

SMALL AND MEDIUM SIZED ENTERPRISES (SMEs) AND TRANSFER PRICING

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Abstract

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Small and medium sized enterprises have very important position in the EU economy, mainly in the area of growth and employment. However, most of SMEs are active only in their home country and only a few of them participate in cross-border activities. Furthermore, their activities in the internal market are limited by great deal of obstacles, mainly in the form of different tax systems which generate excessive compliance costs of taxation and the existence of different SMEs definitions for various purposes in Member states. In addition, from the view of the international taxation issues, the most important obstacles can be considered a transfer pricing and cross-border loss compensations. In this area, SMEs are facing specific problems and have specific needs. The aim of the paper is to analyze and evaluate the specific transfer pricing issues of SMEs and propose recommendations for them.

EU, small and medium enterprises, compliance costs of taxation, transfer pricing

The surveys¹ of European Commission have proved not only the key role of SMEs for EU economy, but simultaneously have also revealed the existence of obstacles for SMEs² mainly in the form of different tax systems which generate excessive compliance costs of taxation and the existence of new distortions within the EU Internal Market in the form of different SMEs definitions for various purposes. In addition, the survey³ has revealed that only 5% of European Union SMEs have reported having subsidiaries or joint ventures abroad. Very

low participation in cross-border activities of SMEs was also proved.

There are more than 20 million enterprises operating in the EU non-financial business economy which provide around 75 million jobs (80%). This means that about 99.8% of companies in EU represent SMEs (having less than 250 employees)⁴. Within the SME-sector, the vast majority (91.8%)⁵ are micro enterprises having less than 10 employees. Furthermore, SMEs in the EU-27 has grown strongly between 2002 and 2008. The number of SMEs

1 European Commission, *Company Taxation in the Internal Market* (COM(2001)582 final), and also in *Internationalisation of SMEs or Modern SME policy for growth and employment* (COM(2005)551 final), European Commission. Furthermore in *Background information on SMEs*, EU Joint transfer pricing forum, European Commission.

2 Enterprises qualify as micro, small and medium-sized enterprises (SMEs) if they fulfill the criteria laid down in Recommendation 2003/361/EC.

3 European Commission, *Observatory of European SMEs, analytical report, 2007*. Directorate-General for Enterprise and Industry.

4 European Commission, *European SMEs under Pressure, Annual report on EU small and medium-sized enterprises 2009*, Directorate-General for Enterprise and Industry or in *SMEs in Europe 2003*, European Commission, DG Enterprise Publications. Furthermore in *Simplified tax compliance procedures for SMEs*, 2007 European Commission, Directorate-General for Enterprise and Industry or in *Modern SME policy for growth and employment* (COM(2005)551 final).

5 European Commission, *Internationalisation of SMEs*, 2003, No. 4. DG Enterprise Publications or *European SMEs under Pressure, Annual report on EU small and medium-sized enterprises 2009*. Directorate-General for Enterprise and Industry.

increased by 2.4 million (i.e. 13%), whereas the number of large enterprises increased only by 2000 (i.e. 5%)⁶. It seems to be obvious that this growth was also reflected in employment figures. During this period, the number of jobs created within SMEs increased annually by 1.9%, while the number of jobs in large enterprises only by 0.8% annually. In absolute numbers, during this period SMEs has created 9.4 million jobs. In that connection, SMEs are considered to be the key factor of economic growth and employment in the EU.

The major economic problem which SMEs are actually facing represents a lack of market demand. Given the large government budget deficits it cannot be expected that market demand will be stimulated by increased government expenditures or decrease in taxes in the EU. Thus, export and the propensity to invest seem to be now the major engine of the economic recovery in Europe. Based on the survey done by Directorate General of Enterprise and Industry⁷, micro enterprises reached a gross investment in tangible goods in the amount 24% of value added, in comparison with 19% for all enterprises. As the propensity to invest in micro enterprises is overall higher than could be expected on the basis of their profitability, it underlines their importance for the EU economy. In addition, the stimulation of export would directly support SMEs that export their products or are subcontractors to exporting business. However, Directorate General Enterprise and Industry⁸ reported that 63% of SMEs were active only in their home country and that only 8%⁹ of them exported and that 12% of SME inputs were purchased abroad in 2007. This is connected mainly with the facts that only 5% of SMEs are associated (have subsidiaries abroad) and that SMEs are less involved in cross-border activities.

I consider that the very small percentage of SMEs that are involved in international business activities can be caused by the complexity and specialized knowledge required in dealing with the international taxation issues, particularly with transfer pricing issues. As was already mentioned above, only 5% of SMEs have subsidiaries abroad, where transfer pricing may be in point. These types of SMEs are facing difficulties as a result of their lack of knowledge, experience of the subject and resource availability in comparison with multinational enterprises (hereinafter as MNEs). In addition, these types of SMEs do not have the same resources to bear the high administrative burden to comply with the transfer pricing rules.

In EU transfer pricing compliance means adherence to the arm's length principle in line with Art 9 of the OECD Model Tax Convention and with recommendations in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter as TP Guidelines). I consider that the application of transfer pricing rules in accordance with Art 9 of the OECD Model Tax Convention and with recommendations included in TP Guidelines is more complex and these difficulties are compounded by the fact there is neither a common definition of SMEs for tax purpose in the EU or symmetry of treatment of this issue. Furthermore, the costs associated with transfer pricing matters can be disproportionately large for SMEs in comparison to large MNEs for both the taxpayer and the tax administration (see further). In addition, transfer pricing methodology included in TP Guidelines is not appropriate for SMEs. From the above mentioned reasons, based on the above mentioned obstacles and compliance costs for SMEs, I consider that the approach "one-size fits all" in case of SMEs dealing with transfer pricing issues is not possible.

Tax obstacles which are SMEs facing on the Internal Market are even higher due to the economic crisis and with respect to the substantial role of SMEs in EU economy it is necessary to find a suitable solution for removing of these obstacles. The aim of the paper is to analyze and evaluate the specific transfer pricing issues of SMEs and propose recommendations for them.

Present situation

The tax obstacles to the cross-border activities are identical for both large enterprises and SMEs. However, SMEs are much more influenced by these tax obstacles because they do not have sufficient human and economic capital in comparison with large enterprises. The most important issues which SMEs are facing when operating on Internal Market are **compliance costs of taxation** which are generated in connection with non-existence of unified system of SMEs taxation (there are 27 different tax system in EU), **transfer prices and problems with cross-border loss compensations**.

Compliance costs of taxation as state Chittenden, Michaleas, Poutziouris (2000) are hundred times higher for SMEs than for large enterprises. Furthermore, as mentions Cressy (2000) these costs are regressive to the size of enterprise and disproportionately large for SMEs in comparison with large enterprises. The same conclusion was

6 European Commission, European SMEs under Pressure, Annual report on EU small and medium-sized enterprises 2009. Directorate-General for Enterprise and Industry.

7 Ibid. footnote No 6.

8 European Commission, *Observatory of European SMEs, analytical report, 2007*. Directorate-General for Enterprise and Industry.

9 In 2003, under the survey of European Commission only 6% of SMEs export. For details see: *Internationalisation of SMEs*, European Commission.

reached by Sandford (1995) who further states that this regressive effect is accumulated and excessive burden of these costs can generate prohibitive effect. In addition, Sandford (1995) mentions that compliance costs of taxation can decrease international competitiveness. Nerudová, Bohušová, Svoboda, Široký (2009) mention that compliance costs of taxation have regressive character with respect to the size of the enterprise which is significantly higher in case of SMEs with foreign branch or subsidiary in comparison with SMEs which are not internationalized.

Transfer prices are significant for both taxpayers and tax administrations because they determine the income and expenses, and therefore taxable profits of associated enterprises in different tax jurisdictions. The Committee on Fiscal Affairs, which is the main tax policy body of the OECD, has issued a number of reports relating to the transfer pricing issues. The most important are the TP Guidelines which was published in 1995. These TP Guidelines focus on the main issues of principle that arise in the transfer pricing area. The Committee on Fiscal Affairs continues its work in this area. On 22 July 2010 the proposed revisions has been approved and released. However, TP Guidelines set treatments of transfer pricing issues with respect to MNEs only. In addition, TP Guidelines make no direct distinction between types or sizes of MNEs. In theory, all enterprises, regardless of their size, are subject to the same principles and recommendations. TP Guidelines (2010) provide that application of the transfer pricing rules may be more complex for SMEs in several places.

Transfer pricing represents an instrument which is used as tax planning tool. Transfer pricing policy can also help to achieve supplementary goals e.g. minimization of taxes, duties and tariffs, or sales and marketing goals. Properly chosen transfer pricing strategies can enable the distribution of the tax risks. However, this policy is available only for large MNEs because SMEs do not have sufficient human and financial capital for expert tax advices and other expert services. Furthermore, the positive effect on overall effective tax rate of the consolidated organization on base the distribution of the tax risks occurs when business operations are shifted between jurisdictions with different statutory tax rates as mention Tierney, De Grave, Moore, Vandervelden, Mathieu (2009).

At present, there is not any TP Guidelines for SMEs, any publicly available guidance on how SMEs should treat transfer pricing, how they should recognize it, how to react and how to improve SME knowledge of transfer pricing. *EU Joint Transfer Pricing Forum* (hereinafter as JTPF) states that solution of this issue would help to ensure the better functioning of the SMEs on the Internal Market.

Another tax obstacle to cross-border activities of the SMEs is the problem with **cross-border loss compensations** as mentions Nerudová (2005). SMEs with foreign subsidiaries have the lack

of possibility of cross-border loss offsetting. In comparison with SMEs, large entities can influence offsetting of losses by the properly chosen transfer pricing strategy. Nerudová, Bohušová, Svoboda, Široký (2009) mention that possibility of cross-border loss offsetting would increase the effective investment allocation on the Internal Market. At present, the lack of the possibility of cross-border loss offsetting in some EU Member States (Czech Republic, Belgium, Greece, Lithuania, Hungary, Slovak Republic, Estonia) not only discourages SMEs from establishment of activities abroad but also restricts their access to financial sources abroad.

Furthermore, as mention *Chen (2002)* and Mintz (2002) beside the above mentioned tax obstacles which discourage SMEs from operating on Internal Market, this fact is also caused by the Member States which favor domestic activities of SMEs in the form of lower tax rates, tax deductions, methods of construction of tax bases in their national tax systems.

The above mentioned issues cause that SMEs have very low participation in cross-border activities on Internal Market in comparison with large entities, because their cross-border activities are connected with higher compliance costs of taxation, higher financial costs and higher business risks. In addition, the existence of tax obstacles can cause significant distortions in allocation of SMEs investments in the EU. Therefore the European Commission has started to solve the issue of the tax obstacles in the area of corporate taxation since 1990s. However, this initiative has just the general character and is not aimed at problem of SMEs. In that connection the European Commission is considering the establishment of the European Private Company which would be suitable for SMEs, including the possible system of unified taxation within the EU. Moreover, International Accounting Standard Board has introduced the accounting standard for SMEs, which is based on IAS/IFRS. Implementation of that standard will cause remarkable decrease in compliance costs of taxation for SMEs.

MATERIALS AND METHODS

Within the paper, mainly the method of description will be used, for it is the basic method, which enables the precise identification and description of researched phenomenon. This should help to classify the gained information in order to reach the higher level of structure and transparency of individual information basis. Furthermore, other important method which will be used is comparative analysis method, which enables to reach scientific knowledge by the comparison of individual processes and phenomenon. In addition, the others methods, namely analysis, quantification, induction and deduction should be followed by the method of synthesis, which will be applied in the process of the creation of the partial outcomes and

of the proposal recommendations for SMEs in the line of TP Guidelines as a final result.

RESULTS AND DISCUSSION

SMEs differ from each other and also very significantly from MNEs. In comparison with MNEs, SMEs generally differ in size, activities, needs and resources. Furthermore, they have a lower labour productivity, lower profitability, differences in the qualification and skill levels of the employees and capital intensity and cannot reach the same scale economies as MNEs. In according to above mentioned reasons, special rules already exist in the area of accounting and financial reporting. However,

SMEs are also facing specific problems and have specific needs in the practical international taxation issues. Should be extended special rules to transfer pricing too?

The first problem, which arises in this area, is **lack of common definition of SMEs** in EU for tax purpose, particularly transfer pricing purposes. A general EU definition for SMEs exists in Art. 2 of Commission Recommendation 2003/361/EC (for details see Fig. 1 below) but is not widely used by Member States for tax purposes.

Member States apply different SMEs definitions concerning various aspects of their legislations, for example to grant particular tax exemptions, to set up simplified tax return modalities, simplified accounting systems or transfer pricing documentation. However these definitions are usually very broad and based on company-size or transaction-size indicators with little recognition of degrees of complexity (for details see fig. 2). The criteria commonly used throughout the EU are balance sheet value, turnover, and number of employees; individual or cumulative transaction values; and some anti abuse rules. As seen, definitions of SMEs in Member States often “borrow” from parts of the EC SME definition.

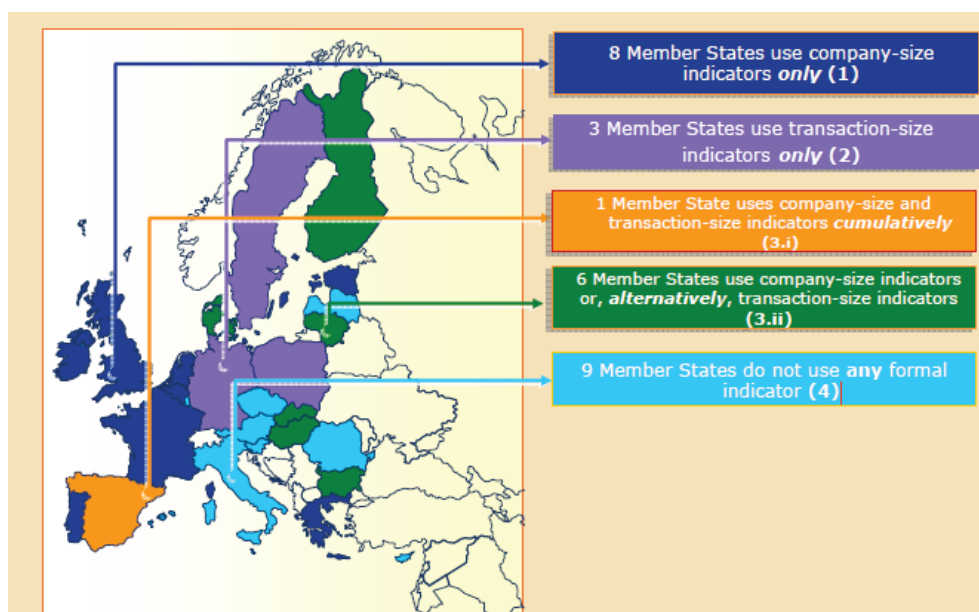
As seen in Fig. 2, no specific size indicator prevails within the EU, even nine Member States do not use any formal indicator (company-size, transaction-size, other indicators) for transfer pricing purpose, namely the Czech Republic, Austria, Italy, Slovenia, Romania, Latvia, Luxembourg, Cyprus and Malta.

Furthermore, there are specific statements of SMEs in case of transfer pricing documentation requirements in EU. Almost all EU Member States require no or less documentation requirements

Enterprise category	Headcount: Annual Work Unit (AWU)	Annual turnover	or	Annual balance sheet total
Medium-sized	< 250	≤ €50 million	or	≤ €43 million
Small	< 50	≤ €10 million	or	≤ €10 million
Micro	< 10	≤ €2 million	or	≤ €2 million

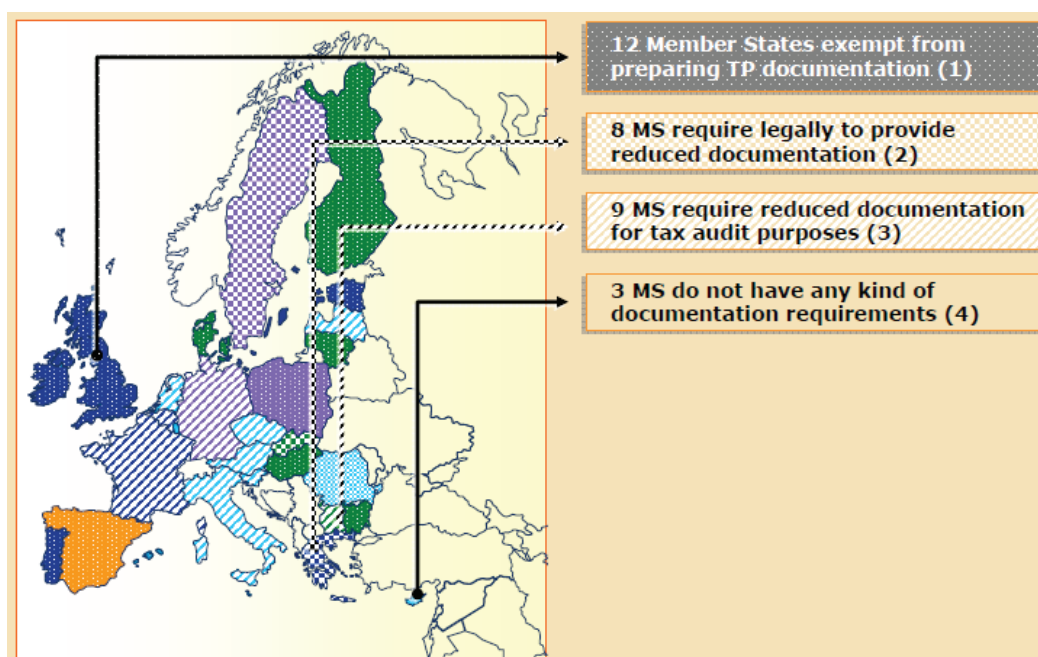
1: Definition of micro, small and medium-sized enterprises (EC SME definition)

Source: European Commission, SME User Guide



2: Current application of size indicators in the EU for transfer pricing purposes

Source: JTPF, Background information on SMEs, 2010



3: Documentation requirements in relation to size in the EU
Source: JTPF, Background information on SMEs, 2010

based on size of company or transactions (for details see Fig. 3 below).

At the beginning as a starting point of the findings and recommendations to this paper, it is recommended defining a common EU definition of SMEs for direct tax purposes or more specifically for transfer pricing purposes. The recommended criteria consist of balance sheet value, turnover, and number of employees; individual or cumulative transaction values, which are commonly used in EU and which should be measured on a consolidated basis. For example in the United Kingdom, SMEs are enterprise that meets at least two of the following criteria:

- Annual turnover must be no more than £ 25.9 million,
- Balance sheet total must be no more than £ 12.9 million,
- Average number of employees must be no more than 250.

However, during the process of defining SMEs tax definition should be considered a situation, where for small Member States applying this SME definition could result in even large domestic companies being classified as SMEs, therefore, special care must be taken regarding the SME definition applied.

The second problem, which arises in this area, is **compliance costs** related to transfer pricing that means the fulfillment of the arm's length principle in line with Art 9 of the OECD Model Tax Convention and with recommendations in the TP Guidelines. These compliance costs can be incurred during pre audit activity, audit activity, and post audit activity, as a consequence of applying transfer pricing rules.

Once a common tax definition for SMEs is considered, the next step would be to suggest specific recommendations related to transfer pricing issues. Such recommendations would seek to set appropriate requirements that would be proportionate to the size of the companies with aim to relieve SMEs from disproportionate burdens and ensure non-discrimination between MNEs and SMEs. Transfer pricing recommendations for SMEs should include framework of the pre audit, the audit process and after the audit, specifically a dispute resolution.

In the first stage (pre audit) should be suitable to develop a specific transfer pricing guidelines for SMEs without deviation from TP Guidelines, adopt a simplified advance pricing agreement (hereinafter APA) and a simplified transfer pricing documentation for SMEs. It is recommended to establish a web site including these Guidelines, advance pricing procedures with their outcomes that can be expected as well as further information (who to contact for further advice, other SME transfer pricing legislation/decrees, administrative practice or training material etc). Furthermore is suitable to organize technical workshops for SMEs.

In the second stage (audit process) should be taken into account that SMEs are not able to ensure all required information related to transfer pricing study, specifically comparable and functional analysis. It should be suitable to consider the simplification measures; furthermore providing assistance to SMEs in preparing comparable data and analysis, and moreover in choosing the most suitable transfer pricing method in line with results of comparable and functional analysis; in addition

to consider a preparation of a limited transfer pricing study from the side of SMEs. Furthermore, it would be inappropriate to impose penalties for the absence of additional documentation that was not required in pre-audit, mainly if SMEs were acting in good faith and are not able to supply the required documentation.

The last stage (after audit) should be focused on the dispute resolution. Once a transfer pricing adjustment has been made it often triggers double taxation requiring an application of Mutual agreement procedure (hereinafter MAP) available under a tax treaty, or the EU Arbitration Convention (hereinafter EU AC) or both of them for elimination of double taxation. However, SMEs very often have little knowledge of how to go about making such application and how the process works. Furthermore, when the adjustment involves transaction with a relatively low monetary value there is a high probability that SMEs do not want to apply of MAP or EU AC with the final result of double taxation. So it is recommended to make easy-friendly MAP or EU AC to eliminate double taxation for SMEs and furthermore use of authority of tax administrators to act unilaterally in SMEs cases.

The last problem, which arises in this area, is **cross-border loss compensations**. This issue should be partial solved under proposal of Directive of Common consolidated corporate tax base (hereinafter CCCTB) which was issued by European Commission on 16th March 2011. However it is

important to note, that this proposal of CCCTB is not focused on SMEs but generally on corporate entities, so it is necessary to further explore this issue in details from the perspective of SMEs.

CONCLUSIONS

SMEs have very important position in the EU economy because SMEs are the key factor of economic growth and employment in the EU. However, most of SMEs are active only in their home country and only a few of them participate in cross-border activities during which SMEs are limited by great deal of obstacles. Any obstacles which SMEs are facing when operating on Internal Market are undesirable and it is necessary to find a suitable solution for removing of these obstacles. The most important issues which SMEs are facing on Internal Market are compliance costs of taxation, transfer prices and problem with cross-border loss compensations. As SMEs have particular needs in meeting their requirement to comply with transfer pricing rules, this paper has been focused on problem of transfer pricing, specifically a lack of common definition of SMEs in EU for tax purpose and compliance costs of fulfillment of the arm's length principle in line with Art 9 of the OECD Model Tax Convention and with recommendations in the TP Guidelines. For both of issues some recommendations were proposed (for details see Tab. I). However, it is necessary to further explore these issues in details.

I: Summary of recommendations for issues of SMEs related to transfer pricing

Issues	Recommendations
a lack of common definition of SMEs in EU for tax purpose	To define a common EU definition of SMEs for direct tax purposes or more specifically for transfer pricing purposes. The recommended criteria consist of balance sheet value, turnover, and number of employees; individual or cumulative transaction values, which are commonly used in EU and which should be measured on a consolidated basis.
	<ul style="list-style-type: none"> ● To develop a specific transfer pricing guidelines for SMEs without deviation from TP Guidelines. ● To adopt a simplified APA and a simplified transfer pricing documentation for SMEs.
	For pre-audit <ul style="list-style-type: none"> ● To establish a web site including these Guidelines, APA procedures with their outcomes and further information (who to contact for further advice, other SME transfer pricing legislation/decrees, administrative practice or training material etc). ● To organize technical workshops for SMEs.
compliance costs related to transfer pricing	<ul style="list-style-type: none"> ● It should be suitable to consider the simplification measures, e.g. a preparation of a limited transfer pricing study from the side of SMEs. ● To provide assistance to SMEs in preparing comparable data and analysis, and moreover in choosing the most suitable transfer pricing method in line with results of comparable and functional analysis. ● Not to impose penalties for the absence of additional documentation that was not required in pre-audit, mainly if SMEs were acting in good faith and are not able to supply the required documentation.
	For audit process
	For after audit <ul style="list-style-type: none"> ● It is recommended to make easy-friendly MAP or EU AC to eliminate double taxation for SMEs. ● Where it is possible in SMEs cases to apply unilateral procedures from the perspective of tax administrators.

Source: own processing

SUMMARY

SMEs have very important position in the EU economy, mainly in the area of growth and employment. However, SMEs differ from each other and also very significantly from MNEs, namely in size, activities, needs and resources. Nowadays from the perspective of SMEs, special rules already exist in the area of accounting and financial reporting. However, SMEs are also facing specific problems and have specific needs in the practical international taxation issues, specifically SMEs are facing on Internal Market with compliance costs of taxation, transfer prices and problem with cross-border loss compensations. This paper focused on analysis and evaluation the specific transfer pricing issues of SMEs. In the end of the paper some recommendations were proposed.

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