unassociated enterprise should be comparable, if possible identical. This would mean that when it comes to using intangible properties in related to comparable products or processes in the similar business or market, which would result in comparable profit. Important factors are terms and circumstances, liability risks and secondary transactions. The licensees' rights to obtain updates and the time span of the license should also be considered when analyzing controlled and arm's length transactions of intangible assets. Regarding services transactions, contractual terms and comparability of services should be taken into consideration. The intangible assets used in providing the services and the economic circumstances under which the transactions occur should also be considered (King, 2009).

2.1.1.1 Examples

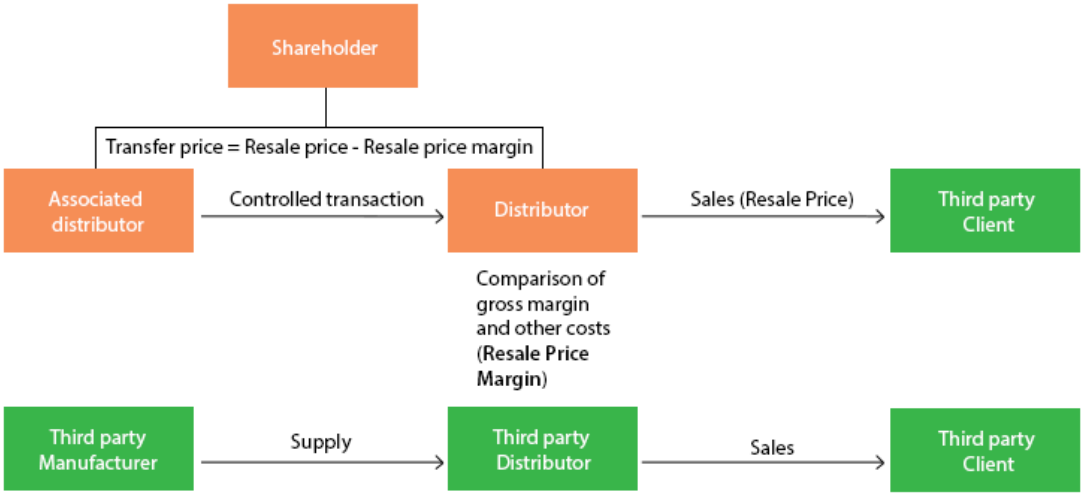
When conditions surrounding sales are indistinguishable bar one factor, adaptations would be appropriate. In this case it would be delivery conditions. The controlled sales price is including the delivery, while comparable sales made are Free on Board (FOB) factory. Transportation and insurance terms in general have a fixed and measurable consequence on the price. In order to establish the uncontrolled transaction price, we have to make adjustments to the price in the amount of disparity in delivery terms (OECD, 2017b).

Another example would be when an enterprise sells 1.000 tons of a product at the price of $80 per ton to an affiliated company. It also sells 500 tons of the identical product at the price of $100 per ton to an unassociated company. Different volumes should be evaluated and checked if they affect the adaptation of the transfer price. The transactions in the market of relevant products must be examined to notice typical volume discounts (OECD, 2017b).

2.1.2 Resale Price Method

The basis for the resale price method is the price of the product bought from an affiliated company and then resold to an unaffiliated company (OECD, 2017b). The "true" transfer price, using the resale price method, is the result of deducting a margin from an identified arm's length price, which is displayed in Figure 3. It can be either a lump sum or a proportion of the margin (Buus & Brada, 2010). The gross profit margin is used to cover the sales and any overhead costs that can be a result of the functions performed by the company, while also counting in a proper profit margin. The remaining amount, after deducting not only the gross margin but also any modification for other expenses related to the purchase of the product, should imitate the arm's-length price (Sporken, 2001).

Figure 3: Resale Price Method



Source: Transferpricingasia (2017).

This method is best utilized for marketing operations, like sales distributors. In case of no substantial value added to the product by the reseller, it is easier to determine the fitting resale price margin. The level of activities carried out by the reseller needs to be determined first, as it greatly influences the sum of the resale price margin (Sporken, 2001).

According to the Rules on transfer prices, the comparable market price can be determined by comparing the dissimilarities in the price of the transaction carried out in equal or comparable circumstances between associated enterprises. There are two different comparisons based on the relationship of the companies involved. The first one is the internal comparison of the difference in price, which compares the differences in price achieved between associated enterprises with those differences in price achieved by associated enterprises themselves, or enterprises associated with them, with non-associated enterprises. The other is external comparison of the difference in price, which compares the difference in prices achieved between associated enterprises with those differences in price that are or would be achieved on the market by non-affiliated enterprises (Rules on transfer prices).

The economic justification for internal comparisons of resale margins is that specific distributors and manufacturers would basically collect a practically even gross margin across transactions. The only economic rationale regarding external comparison of differences in price might be that the resale margins are equalised across firms by market forces (King, 2009). Usually, when applying the resale price method, the distributor, when purchasing and reselling the tangible property, does not change the nature of the product by embedding intangible properties to it. An example would be buying a product from a manufacturer and substituting their brand name with your own (Rosenberg, McLennan, Mohamed & McInnes 2003).

The resale price method and the comparable uncontrolled price method are both traditional transaction methods, but with some differences. Unlike the CUP method, the products do not need to be the same as long as there is no noteworthy functional difference between them. It is enough that the transactions belong to the same general type (e.g., kitchen gadgets). The main dependence is on the comparability of functions carried out, risks borne and contractual terms. The key difference between the previously mentioned methods is that with the CUP method the market price is directly equated with the controlled transaction. With the resale price method application, the goal is to identify the arm's length gross margin. Assuming that the net revenues represent the value of transactions with an un-associated enterprise and meet arm's length standards (Rosenberg, McLennan, Mohamed & McInnes 2003).

Differences in operating expenses between gross incomes of the tested party and comparables can be accustomed using adjustments. These differences occur with inventory levels, turnover rates, and interrelated risks, including pricing guaranties by the manufacturer. Comparables can also vary in contractual terms, sales or performed actions like marketing, advertising programs and services like promotional programs or rebates.

Operating expenses as well differentiate depending on the level of the market or foreign currency risks (Rosenberg, McLennan, Mohamed & McInnes 2003).

2.1.2.1 Examples

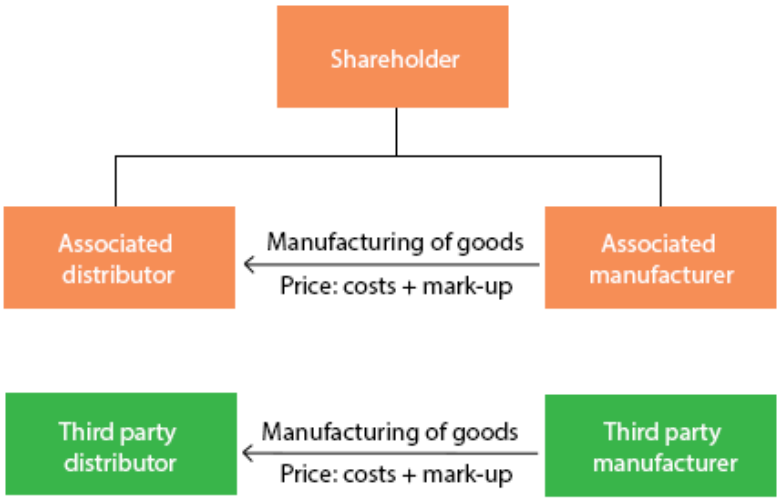
In the first case there are two distributors on the market that are offering the identical brand of the product. The only difference is that offer of the Distributor A includes a warranty, while Distributor B's does not. As Distributor A offers warranty, it charges higher price for its product, which results in a larger gross profit margin than that of Distributor B. These two margins are not comparable until the appropriate change is made to compensate for the inequality (OECD, 2017b).

The other case is about an enterprise that sells a product through unassociated distributors in several countries, without subsidiaries. The distributors do the marketing without supplementary work. Because of the strategic importance of the particular market, the company sets up a subsidiary in that country. This subsidiary only sells the product of that company and does technical applications for the customers as part of the service. All the circumstances and other facts are comparable, however, when the margins are resulting from unassociated companies without having privileged sales arrangements or provide technical applications like the subsidiary does, it is very likely that adjustments need to be made in order to accomplish comparability (OECD, 2017b).

2.1.3 Cost Plus method

The cost-plus method is based on the costs of the supplier of assets or services in an associated transaction. The comparable market price is composed of costs and added cost plus, which would be reached in equal or comparable situation in the market by non-associated enterprises (Rules on transfer prices). As shown in Figure 4, by adding a suitable cost plus mark-up, suitable profit is made according to the functions performed and conditions of the market. The costs and the mark-up can be considered as an arm's length price of the controlled transaction. The cost-plus method is usually used in the next scenarios involving affiliated enterprises: Selling semi-finished goods, concluding joint facility agreements and long-term arrangements, or in case where the controlled transaction reflects the provision of services (OECD, 2017b).

Figure 4: Cost Plus method



Source: Transferpricingasia (2017).

The comparable market price is concluded by analyzing the cost-plus in a transaction or transactions performed in equal or comparable circumstances by non-associated enterprises. The comparison of cost-plus is carried out based on the type of it. The first option is internal comparison, which compares cost-plus – on the appropriate comparable cost basis – achieved between associated enterprises with those cost-plus achieved by associated enterprises themselves, or enterprises associated with them, with non-associated enterprises. The other option is external comparison, which compares cost-plus prices – on the appropriate comparable cost basis – achieved between associated enterprises with those cost-plus prices that are or would be achieved on the market by non-associated enterprises (Rules on transfer prices).

According to the OECD Transfer pricing guidelines, for the purpose of the cost-plus method, an uncontrolled transaction and a controlled transaction are comparable when two conditions are met: a) Compared transactions are the same or the companies undertaking those transactions have no effect on the cost-plus mark-up in the market, b) rationally precise changes can be made to compensate for the effects (OECD, 2017b).

Possible adjustments for altering the ratios of gross income to the costs of goods sold to eliminate differences between comparables in operating expenses and during the manufacturing process are the intricacy of manufacturing, process engineering, procurement and inventory control actions. Adjustments can also be made accounting for selling, testing functions, overhead costs, foreign currency risks and contractually determined conditions (Rosenberg, McLennan, Mohamed & McInnes, 2003).

The cost-plus method has both pros and cons, identical to all transfer pricing methods. It is the most useful when evaluating the arm's length transaction of low-risk, routine activities.

Contract manufacturing is the best example, with a manufacturing enterprise which contracts exclusively with one client and assumes limited risks. This model is present in many car producing multinationals. A major disadvantage of the cost-plus method is the need for high similarity of controlled and uncontrolled transactions. Such level of comparability can only be achieved by accessing transaction's specific information. Such data would be the type of manufactured product, structure of costs and usage of intangible assets. Without the data it is hard to apply the cost-plus method (Transferpricingasia, 2017). This method is most commonly used in manufacturing companies, especially in construction contracts or the provision of basic administrative services, such as financial advice, legal advice, information technology (IT) (Ondrušova, 2015).

2.1.3.1 Example

Company A is a member of the multinational group Company B. Company A agrees to perform a research for the parent firm, which carries all of the risk. Intangible assets developed during the course of the research are owned by the Company B and consequently collects research's profits. In cases like this, we apply the cost-plus method. Any expenses related to the research should be compensated. Extra cost-plus would indicate research's innovativeness and complexity (OECD, 2017b).

2.2 Transaction profit method

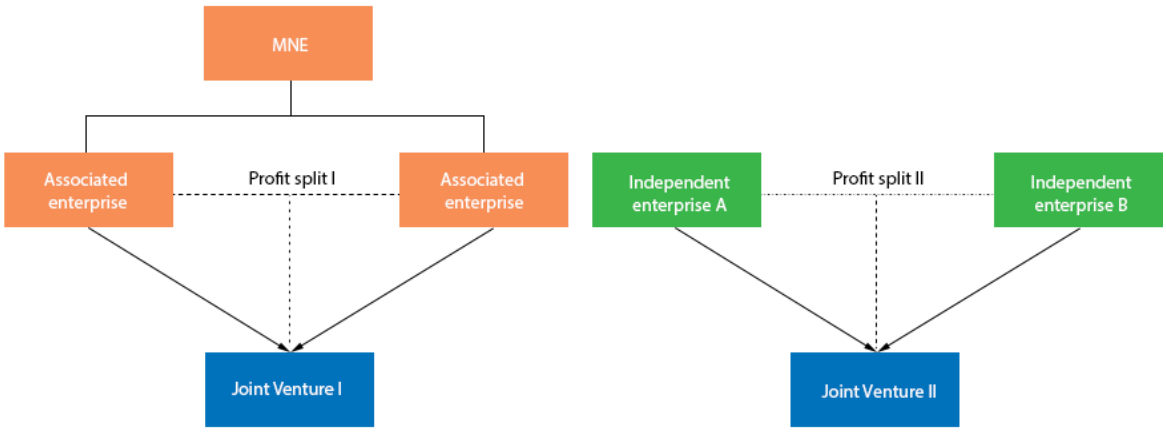
Transactional profit methods are the profit split method (sl. metoda porazdelitve dobička) and the transactional net margin method (TNMM) (sl. metoda stopnje čistega dobička). They are more complex than traditional transaction methods. However, in some cases, they may be more suitable. In a situation where both enterprises make unique and valuable contributions concerning the controlled transaction, or where the enterprises present highly integrated activities, the transactional profit split might be better suited for analysis than one-sided methods. Furthermore, if there is zero or very restricted freely accessible reliable gross margin information on third parties, the application of traditional methods may be challenging, especially outside cases that present internal comparables, thus making the transactional profit method most applicable method due to obtainability of information (OECD, 2017b).

2.2.1 Profit split method

This method examines the two related enterprises' the joint profits and divides them by resources used by them and their respective functions, taking into consideration division of profits in comparable joint ventures (Lyal, 2015). The profit split method is presented in Figure 5. There are two approaches for splitting the profits. Firstly, contribution analysis splits combined profits from the controlled transaction among the affiliated companies under

the assumption of a reasonable estimation of the division of profits, which unaffiliated entities could obtain from engaging in alike transactions. If information on comparables exists, such division of profits can be argued. Without comparable data, the split can only be supported by the relative value of the functions performed by affiliated businesses partaking in controlled transaction, by carefully examining assets involved and assumed risks. The second approach, residual analysis, distributes the joint profits in two steps. To begin with, an arm's length remuneration for its non-unique contributions in the controlled transaction is attributed to each entity. The remuneration is allocated by using traditional transaction methods or a transactional net margin method, while taking into account the compensation of the comparable transaction among independents. The second step of residual analysis allocates the remaining profit between the enterprises based on the facts and circumstances. One-sided methods can be argued to be less reliable in certain cases when compared to the profit split method. For example, the profit split methods can be argued to achieve "a closer alignment between profits and value creation," in instances of high incorporation of functions and risks, or a multisided and integrated business. Also, in cases of highly fragmented functions of the two participating enterprises, it is likely that profit split method supports outcomes of pricing based on probable comparables (Mazur, 2016).

Figure 5: Profit split method



Source: Transferpricingasia (2017).

The profit split method offers flexibility by considering specific, sometimes unique, facts and circumstances of the associated companies which cannot exist in independent parties. By appraising both transaction participants, the chance that either of the enterprises could gain an extreme and unlikely profit result decreases. The use profit split method is furthermore crucial when dealing with intangible property (OECD, 2017b).

Availability of data can be identified as the primary weakness of the profit split method. Both the affiliated companies as well as administrations may experience difficulties in attaining information from foreign affiliates. Observation of such controlled transactions calls for stating books and records on a common basis and adapting accounting practices and

currencies. When applying the profit split method to operating profit, it may be problematic to determine the suitable operating expenses linked to the transactions and to distribute the costs between the transactions and the affiliated companies' other activities (OECD, 2017b).

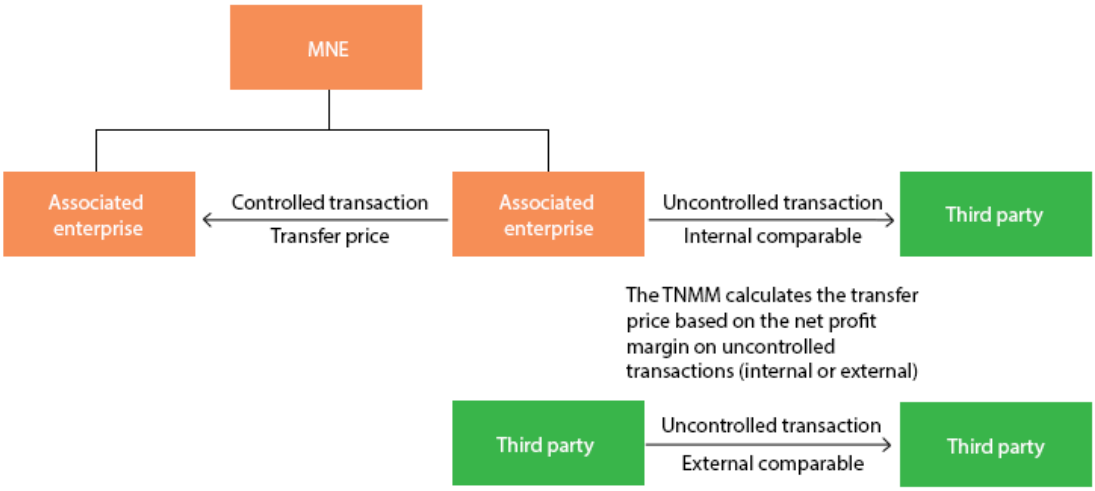
2.2.1.1 Example

A pharmaceutical company is working with a research and development (R&D) company to market a new drug. The R&D company will bear the costs and risks related to the introduction of the new drug to the market. The two related parties need to determine the profit split terms that will be included in their pharmaceutical agreement. Based on the relative investments and risks, they will use the contribution profit split method to divide the profits fairly. First, they need to determine the contributions made by each party and expenses that occur prior and after launch. A total of $500 million was invested by the parties to bring the new drug to market. It was calculated that $375 million of the total investment was made by the R&D company. Since this is 75% of the overall expenses, the R&D company will make 75% of the future profits, while the drug manufacturer will be collecting the remaining 25% (Valentiam Group, 2019).

2.2.2 Transactional net margin method

As written in the Rules on transfer prices, the transactional net margin method compares the net profit achieved in an associated transaction with an appropriate base (for example: costs, sales revenues, assets). The comparable market price is determined based on the relation between net profit and the appropriate base, considering the performed functions and the related funds invested, as well as all the risks assumed. The comparable market price can be defined through comparison of the transactional net margin achieved in the transaction or transactions performed in equal or comparable circumstances between non-associated enterprises. The comparison of the transactional net margin is carried out based on its type. One of the two is the internal comparison of transactional net margins, which compares the transactional net margins achieved between associated enterprises with those transactional net margins achieved by associated enterprises themselves, enterprises associated with them, and with non-associated enterprises. The second one is external comparison, which compares the transactional net margins achieved between associated enterprises with transactional net margins that are or would be achieved in the market by non-affiliated businesses (Rules on transfer prices). Figure 6 presents the transactional net margin method.

Figure 6: Transactional net margin method



Source: Transferpricingasia (2017).

In practice, this method would be used in cases where providing service between related enterprises, such as management fees and distribution of products where the resale price method cannot be appropriately applied (Guvemli, Alpaslan & Susoglu, 2017). Out of the five transfer pricing methods promoted by OECD, the Transactional net margin method is their second choice, right after the Comparable unrelated price method. If the CUP method cannot be invoked, TNMM may thus be identified as an alternative to appraise the value of the contributions by the parties of the transaction (Juranek, Schindler & Schjelderup, 2018).

The following assumptions are required to support the economic legitimacy of transactional net margin method. Product markets should in principle be competitive and in equilibrium; which is why accounting rates of return (defined in the U.S. regulations as operating profits divided by operating assets) are equalized across manufacturing or distribution firms in broadly similar product markets. Additionally, service markets are expected to also be competitive and in equilibrium, with operating margins over total cost equalized across service providers with broadly comparable services (King, 2009).

In the last 20 years, the TNMM has become the standard for the compensation of local manufacturing and sales function and an extensive range of services. Lately the quality of screening procedures and comparables gained through database benchmarking has become less important when preparing transfer pricing documentation. The main reason is that many comparables selected can reasonably be challenged by the multinationals. However, with the new OECD transfer pricing guidelines, tax authorities have more flexibility to argue local companies' contributions to intangibles. In the future, intangible functions like potential development, enchancement, maintenance, protection and exploitation will be more strictly challenged by the authorities and the transactional net margin method will be more often rejected, requested to be substituted by profit split method (Herve & de Homont, 2018).

Like other methods, the Transactional net margin method has its strengths and weaknesess. First advantage would be that the effect on net profit indicators by transactional differences is lower than with other methods like the CUP method. The tolerance of net profit indicators may also be higher to some functional inequalities in transactions among associated and unassociated companies opposed to gross profit margins (OECD, 2017b). As the transactions reviewed require only broad similarities to be eligible as comparable, this increases the number of situations where the Transactional net margin method can be used (Transferpricingasia, 2017).

Another strength of the TNMM is that the financial indicator for only one of the affiliated companies must be examined. Also, usually the books and records of all contributors in the business activity on a common basis do not need to be stated. It is also not required for the participants to allocate costs like with the profit split method. The first weakness of the TNMM is that the net profit indicator can be affected by factors that have lesser impact on price or gross margins among independent parties. Such characteristics might prove problematic with accuracy and reliability in determining the arm's length net profit indicators. Other difficulties that arise when trying to apply the transactional net margin method are issues related to time and information accessibility on the profits of comparable uncontrolled transactions. It may also be challenging to determine income and overhead costs related to the controlled transactions to make the net profit indicator to be utilized as the profit measure for the transactions. As the TNMM is used for only one of the affiliated companies, several transfer pricing unrelated factors might influence net profits, which may affect the overall trustworthiness of the TNMM when applying an insufficient standard of comparability. A potential weakness of the transactional net margin method when both buyer and seller of the controlled transaction are associated companies. When adjusting profits of the companies upwards, it might be uncertain which of the affiliated companies' profits to reduce (OECD, 2017b).

Durst argues that global structures based on a transactional net margin method do not represent an economically determined equilibrium. The current equilibrium has settled at a point that is not optimal in terms of social well-being. The current situation leaves developing countries with far lower corporate tax revenue than needed to meet the countries' reasonable economic and social needs (Durst, 2016).

2.2.2.1 Example

When applying the TNMM to the tested party manufacturer as an alternative to the more direct method, costs of goods sold, and overhead costs of the comparable manufacturer are available. Conducting a benchmarking analysis will determine the net profit in line with the arm's length principle using a profit margin indicator such as the proportion of the net profit in aggregate expenses. The selling price as well as the gross profit are both not accessible. Assuming that total costs of goods sold are $5,000, while overhead costs amount for $1,000

and an arm's length net profit ratio to costs would be 25 per cent, the transfer price totals $7,500. Technique of working backwards with available information would lead to the conclusion that the selling price in line with the arm's length principle is $7,500 (Wentzel, 2017).

2.3 Alternative methods

In accordance with OECD Guidelines, MNE groups have the freedom to apply other alternative transfer pricing methods not described in OECD guidelines, to establish prices in line with the arm's length principle. However, alternative methods should not be used as a substitute for the ones recognized by the OECD, when the latter are more suitable taking into account the facts and circumstances relevant to the case. When using other methods, selection has to be backed by an explanation why the methods suggested by the OECD were not sufficient. There should also be an explanation why the particular alternative method was viewed as the one providing a better result. The documentation should be prepared and maintained by a taxpayer to explain and prove how the transfer prices were established (OECD, 2017b).

2.3.1 Indirect-charge method

The indirect-charge method is not described in the Corporate tax act nor in the Rules on transfer prices. However, this method may be used according to the OECD Transfer pricing guidelines. Three conditions have to be met in order to use this type of methods (Guzina, 2019):

- Revenues should account for less than 5% of total revenue
- Those economic activities should not be the company's main one
- The company does not perform this activity for third parties (purpose of the activity is not accumulating profit)

In cases where companies can not use direct methods, they are allowed to use indirect methods. Cost allocation, redistribution and apportionment usually require estimation or approximation to some degree as a basis for calculating the arm's length price. When using these methods, sufficient evidence should be provided to prove how and why the costs have been redistributed according to the arm's length. The allocation method's results achieved must be consistent in order to be comparable to those of independent enterprises (OECD, 2017b).

2.3.2 Modified comparable uncontrolled price method

The comparable uncontrolled price method is one of the most direct transfer pricing method. It establishes the most reliable arm's length price. However, since it is very difficult to find

exact comparable uncontrolled transactions, the authorities frequently reject them. Even though some CUPs are inexact, they contain some useful information, which should be utilized to the extent possible. When there are no exact comparable transactions available or they do not exist at all, the industry that is relatively similar should be observed with possible adjustments. Some of those could be: Attributing the tested party's ratio of an approximate of working capital to sales or assets, applying a realistic cost of capital or changing the sample enterprise's profit level indicators downward or upward to replicate differences among their imputed and actual costs of working capital (King, 2009).

2.3.3 Numerical standards

Numerical standards could be established by taxing authorities for comparatively simple cases that would be applied uniformly. In such cases, tax authorities could determine a resale margin. An associated distributor for personal care products, for example, should report a resale margin of 35% to 40%. First tier trademarks might then be entitled to an extra % of net sales compared to second and third tier. When it comes to services, it could be divided by the required level of skill of the labor. Extra cost plus could be determined from most standard to most speacialized skills from 5-15%. The numerical standards approach could ensure significantly reduced agreement, audit and dispute resolution costs, while also preventing double taxation. It would reduce costs for authorities and multinational firms, as it would not be necessary to audit individual firms or make extensive transfer pricing studies (King, 2009).

2.3.4 Required return method

When it comes to intangible property or other highly complex cases, we can determine individual group members' tax liabilities based on their annual required return on debt and equity capital. In order to do a required return analysis, the company has to quantify the fair market value of an individual group members' equity capital, required return on that, and their costs of debt in line with the arm's length principle. The required return method might be proved successful, when a group member's measure of the market prices and capital's costs are reliable. Furthermore, a required return analysis' theoretical foundation is very solid compared to the existing transfer pricing methodologies. This method is most useful for companies utilizing unique and highly valuable intangible assets (King, 2009).

2.3.5 Franchise model

In cases when the labor between individual companies is similar, but certain entity developed a business model along with other intangible assets, that others base their operations on, and each of them does business in an independent part of the world, companies can determine the arm's length division of income between group members in various tax juristictions

based on the francise agreements. It could be used in cases where a firm operates in selected country, with a developed business model, intellectual property, vendor and customer relationships. Geographic expansions take the form of replicating the same business as the founding company. The latter then transfers its business model rights, intangible property, vendor and customer relationships. Instead of establishing individual transaction's arm's length charges, an alternative approach can be utilized. Companies could use franchise agreements to determine the arm's length fees for the group of transferred tangible and intangible assets and the services rendered (King, 2009).

3 TRANSFER PRICING IN COMPANY M D.O.O.

In this chapter I will analyse transfer prices for a group of associated companies who do not want to be named. Therefore, I will use generic names M d.o.o., S d.o.o. and H GmbH. The preparation of the transfer pricing documentation will follow OECD transfer pricing guidelines. Data related to transfer prices between the associated companies will be shown as a part of the documentation required by tax authorities written in the Tax procedure act. Facts and numbers of the companies included are real, but anonymous.

3.1 Transfer pricing documentation

Chapter 5 of the OECD Guidelines is entirely devoted to transfer pricing documentation. This chapter provides general instructions for tax authorities to follow when preparing rules and procedures for documentation which has to be obtained from taxpayers in connection with transfer pricing inquiries. The scope of documentation may differ from country to country. For the most part, countries are trying to follow the OECD guidelines to reduce or even resolve disputes between the taxpayer and the tax authorities. The OECD guidelines state that the taxpayer does not need to obtain and produce more information than is strictly necessary. However, the tax authority may not require documentation that would incur disproportionately high costs for the taxpayer (OECD, 2017b). According to the Tax procedure act (ZDavP-2), the taxpayer must provide the following documentation regarding related parties, the scope and type of business with them and the determination of comparable market prices.

The documentation consists of two parts, a Master file and Country-specific documentation. The first one should include a description of the taxpayer, it's organizational structure at the global level and the type of cohesion (such as capital, contractual, personal). The company should also picture it's transfer pricing system, a general description of operations and business strategies, while providing a wider view with data such as the general economic factors and the competitive environment. The second part must contain information linked to transactions with related parties and information on the performance of the transaction comparability analysis on the characteristics of the assets and services. The performed functional analysis gives a great insight into the company's business. The contractual terms

should be listed, complemented with the economic and other conditions affecting the transactions. The second part also includes business strategies, other influences relevant to the execution of the transaction and information on the use of the methods for determining transfer prices in accordance with comparable market prices. Any other documentation demonstrating the conformity of transfer prices with comparable market prices should be included in this second part (ZDavP-2).

3.2 Master file

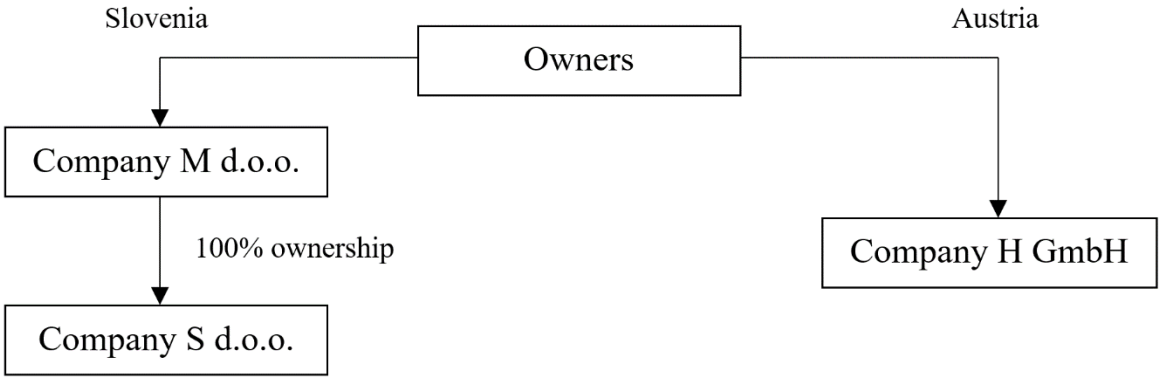
As part of the master file, I will go through the organisational structure and basic data of the companies in the group or companies associated according to the Corporate tax act (ZDDPO-2).

3.2.1 Organizational structure of the group

The group of the companies consists of the parent company M d.o.o. and its subsidiary S d.o.o. Company M d.o.o. owns 100% of shares of company S d.o.o. Both companies are tax residents of Republic of Slovenia and, according to article 17 of the Corporate tax act, affiliated in capital.

Company H GmbH is a tax resident of Republic of Austria. Company M d.o.o. or S d.o.o. do not own shares of H gmbH. Even though they are not affiliated in capital, according to article 17 of the Corporate tax act (ZDDPO-2), companies M d.o.o. and H GmbH are associated in management, because the same individuals directly hold all the shares and have control over both companies. A 25% match in ownership would already be sufficient for the companies to be deemed associated, but in this case, the ownership structure match is much higher. The organisational structure of the group is presented in Figure 7.

Figure 7: Organisational structure of the group



Source: Adapted from S d.o.o. (2019).

M d.o.o. and S d.o.o. are obliged to pay corporate taxes (sl. Davek od dohodka pravnih oseb) according to article 3 of the Corporate income tax act (ZDDPO-2). Since it is based in Austria, H GmbH has to pay corporate taxes according to the Corporate income tax act (KStG), BGBl. No. 401/1988.

3.2.2 General description of the companies

The parent company, M d.o.o., was established in 1993. The main economic activity according to the Standard classification of economic activity (SKD) 2008, which is based on NACE (Statistical classification of economic activities), is Other business and management consultancy activities (SKD code M 70.220). The company's core activity until 2009 was manufacture and assembly of greenhouses and fabric structures. In this year, the subsidiary company S d.o.o. was established, which took over the core activity. M d.o.o. was renamed and internally restructured to separate activities between the companies, keeping only services. It conducts activities like consulting, accounting, marketing, making project documentation and research. It only does business with its subsidiary company S d.o.o..

The subsidiary company S d.o.o. was established in 2009. The main economic activity according to SKD is Manufacture of metal structures and its parts (SKD code: C 25.110). In the beginning, the company manufactured greenhouses and fabric structures. Through years, the share of greenhouses in total sales declined, while the share of fabric structures increased. With development in the field of structures covered with insulated panels, the company decided to gradually quit the manufacture of greenhouses due to the growth of the company and the potential seen on other markets, which was finalized in 2019.

Currently, most of the income of S d.o.o. is generated with sales of fabric structures. However, the share of structures covered with insulated panels is rapidly increasing. It is expected that in a few years industrial halls and aircraft hangars covered with insulated panels will become the company's main products. The company's strategy regarding industrial halls is to increase their market share, while at the same time gaining recognition in the aviation industry, mostly in aircraft maintainance and garaging.

Company S d.o.o. is present on many markets. The main one is Slovenia, followed by Austria and Switzerland. However, the Austrian market was taken over by company H GmbH, which was established to represent the company's brand in Austria. Company S d.o.o. is not limited only to those markets; their products can be found all across Europe and other continents as well.

Company H GmbH was established in 2017 and operates in Austria. The main economic activity according to Klassifikation der Wirtschaftstätigkeiten (ÖNACE) 2008 is Herstellung von Metallkonstruktionen (Manufacture of metal structures) (ÖNACE code: 25.11-0). Company H GmbH operates on the Austrian market only.

Table 3: General information on associated companies

Company	Total revenue (in thousand EUR)	Net profit (in thousand EUR)	Assets (in thousand EUR)
M d.o.o.	850	69	874
S d.o.o.	11.571	230	6.113
H GmbH	1.892	65	174

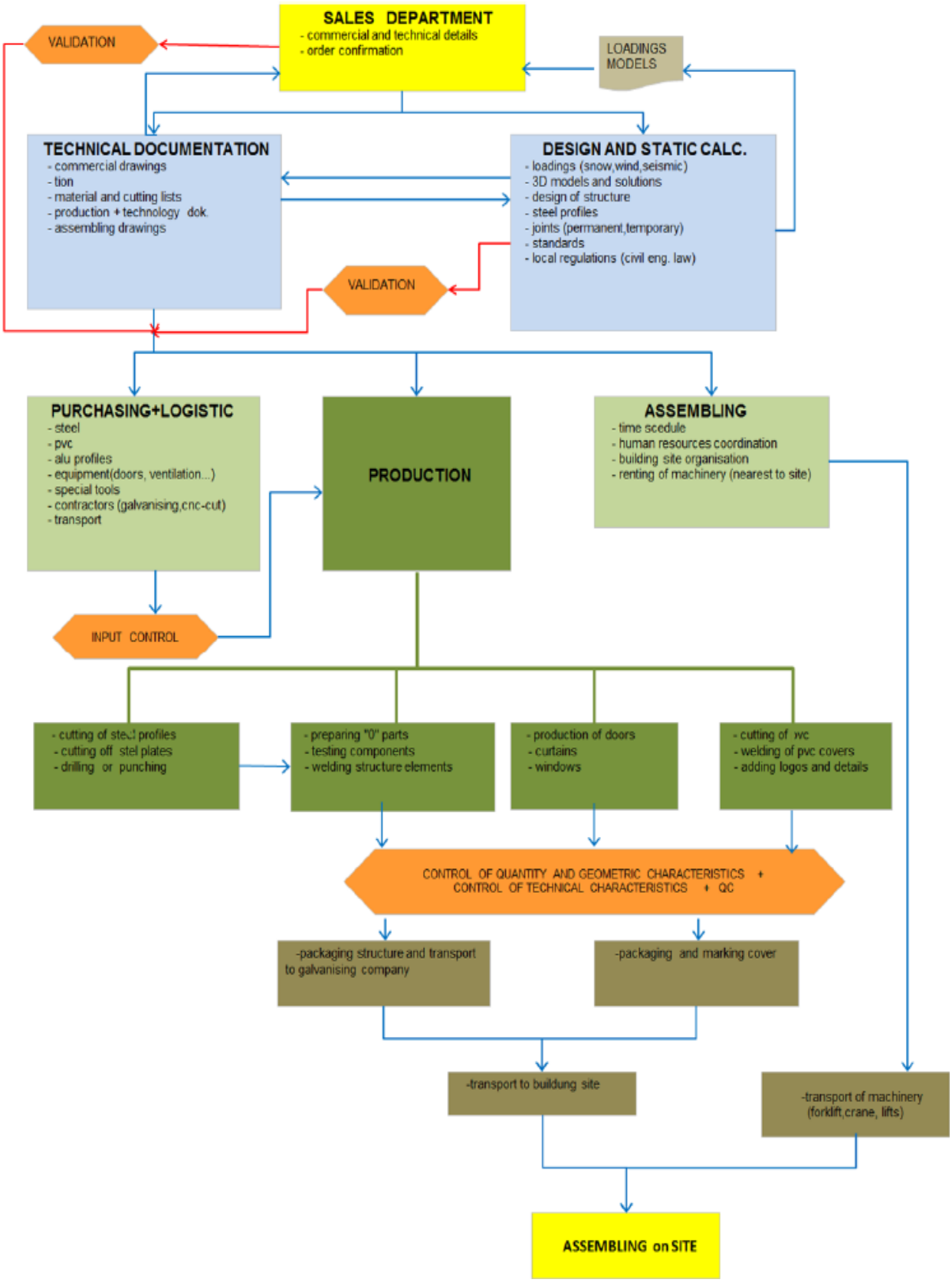
Source: Adapted from GVIN (n.d.), and S d.o.o. (2019).

In Table 3 total revenue, net profit and total assets are shown. Data is taken from balance sheets for the business year 2018. A business and financial year of the companies equals one calendar year.

3.2.3 General description of operations

Company M d.o.o. prepares the annual sales plan for the group as a whole. The segmentation of the sales plan is based on main markets and is made once a year. Even though the expected numbers are group-wide, the sales plan for the Austrian market is actually a plan for company H GmbH, while other markets represent the plan for S d.o.o.. The production process of the company S d.o.o. is described in Figure 8.

Figure 8: Production process



Source: S d.o.o. (2014).

It starts with marketing. After potencial customers send their inquiry or call to the company, the sales department of M d.o.o. arranges a meeting with them to discuss the details of the solution they need. Since the product is usually unique, salesmen do the measurements on spot to prevent problems with assembly. Every product is tailored to the customer's needs. After all the details are confirmed from the client and they issue an order, the technical department of M d.o.o. starts preparing technical documentation. As soon as the quantity of the needed materials is known, the procurement department starts with purchasing and arranging logistics. With the finished technical documentation, production starts with the cutting of steel profiles, welding structure elements, production of doors, windows and welding of PVC fabric. Before transportation to the building site, control of quantity, quality, geometric and technical characteristics is made. The structure is galvanized and usually transported directly to the building site from the galvanizing company. The last stage is assembly on site. Company S d.o.o. provides the installers, while the machinery is rented. Post purchasing services are also provided. Warehousing is taken care of by the company S d.o.o., which also owns the majority of storage premises, renting the remaining part from M d.o.o.. The latter owns the offices. Company H GmbH rents their office space from a third party.

Company M d.o.o. does the control of sales and also evaluates the performance of it. The sales activities are carried out by H GmbH for the Austrian market and M d.o.o. for others. Marketing and promotions are done by M d.o.o.. Accounting is done by M d.o.o. for S d.o.o., while H GmbH outsources it. Other services like human resource management (HRM) are done by M d.o.o. for the whole group.

3.2.4 Business strategy

Company M d.o.o. plans to further carry out consulting and other services for the company S d.o.o.. This means that their growth is directly connected to their subsidiary. Company S d.o.o. aims to moderately but steadily grow each year. The company recently acquired new production facilities, which enables the company to comfortably operate, while also allowing growth. The management's main goal is to achieve steady growth with no further investments, at least for the next five years.

Increasing the company's market share on the Slovenian market of industrial halls is one of the main goals, especially after the exit of the biggest player on the market in the last year. The company's aim is to take their spot in the next five years. With the recent entry into the aviation segment, the company S d.o.o. is trying to increase their market share through hangars made for aircraft maintenance or garaging. The company devoted many resoures to develop in that field and plans to further do so. Company H GmbH is expected to grow faster than S d.o.o. since the Austrian market, being the main one, is much bigger than the Slovenian market. In order to acquire a higher market share, the company aims to employ

additional salesmen, as the management believes this is the current bottleneck of the company.

3.2.5 General economic factors and competition

The economic situation after the global financial crisis has stabilised and is improving. The general macroeconomic information for years 2016, 2017, 2018 and 2019 for Slovenia is presented in Table 4 and for Austria in Table 5. It can be seen from the data that the company's both main markets are slowly but steadily growing. The group's goal is to increase their market share, especially in Austria, as it's gross domestic product (GDP) is nearly eight times that of Slovenia. The first step in that direction was establishing H GmbH. Since the Austrian market is much larger than the Slovenian and relatively close, it should become their main market in the next few years.

Table 4: General macroeconomic information for Slovenia

Slovenia	**2016**	**2017**	**2018**	**2019**
Population (in thousand)	2.064	2.066	2.067	2.081
GDP per capita (EUR)	18.500	19.400	20.200	20.490
GDP per capita change (%)	3,4	4,9	4,2	1,4
Unemployment rate (%)	8,0	6,6	5,1	4,6
Inflation (%)	-0,2	1,6	1,9	1,7

Source: Adapted from EUROSTAT (n.d.).

Table 5: General macroeconomic information for Austria

Austria	**2016**	**2017**	**2018**	**2019**
Population (in thousand)	8.700	8.773	8.822	8.859
GDP per capita (EUR)	36.500	37.200	38.000	38.240
GDP per capita change (%)	0,8	1,9	2,2	0,6
Unemployment rate (%)	6,0	5,5	4,9	4,5
Inflation (%)	1,0	2,2	2,1	1,5

Source: Adapted from EUROSTAT (n.d.).

The biggest competitors according to the main economic activity of S d.o.o. are Arcont d.d. Gornja Radgona, MDM d.o.o. and REM d.o.o.. Their total revenue and net profit are presented in Table 6.

Table 6: Total revenue and net profit of the biggest competitors according to SKD in 2018

Competition	Arcont d.d.	MDM d.o.o.	REM d.o.o.
Total revenue (EUR)	71.653.740	51.970.261	29.581.349
Net profit (EUR)	2.232.333	1.628.054	2.120.293

Source: Adapted from GVIN (n.d.).

Even though these companies are classified as competitors according to SKD, they are not deemed competition by the company S d.o.o.. It is difficult to pinpoint the companies who offer exactly the same products and services. The first problem is that the product itself is unique, tailored to the buyer's needs. The primary differentiation of the competition is the type of material for structure, which can be steel or concrete. Another problem is that companies sometimes provide only one part of the end product. If company S d.o.o. offers a turn-key solution, direct competitors are companies who provide the steel structure, while indirect competitors would also be companies offering only insulation or assembly of the structure.

Company S d.o.o. is trying to differentiate from the competition by providing clear span steel structures of more than 50 meters wide, which extremely reduces the competition in Slovenia and also Europe. The main competitors according to experience and analysis of company S d.o.o. on the Slovenian market are Armat d.o.o., Bemija d.o.o. and Biro Ogis d.o.o.. Their key financial information is presented in Table 7. The main competitors on markets across Europe are Haltec Hallensysteme GmbH (Germany), Best-Hall Oy (Finland), Rubb Hall AS (Norway) and Modular Hallensysteme GmbH (Austria).

Table 7: Total revenue and net profit of the competition on the Slovenian market according to the company's experience in 2018

Competition	Armat d.o.o.	Biro Ogis d.o.o.	Bemija d.o.o.
Total revenue (EUR)	10.464.375	3.274.259	1.925.957
Net profit (EUR)	201.229	166.115	153.818

Source: GVIN (n.d.).

3.3 Local file

3.3.1 Transactions between associated companies

All transactions between affiliated enterprises are described below. The majority is contractually determined. The only transactions without the contract are between S d.o.o. and H GmbH. It is in the interest of the management of the group to make a contract for these transactions soon. The transactions are presented in Tables 8 and 9 below.

3.3.1.1 Accounting, HRM and administration services

Company M d.o.o. does the accounting, human resource management and administration services for company S d.o.o.. The services provided are contractually determined. Some of accounting activities covered in the contract are managing and organizing accounting and personnel services, preparation of financial statements, managing the financial sector, planning, organizing, monitoring, coordinating and supervising work in the financial sector, preparing reports and analysis. HRM activities described in the contract are editing, updating and archiving documentation related to employment relationships, record keeping (data protection), preparation of monthly reports for the needs of the company and the Statistical Office of the Republic of Slovenia, keeping records of occupational safety and health, accounting for employee attendance, issuing and accounting of travel orders. The administration tasks listed in the contract are recording and archiving mail. Next are editing, updating and archiving business documentation and procurement of stationery and auxiliary materials. Transactions are based on monthly issued invoices. Prices were set after analysing market prices for comparable services offered.

3.3.1.2 Business cooperation fee

Terms and conditions of the cooperation of M d.o.o. and S d.o.o. are described in the business contract. M d.o.o. does the sales functions for S d.o.o.. The tasks defined in the contract are communication with customers, preparing offers, cooperation with the technical department and the company's management. Other more administrative tasks of the selling process are also listed, for example, preparation of documentation for tenders, assistance to the Head of sales, entering data into the company's information system Largo and storing sales documentation.

S d.o.o. is obliged to pay a commission of 2,5% of annual sales. It is agreed that invoices are issued monthly in the amount of 26.500 EUR excluding VAT. The final assessment is made at the end of the business year. The payment is due in 30 days after the issue of the invoice.

3.3.1.3 Rental of equipment

M d.o.o. leases equipment to S d.o.o.. The rent is contractually determined and includes the lease and any running costs. The lessor is obliged to maintain the equipment and, if necessary, repair it. M d.o.o. must also reimburse S d.o.o. for the maintenance of the things paid by the lessee in lieu of the lessor.

Invoices are issued monthly and due within 30 days. The equipment rented is listed in the contract. The list is reviewed at the end of each business year. Any changes are written in the annex to the contract, including the monthly fee, adjusted to the new equipment list.

3.3.1.4 Rental of premises

M d.o.o. leases business premises to S d.o.o.. The rent is contractually determined and includes the office building and yard. The rental price does not include the cost of routine maintenance of the property, the cost of electricity, heating, water, the cost of garbage collection and other costs.

Invoices are issued monthly and have to be paid in advance for the current month until the 15th. The contract is concluded for a period of 20 years, signed in 2009. The price paid monthly is adjusted once a year with the annex to the contract.

3.3.1.5 Project documentation

It is contractually determined that M d.o.o. will produce project documentation and static calculations of steel structures for the preparation of project documentation for S d.o.o.. It will also provide static calculations for the development and optimization of new structures. Documentation is required to be made using specific software. Structures need to be designed in HiCAD or AUTOCAD in the DWG format, written documents in Word and tables in EXCEL. Invoices are issued monthly and are due in 30 days. Documentation made in the last month is listed in the invoice.

3.3.1.6 Redistribution of costs

Since the costs of electricity, heating and similar are not covered with rental price for the premises, M d.o.o. redistributes those costs to S d.o.o. according to the contract. It is more efficient that one company takes care of operating expenses than each business individually. Costs being redistributed are internet, phones, electricity, waste disposal, cleaning, water, software for attendance and access control, maintenance of hardware and software licenses. Invoices are issued monthly and are due within 30 days. Invoices include the specifications of the items charged.

3.3.1.7 Product with assembly and transportation included

Even though H GbmH does not have an exclusive right to sell on the Austrian market, the group does 95% of business on said market through the Austrian company, using the group's brand. Company S d.o.o. provides the end product for H GmbH. The price of the product includes assembly and transportation. However, H GmbH takes care of the machinery and any additional costs related to assembly, for example waste disposal. The price charged for the product is the same as it would be to an unaffiliated company, lowered only for the costs of machinery.

These transactions are not contractually determined yet. Terms and conditions are usually adapted to those agreed with the end client. Payments are typically divided into three instalments; one paid in advance, one at the delivery of the material to the construction site and last upon signature of the handover protocol. S d.o.o. issues the invoice to H GmbH after the end client has paid the instalment, with the due date in seven days.

Table 8: Description of the transactions made with M d.o.o.

TRANSACTION	PARTICIPANT	TYPE	CONTRACT (yes/no)	FREQUENCY (invoicing)	ANNUAL VALUE (EUR)	CURRENCY	TERMS AND CONDITIONS
Accounting, HRM and administration services	S d.o.o.	Service	Yes	Monthly	92.400	EUR	30 days
Business cooperation fee	S d.o.o.	Service	Yes	Monthly	318.000	EUR	30 days
Rental of equipment	S d.o.o.	Service	Yes	Monthly	19.400	EUR	30 days
Rental of premises	S d.o.o.	Service	Yes	Monthly	26.400	EUR	30 days
Project documentation	S d.o.o.	Service	Yes	Monthly	324.000	EUR	30 days
Redistribution of costs	S d.o.o.	Service	Yes	Monthly	72.000	EUR	30 days

Source: Adapted from Guzina (2012).

Table 9: Description of the transactions made with S d.o.o. without M d.o.o.

TRANSACTION	PARTICIPANT	TYPE	CONTRACT (yes/no)	FREQUENCY (invoicing)	ANNUAL VALUE (EUR)	CURRENCY	TERMS AND CONDITIONS
Product with assembly and transportation included	H GmbH	Goods	No	As needed	1.700.759	EUR	7 days

Source: Adapted from Guzina (2012).

Company M d.o.o. has the following contracts with S d.o.o.:

- Accounting, HRM and administration services contract from 14.3.2016,
- business cooperation contract from 10.1.2018,
- contract for rental of equipment from 14.9.2009,
- contract for rental of premises from 2.10.2009,
- contract for project documentation from 14.12.2015,
- contract for redistribution of costs from 14.12.2015.

3.3.2 Functional analysis

3.3.2.1 Main functions

The main functions performed in the group are presented in Table 10. The table clearly shows that companies M d.o.o. and S d.o.o. perform the majority of functions, while H GmbH provides only the assembly and does the sales function.

Table 10: Functions performed in the group

Function	M d.o.o.	S d.o.o.	H GmbH
Strategic management	x		
Accounting and finance	x		
Human resource management	x		
Functions connected to intellectual propery	x		
Research and development	x	x	
Procurement		x	
Manufacturing		x	
Assembly		x	x
Sales	x		x
Warehousing		x	
Logistics		x	
Marketing	x		

Source: Adapted from Guzina (2012).

The function of strategic management is done by M d.o.o. for the whole group. Activities included are defining the company vision and business model, planning business success and regulating business from a legal point of view. M d.o.o. prepares the annual sales plan for the whole group, including segmentation based on the market and type of structure. The plan is prepared in December for the next year. The same applies for marketing, finance and employment plans.

Company M d.o.o. conducts, according to the contract, the accounting and finance function for the company S d.o.o. and provides information for internal and external users such as tax

administration. H GmbH outsources these functions. M d.o.o. does the accounting and management of VAT for S d.o.o.. Some of the other functions provided are payroll, invoicing, import and export documentation, insurance of claims and archiving the needed documentation.

The HRM function is performed by M d.o.o. for the whole group, which is contractually determined. This includes new employement, preparing job classification, which is based on planning and developing the personnel and staff training. Other HRM functions performed are scheduling and relocating the workers according to production needs, controlling the safety at work and providing legal support.

If required, M d.o.o. organises internal staff trainings or applies employees to seminars or workshops carried out by third parties. Most common are software training, foreign language courses and seminars regarding novelties in laws concerning the business. When management wants a certain employee to acquire special skills, they send them on specific workshops in their field of work.

Since safety at work is very important to the company, all employees are required to renew their licences for operating with machinery prescribed for their job. Otherwise they can not work at their workspace. M d.o.o. controls the licences for machinery and medical examinations for the whole group.

Functions related to intellectual property are managed by M d.o.o. for the whole group. This includes patents, brands and improving reputation. The company's logos and logo of the brand are patented. Some structure types are patented as well. Both S d.o.o. and H GmbH have the rights to use the logos, brands and patents. M d.o.o. is responsible for validity, extension or renewing, protection and security of the groups' intellectual property.

The R&D department of the company M d.o.o. is responsible for functions such as innovation, new product development, optimisation of existing products and adapting to market needs. Company M d.o.o. employs a number of professionals who provide expertise in the field of metal structures. As the company aims to become the leading panel covered industrial halls manufacturer, the need to cooperate with architects has emerged. The few years plan is to have their own team of architects, for now they only employ one.

Even though the main part of research and development is done by M d.o.o., they have to collaborate with S d.o.o. as sometimes the problems only appear during the process of production. Theoretical solutions are not always the best practical ones, that is why cooperation of both is of great importance. H GmbH is not included in the process of development or optimisation of the products. However, if the salesmen in the field notice a good solution implemented by the competition, they pass the information on to M d.o.o..

Procurement is taken care of by Company S d.o.o., which orders materials and goods as needed or based on customer orders. The procurement sector looks for suppliers, takes care

of negotiations with them for the best possible purchase prices, while also keeping good business relations and timely procurement of materials. Supplies and consumables for production are procured in stock.

Manufacturing is performed by S d.o.o.. Functions included are planning, managing and controlling of the production. The main production segments are cutting of the steel, welding of the steel and welding of the fabric. Before the product leaves production, the quality is checked by a specialist. No structure leaves without his check and confirmation that it meets the standards.

Products are sold with assembly included. It is provided by S d.o.o. which has four teams of installers. Since there are eight projects running at the same time on average, the teams of installers for other projects are outsourced. S d.o.o. is cooperating with them for many years.

The machinery needed for the assembly to run smoothly is rented. S d.o.o. finds the best value provider and rents scissor lifts, forklifts, telescopic forklifts and cranes for the duration needed. However, the machinery for the Austrian market is taken care of by H GmbH. If the assembly lasts for several days, it is necessary to reserve accommodation for the installers. S d.o.o. organises it for foreign markets and H GmbH for the Austrian market respectively.

Company M d.o.o. performs the sales functions for S d.o.o. based on the contract, while H GmbH does it on its own. These functions are determining the sales strategy, designing sales models, customer management, training sales staff, control and evaluation of sales performance.

The products offered by the group are divided into three main groups: fabric structures, industrial halls and aircraft hangars. Every product is unique, therefore nothing can be produced in advance and kept in stock. Salesmen visit potential customers to determine the width, length and side height, and the number and type of windows and doors. The salesman also measures the terrain to avoid potential problems regarding inclination or obstacles. The sales staff then monitors and is in contact with the client throughout the project until the takeover record is signed.

S d.o.o. rents the warehouse from M d.o.o. as written in the contract. S d.o.o. does the admission of material to the storage. Employees designated to operate the forklifts then move the steel and other material from one workstation to another when needed. After all parts of the end product are cut and welded, they move them to a special place where it waits to be transported either to the galvanizing plant or directly to the customer.

Logistics are carried out by S d.o.o. for the whole group. They organise transportation of incoming and outgoing material. As around ten trucks are needed daily to move the steel to or from the company, the three trucks owned by S d.o.o. are not enough for the company’s needs, the rest is outsourced from transportation services.

Marketing and promotion in the Slovenian and foreign markets is handled by M d.o.o. for both other companies. Before the beginning of the year, the marketing department prepares the plan for the whole year, which is then monitored monthly. Other marketing activities performed are marketing communications, preparation and release of promotional material, sponsorships and participation in international fairs.

3.3.2.2 Risks assumed

Risks assumed are presented in Table 11.

Table 11: Risks assumed by companies in the group

Risk	M d.o.o.	S d.o.o.	H GmbH
Market	x	x	x
Customers defaults		x	x
Liquidity	x	x	x
Risks associated with procurement		x	
Risks associated with inventory		x	
Risks associated with quality	x	x	
Production planning and capacity utilization	x	x	x
Business regulation	x	x	x

Source: Adapted from Guzina (2012).

The demand for the products depends on market communication, competition and season. During the winter, sales figures are usually lower and in case of longer periods of snow days assembly is sometimes not possible.

Market risks are present in S d.o.o. and H GmbH, whose sales are directly connected to market movements. S d.o.o. and H GmbH are directly affected by market risks, while M d.o.o. only does business with S d.o.o., which means it is indirectly affected.

The inability to pay the obligations incurred by the business partners towards S d.o.o. and H GmbH creates the risk of customer defaults, which directly impacts both. Since S d.o.o. is the only customer of M d.o.o., the latter is not affected by risks associated with customer deafults.

Exposure to liquidity or solvency risks implies the possibility that at one point in time, any of the companies may not have sufficient cash to cover all the liabilities that enable smooth operation. All three companies are affected by liquidity risks. Companies try to mitigate the risk by planning the cash flows and using revolving loans from the banks.

Company S d.o.o. is the only one in the group with production. They procure the materials themselves, which means that the risks associated with procurement only affect S d.o.o. They

try to spread the risks by having numerous suppliers. To avoid long delivery times, they try to do business with local suppliers whenever possible.

The warehouse is taken care of by S d.o.o., who rents it from M d.o.o.. The risks associated with inventory affect only S d.o.o. as H GmbH does not own or use any storage in Austria. Materials, semi-finished product and end products are all stored in Slovenia until transported to customers where assembly takes part.

Both M d.o.o. and S d.o.o. are affected by risks associated with quality. M d.o.o. prepares technical documentation for the projects. They guarantee the customers that the product can sustain the snow and wind load prescribed by Eurocode. S d.o.o. then produces all parts of the structure according to the blueprints received from the technical department of M d.o.o.. Before the structure is transported, one last quality check is done.

S d.o.o. assumes the risks connected to production activities. However, H GmbH and M d.o.o. cooperate on production planning. When it comes to scheduling the order of the projects, all companies work together to avoid any delay in delivery time. After the projects are ranked by priority, S d.o.o. organises and manages the workforce and machines to operate on optimal capacity.

Most structures covered with fabric required no building permit until 2018 when the new legislation came into force. In theory, it is supposed to be simplified, but in practice it is often much more complicated. With the new legislation, all structures require a building permit. However, those covered with fabric need to only obtain a simplified building permit, which should be a short and easy process. Since the launch of the new law, many clients stopped their investments, because they could not obtain the building permit. M d.o.o. offers their clients help during the process of obtaining all the required papers.

Assembly is also regulated, in some countries more than others. Switzerland is very strict when it comes to installers from foreign countries. The registration, hourly rate and working hours are all controlled by inspectors. Both S d.o.o. and H GmbH assume risks related to business regulation. A great deal of emphasis is on safety at work.

3.3.2.3 Assets used

Company S d.o.o. rents the premises and warehouse from M d.o.o.. The terms and conditions are described in the contract. Invoices are issued monthly; the costs connected with electricity, heating and similar are divided based on the calculated consumption of each company. S d.o.o. rents the offices, and a yard and fabric structure used as a storage facility. The premises where production takes place are owned by S d.o.o..

Equipment and machinery are also owned by M d.o.o. and rented by S d.o.o.. Invoices are issued monthly, and all other terms and conditions are contractually determined. The objects

of the contract are welding machines, saw, welding robot and similar. M d.o.o. covers the maintainance and repair costs.

3.3.3 Chosen methods for determining transfer prices in the group

Table 12 shows the methods chosen for determining transfer prices for the transactions between companies in the group.

Table 12: Methods chosen based on the transactions

Participants	Transaction	Chosen method	Frequency
M d.o.o. and S d.o.o.	Accounting, HRM and administrative services	External CUP method	Monthly
M d.o.o. and S d.o.o.	Business cooperation fee	Cost plus method	Monthly
M d.o.o. and S d.o.o.	Rental of equipment	Cost plus method	Monthly
M d.o.o. and S d.o.o.	Rental of premises	External CUP method	Monthly
M d.o.o. and S d.o.o.	Project documentation	External CUP method	Monthly
M d.o.o. and S d.o.o.	Redistribution of costs	Indirect-charge method	Monthly
S d.o.o. and H GmbH	Product with assembly and transportation included	Internal CUP method	As needed

Source: Adapted from Guzina (2012).

3.3.3.1 Accounting, HRM and administrative services

The price for the transactions related to accounting, HRM and administrative services that M d.o.o. provides for S d.o.o. is determined in accordance with the signed contract between the two companies. Invoices are issued monthly with the due date in 30 days.

The method chosen for calculating the transfer price is the external CUP method. The price is comparable to those of third parties offering their services on the market. The companies on the market do not offer accounting, HRM and administrative services all together, that is why the transfer price is an average of the prices offered for a single service. The average is adjusted to cover the actual parts of the services offered. For example, accounting represents 50%, HRM 15% and administrative services 35%.

The reason, why the three services are grouped together in one transaction, is that three employees performing the services work on all of the services, not just one. It is impossible to measure how much time an employee spends on HRM only, because for example, some tasks of all three services can be performed in an hour. According to Article 17 of the Rules on transfer prices, comparable market prices may be determined on the basis of combined transactions by assessing the circumstances of the transaction together and not on an individual basis, and on the condition that individual transactions are closely related to or

directly follow one another, so that they cannot be separately adequately assessed (Rules on transfer prices).

3.3.3.2 Business cooperation fee

Business cooperation between the companies M d.o.o. and S d.o.o. is contractually determined. Invoices are issued monthly and adjusted at the end of the year in regard to total sales. The due date is in 30 days.

Since it is impossible to predict the exact sum of total sales in advance, the companies have agreed to make the payments every month to operate without difficulties and then adjust the total sum at the end of the year. The cost-plus method was selected. The monthly transaction is calculated as an average of the costs of performing sales functions from previous years, which is around 2,5% of total sales of S d.o.o. (these costs do not vary much from year to year), plus a mark-up of 5%. At the end of the year, the difference between the sum of monthly transactions and 2,5% of the total sales is paid.

3.3.3.3 Rental of the equipment

Rent for the equipment is issued every month, as described in the contract, for the previous month, up until the last day of the next month. The due date is in 30 days.

The rental price of the equipment is calculated with the cost-plus method. The total sum changes every year and equals the costs of amortisation of the equipment rented. To those costs, a mark-up of 5% is added. The contract is adjusted every year with the new monthly rent with the annex to the contact.

3.3.3.4 Rental of the premises

The rental of the premises is contractually determined and has to be paid until the 15th of the month for the current month in advance.

The rental price of the premises is set in accordance with the external CUP method. The price is calculated as an estimate of the price of a square meter rented in the area where the companies are settled. If necessary, prices are adjusted according to the recent prices of renting a square meter once a year with the annex to the contract.

3.3.3.5 Project documentation

Project documentation is prepared by M d.o.o., after which the production of S d.o.o. cuts and welds the steel. The parent company issues the invoice once every month, with the due

date in 30 days. As described in the contract, the invoice includes the specification of the documentations done in the previous month.

Prices are calculated using the external CUP method. M d.o.o. tracks the exact number of hours spent on a specific project, which is then multiplied by the hourly rate set by the Slovenian Chamber of Engineers. Latest hourly rate published was 34 EUR/h. Changes made to the prices are written in the annex to the contract for project documentation.

3.3.3.6 Redistribution of costs

M d.o.o. takes care of the bills for operating expenses and invoices S d.o.o.'s share to it, as agreed in the contract. Invoices are issued once per month, with the due date in 30 days. Specifications of the items charged are included in the invoice.

The method chosen for the redistribution of the operating expenses is the indirect-charge method. Even thought this method is not described in the Corporate tax act nor in the Rules on transfer prices, it can be used according to the OECD Transfer pricing guidelines. All three conditions required to use the method are met: It represents less than 5% of the total revenue, it is not one of the main economic activities and the company does not perform this activity for third parties. Prices are based on the share of the operating expenses each company incurred. The shares were determined in line with the analysis made by the companies and are described in the contract.

3.3.3.7 Product with assembly and transportation included

S d.o.o. provides the products for H GmbH, including assembly and transportation. These transactions are not yet contractually determined. Invoices are usually connected to the client's payments to H GmbH. A project is divided into three instalments, in case of total value exceeding 300.000 EUR. The first instalment is an advance payment, the second is paid at the delivery of the material to the client and the last after the signing of the takeover record. When it comes to projects worth more than a million euros, invoices are issued based on monthly situations.

The transfer pricing method used for those transactions is the internal CUP method. The prices are comparable to those existing to third parties. Calculations for the prices between S d.o.o. and H GmbH are prices offered to the market, the only difference is in the lifting machinery. H GmbH provides the lifting machinery by itself. The same can be offered to third parties. However, in 99% of cases the clients prefer the turn-key solution.

3.4 Research results

After studying the literature on transfer prices and conducting a case study, I can provide an answer to the research questions:

Are transactions between the observed associated companies compliant with the national legislation and the arm's length principle?

Which transfer pricing methods do the observed companies apply to the transactions? Are those methods the most suitable?

The group of associated companies uses the CUP and the cost-plus methods for transactions between them. Those are defined in the Rules on transfer prices, which means they are definitely compliant with the national legislation (Rules on transfer prices). The indirect-charge method used for redistribution of costs is not directly described in the Rules on transfer prices. However, it can be used in accordance with the OECD transfer pricing guidelines (OECD, 2017b).

Since the product and the whole service provided by the group of companies are unique, the market prices are more difficult to be assessed. However, transactions that apply the CUP method are definitely compliant with the arm's length principle. This cannot be said with 100% certainty for the transactions using the Cost-plus method. Calculating the profit margin of the competitors gives us an estimate of what an appropriate mark up should be. The profit margins of the competitors range from 2-8%. The cost-plus mark up used by the group of companies is 5%, which is within the previously mentioned boundaries. I can conclude that the mark up is in line with the arm's length principle.

The answer to the second research question is provided in Table 13. In all but one case, the companies use one of the traditional transaction methods, mostly the CUP and the cost-plus method. An alternative method is utilized for one transaction, the indirect-charge method is used for redistribution of costs. According to OECD, it is preferable to use the traditional transaction method over transactional profit methods. In case the direct method is not applicable, companies can use indirect methods (OECD, 2017b). If all the conditions are met, companies can use the indirect-charge method for redistribution of costs (Guzina, 2019). All conditions to use the alternative method are met and the method used for four other transactions is the CUP method. For those, I can conclude that the transfer pricing methods are suitable. Regarding the Cost-plus method, I conclude that one of the transactional methods would be more suitable, the TNMM or the Profit split method.

Table 13: Methods chosen for transaction between associated companies

Participants	Transaction	Chosen method
M d.o.o. and S d.o.o.	Accounting, HRM and administrative services	External CUP method
M d.o.o. and S d.o.o.	Business cooperation fee	Cost plus method
M d.o.o. and S d.o.o.	Rental of equipment	Cost plus method
M d.o.o. and S d.o.o.	Rental of premises	External CUP method
M d.o.o. and S d.o.o.	Project documentation	External CUP method
M d.o.o. and S d.o.o.	Redistribution of costs	Indirect-charge method
S d.o.o. and H GmbH	Product with assembly and transportation included	Internal CUP method

Source: Adapted from Guzina (2012).

3.5 Recommendations

Since there is not much comparable data available, I recommend the company to replace the Cost-plus method with one of the transactional, profit-based methods, which are better used in such cases. It would be easier to prove that the mark ups of these two transactions are in line with the arm's length principle in case of being audited. Transfer pricing methods currently chosen for the intra group transactions and those I would recommend to the group are presented in Table 14.

Table 14: Currently chosen and recommended transfer pricing methods

Transaction	Chosen method	Recommended method
Accounting, HRM and administrative services	External CUP method	External CUP method
Business cooperation fee	Cost plus method	Transactional net margin method
Rental of equipment	Cost plus method	Transactional net margin method
Rental of premises	External CUP method	External CUP method
Project documentation	External CUP method	External CUP method
Redistribution of costs	Indirect-charge method	Indirect-charge method
Product with assembly and transportation included	Internal CUP method	Transactional net margin method

Source: Own work.

My recommendation to the group is to contractually determine the transactions between S d.o.o. and H GmbH. This way they would save time as every transaction would not have to be individually addressed. I would recommend to them to issue invoices monthly, similarly to the transactions between M d.o.o. and S d.o.o.. Such invoicing would reduce the number of events, which would result in increased efficiency.

I do not see any benefit in using the Advance pricing agreement for the studied group of associated companies as the filling and extension fees are relatively high. Considering the

volume of the business and the fact that the transfer prices used in transactions are in accordance with the arm's length principle, I suggest the companies not to engage in concluding the APAs, as tax authorities should not be inspecting them. Now that they have the transfer pricing documentation, the risk of the group being penalised is additionally reduced.

My final recommendation and probably the most crucial one is to consider merging the companies in Slovenia, M d.o.o. and S d.o.o.. The latter was founded in 2009 as the result of the financial crisis that started in 2008 to help the companies spread the risk. As the group records growth for the past few years, the consequences of the crisis are not visible anymore. Merging of the companies would greatly reduce the number of transactions and lower administrative costs by relieving employees of the additional paperwork that is required for the companies to operate separately. However, with the occurrence of the Covid-19 virus in winter 2020 (Frieden, 2020), the group should wait for the situation to end and then re-assess how the key markets and business in general will be affected.

My recommendation to the groups of companies providing similar solutions or products as the observed group is to use the transactional transfer pricing methods rather than traditional ones. As the product is complex and usually unique, it is difficult to acquire data that would be comparable without making any adjustments. With transactional transfer pricing methods, like TNMM comparing net profits, it would be easier to determine transfer prices in line with the arm's length principle. Regarding APAs, I recommend smaller companies to not engage in concluding them as the fees are relatively high. On the other hand, for groups much larger than the observed one, APAs should be considered, but are by no means necessary.

My recommendation for the tax authorities would be to create criteria to determine when it becomes mandatory for companies to have the transfer pricing documentation prepared annualy. Since this is very time consuming, it should depend on the volume of business between the resident and non resident associated enterprises whether they should have to prepare the documentation. Smaller companies who do not meet the criteria would be obliged to prepare the transfer pricing documentation in 30 days in case of being audited by tax authorities.

Another thing I suggest the tax authorities to do is lower the APA's filling and extension fees, which would motivate taxpayers to engage in concluding APAs. This way they would reduce their and taxpayer's paperwork. The other factor besides the fees that would motivate companies to work on APAs is the complexity of the mentioned agreements. It should be simplified as much as possible while still providing all the necessary data for the tax authorities to be able to determine whether the taxpayer's transfer prices are in line with legislation.

3.6 Limitations and future research

The main limitation of this case study was the availability of comparable data, as the company's product is very unique and therefore not many are present in the market. Adjustments to the comparable data were necessary in order to have been able to use it.

Generalisation is definitely a limitation of this case study. The studied group of companies offers very unique products and services, which means that the results of this case study cannot be applied to a larger population of cases (Yin, 2013). Very high internal validity, and on the other hand very low external, is typical for single case studies (Jacobsen, 2002).

Another potential limitation is subjectivity. As I work for the company that is the main subject of the case study, my findings could contain bias towards falsification of data (Flyvbjerg, 2006).

Future research should focus on providing comparable data. This would enable the company to prove that their prices are in line with the arm's length principle with higher degree of certainty. This could be achieved by retrieving data from the Amadeus database, provided by Bureau van Dijk. With access to this database, it would be possible to find comparable companies and their financial data, which could be used to apply TNMM to transactions within the group. However, it would probably be necessary to separate processes (project documentation, manufacture of steel structure, assembly, etc.) and search one by one, as other companies usually outsource at least one part of the turn-key solution, provided by the studied group of companies. Another option to get comparable data is public tenders. However, as mentioned earlier, companies who apply to these tenders almost never provide project documentation, structure and assembly by themselves.

CONCLUSION

Transfer prices have gained attention in recent years, mainly due to the scandals of large multinationals. Companies attempt to pay as little tax as possible and often manipulate transfer prices. Developed countries, including Slovenia, have recently tightened their legislation. They have prescribed extensive documentation based on the OECD guidelines. It must be submitted when transfer prices are reviewed by tax authorities. This places the burden of proving the suitability of transfer prices in tax proceedings on the taxpayer. Double taxation and possible penalties or adjustments to the tax base may occur (Kuhar, 2008).

Multinational companies often try to transfer profits into countries where effective income tax rates are lower (Buettner and Wamser, 2013). However, if the related parties are residents, the transfer prices are checked only if one of the companies is in a more favorable tax position. In recent years, the Slovenian tax authorities have been looking into companies with foreign owners doing business in Slovenia, as their profits often flow to countries with more favorable tax rates (Guzina, 2019).

For the determination of transfer pricing, related enterprises must take into account comparable market prices in their interactions. According to the Article 16 of ZDDPO-2, the comparable market price is the price of comparable assets and services between related enterprises, which is or would be reached on the market among non-associated enterprises in the same or similar circumstances (Corporate Income Tax Act, 2006). The arm's length principle is used to make transfer prices comparable to transactions of independent enterprises in comparable conditions (OECD, 2017b).

Transfer prices are not always inadequate. They must follow the arm's length principle which states that prices between affiliates must be the same as those charged by unrelated companies. The transfer price should therefore be equal to the market price, which is rarely seen in practice. The main reasons for this are differences in products, payment terms, assumed functions and risks. These should be detailed in the transfer pricing documentation, as it is difficult to find comparable transactions in the market between unrelated companies (Guzina, 2012).

The methods for determining transfer prices are primarily divided into two groups: traditional transaction methods and transactional profit methods. The main difference between the groups is based on the availability of data. Traditional transaction methods use comparable transactions on the market to determine the transfer prices, while transactional profit methods, which are based on profits, use data exclusive to the associated enterprises, because of a lack of data from the market. Traditional transaction methods are the Comparable uncontrolled price, the Resale and the Cost-plus method. Transactional profit methods are the Transactional net margin and the Profit split method. (OECD, 2017b).

In this master thesis, I prepared the transfer pricing documentation for a group of associated companies. Company M d.o.o. does business with a resident manufacturing company S d.o.o. and a non-resident company H GmbH, based in Austria. All three companies are operating at a net profit. In the group, transfer prices are determined with the method of comparable uncontrolled prices; when this method is not possible, the cost-plus method is used. In one case with redistribution of costs, the indirect-charge method is used. A comprehensive analysis of transfer prices has shown that companies operate in accordance with the arm's length principle.

I find it interesting that the studied group of associated companies uses the Comparable uncontrolled price method in four out of seven intra-group transactions. Even though it is the most widely and commonly used method, while also preferred by tax administrations (Perčević, 2011), I expected that, because of the uniqueness of the product and the service provided, and lack of accessible data regarding comparable transactions in the market, they would have to use the TNMM or the Profit split method.

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APPENDIX

Appendix: Povzetek (Summary in Slovene language)

Transferne cene so v zadnjih letih pridobile pozornost, predvsem zaradi škandalov velikih multinacionalk. Podjetja pogosto oblikujejo transferne cene z namenom zmanjšanja skupnega davka v skupini. Razvite države, med njimi tudi Slovenija, so poostrile svoje zakonodaje. Predpisale so obsežno dokumentacijo, ki temelji na smernicah OECD. Predložiti jo je potrebno ob morebitnem pregledu transfernih cen s strani davčne inšpekcije. S tem se breme dokazovanja v davčnih postopkih prestavi na davčnega zavezanca. Pojavi se lahko tudi dvojna obdavčitev in morebitne kazni ali prilagajanje davčne osnove.

Multinacionalna podjetja pogosto poskušajo preliti dobičke v države, kjer so efektivne davčne stopnje na dohodek nižje. V primeru, da sta povezani osebi rezidenta, pa se cene preverja le v primeru, ko je eno izmed podjetij v ugodnejšem davčnem položaju. Slovenski finančni urad v zadnjem času pod drobnogled postavlja podjetja s tujimi lastniki, ki poslujejo v Sloveniji, saj pogosto njihov dobiček odteka v države z ugodnejšimi davčnimi stopnjami.

Transferne cene niso vedno neustrezne. Slediti morajo neodvisnemu tržnemu načelu, ki pravi, da morajo biti cene med povezanimi podjetji enake tistim, ki bi si jih med sabo zaračunavala nepovezana podjetja. Transferna cena bi torej morala biti enaka tržni, kar pa je v praksi redko videno. Glavni razlog za to so razlike v izdelkih, plačilnih pogojih, prevzetih funkcijah in tveganjih. Le te morajo biti podrobno opisane v dokumentaciji o transfernih cenah, saj je na trgu med nepovezanimi podjetji težko najti primerljive transakcije.

V magistrskem delu sem za skupino povezanih podjetij analiziral medsebojne transakcije in pripravil dokumentacijo o transfernih cenah. Proizvodno podjetje M d.o.o. posluje s podjetjem S d.o.o., ki je rezident, in podjetjem H GmbH, nerezidentom iz Avstrije. Vsa tri podjetja poslujejo z dobičkom. V skupini podjetij transferne cene določajo po metodi primerljivih prostih cen, kadar ta metoda ni možna pa uporabijo metodo stroški plus. V enem primeru je uporabljena tudi metoda prerazporeditve stroškov. Analiza transfernih cen je pokazala, da podjetja poslujejo v skladu z neodvisnim tržnim načelom.