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SERBIA: BDK Tax Note on Transfer Pricing

In the face of the growing public deficits, tax authorities around the globe have made the regulation and enforcement of transfer pricing legislation and the underlying arm's length principle a top priority.

In Serbia, the first transfer pricing rules have been introduced in 1991. However, the actual application of the transfer pricing legislation is starting only as of the Fiscal Year 2013. In December 2012, amendments were introduced to the legislation in order to be fully compliant with the OECD Transfer Pricing Guidelines (2010). The law now requires the submission of mandatory documentation by the taxpayers who engage in transactions with related entities, along with their corporate income tax returns. Such documentation should disclose and explain the related party transactions and the selected pricing methodology. The Minister of Finance is yet to prescribe the content of such documentation in a separate rulebook. It is still uncertain whether the rulebook will contain any safe harbor rules or allow advance pricing arrangements with the tax authority. Safe harbor is a statutory provision offering relief to eligible taxpayers from certain obligations. In case of transfer pricing, a safe harbor provision may exclude certain types of transactions from the application of transfer pricing provisions (e.g. by setting materiality thresholds) or subject them to simplified requirements (e.g. by designating ranges within which prices or profits must fall). Advanced pricing arrangement is a binding arrangement between the tax authority and a taxpayer that determines in advance a set of criteria applicable to transfer pricing of particular transactions over a fixed period of time, such as method, comparables and appropriate adjustments and critical assumptions regarding future events.

In the meantime, the World Bank has been providing training to tax inspectors on how to run transfer pricing audits in accordance with the international standards and best practices.

This notice aims to clarify the risks for Serbian companies using intra-group transactions and the necessary tools in order to avoid these under the new transfer-pricing legislation.

Since the transfer pricing rules are fact-sensitive, there is a huge potential for disagreement related to whether the taxpayer has reported the correct amount of taxable profits or not. So far, Serbian tax inspectors have been inclined towards lightly qualifying transfer pricing as tax evasion. Due to the fact that the new rules introduce the OECD approach in the transfer pricing area, it is expected that in the future, situations which will typically trigger a transfer pricing investigation in Serbia will be similar to the situations arising in more developed jurisdictions, namely:

- Corporate restructurings, particularly downsizing of operations in the Serbian entity;
- Significant transactions with related parties located in tax havens or low tax jurisdictions;
- The situation where the Serbian entity is reporting losses or claiming significant tax credits or other tax incentives (in these circumstances, even transactions between Serbian related parties may become the focus of the tax authority);
- Deductions claimed on the basis of fees paid under cross-border intra-group service or management agreements, or royalty payments for unregistered intellectual property such as know-how;

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- Inconsistencies within the description of the transaction amongst various transaction documents, such as contracts, invoices and/or customs documentation;
- Separation of business functions and assignment of related risks to a related party in another jurisdiction, frequent revisions of transfer pricing policies and procedures, recurring year-end pricing adjustments, particularly if they create book/tax differences, may also alert the tax auditors.

These are the risks faced by taxpayers with the related party transactions:

- Local tax re-assessments;
- Potential double taxation of income where relief under tax treaties is not available (due to fact that the Serbian Ministry of Finance rarely applies the Mutual Agreement Procedure);
- Penalties and interest on overdue tax;
- Damage to reputation and diminution in brand value as a consequence of being perceived as a 'bad corporate citizen'.

Transfer pricing rules do not offer absolute protection, in particular if there are no safe harbor rules or advance pricing arrangements, and the government is under budgetary pressure. Serbian taxpayers cannot discard the possibility of being challenged by the tax authority, no matter how much of a conservative transfer pricing strategy they adopt. The burden of proof is on taxpayers to establish transfer pricing at arm's length in a way compliant with the local documentation requirements. It is not sufficient for taxpayers to presume that they have the right answer – they will need to be able to prove it.

The requirement introduced within the Serbian law for the submission of mandatory documentation which is still to be elaborated by the Minister of Finance, provides an opportunity to companies engaged in transactions with related parties to set up a new transfer pricing policy or update an existing one. From the management perspective, the gathering of information during the set-up process of the policy can offer valuable insight into the business and reveal new tax and commercial opportunities that have previously been disregarded. A carefully planned transfer pricing structure can increase tax efficiency of the respective company's supply chain and allow the entire group to consider other non-tax implications such as the effect on the corporate restructuring, resource allocation, management compensation plans and management of third party liability exposure.

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