



Importance of robust TP-documentation highlighted in Slovak case

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This blog analyses a Slovak TP-case with the aim of highlighting the importance of a robust and meticulously documented TP-strategy, which could have, in the case discussed herein, helped avoid years of litigation. In the context of the benchmarking process, the case highlights the need for a well-reasoned comparability analysis based on economically significant factors, rather than outcome-based screening of comparables. The decision of the court also highlights the relevance of carrying out a manual screening of the selected comparables, especially with respect to criteria such as independence (A+, A, A-).

Illichmann Castalloy s.r.o. (“Illichmann”), an aluminium-casting manufacturer in the Slovak Republic, part of the Austrian-headquartered Alicon Group, reported a loss of EUR 562k (approx.) in FY 2012-13. Illichmann used the profit split method (“PSM”) for the valuation of its most significant transaction, but did not include a functional and risk analysis in its (simplified) transfer pricing (“TP”) documentation. As part of the tax audit, the Slovak tax authorities performed a TP-analysis of Illichmann, finding that Illichmann did not perform any functions related to strategic decision-making or marketing activities, and hence had no control over the risks it had been assigned according to Illichmann.

The tax authorities thus concluded that Illichmann’s profile was that of a manufacturer with limited risk, and therefore, the PSM was not the most appropriate method for pricing the transaction in question. Instead, the tax authorities used the transactional net margin method (“TNMM”) to determine the taxable profit from Illichmann’s controlled transactions. Their benchmark excluded loss-making comparables and included some related/controlled companies. Increasing Illichmann’s taxable base to the resulting benchmark-median, the tax authorities made a TP adjustment, which was appealed against by Illichmann.

The issue before the Administrative Court was whether the use of the TNMM and the TP-adjustment made by the tax authorities was justifiable based on whether Illichmann was in fact a limited-risk manufacturer and should not be allowed to report a loss.

The Administrative Court ruled in favour of Illichmann, concluding that the tax authorities had failed to prove that Illichmann was a limited-function and limited-risk company that could not incur losses. The court also identified methodological defects in the tax authorities’ benchmarking process (relating to the inclusion of controlled entities and the unjustifiable exclusion of loss-making comparables). Accordingly, the court annulled the TP-adjustment in favour of Illichmann’s position (i.e., that the PSM could be applied and Illichmann had a tax loss in FY 2012-13).

Slovakia v Illichmann Castalloy s.r.o., Administrative Court, BA-1S/111/2019 (09.08.2024)

Background

The dispute arose from a TP-audit of Illichmann, a Slovak manufacturer of aluminium castings, operating within the Alicon Group, headquartered in Austria. For the audited period 1 April 2012 – 31 March 2013, Illichman reported a loss of EUR 562,183.94. The Slovak tax authorities initiated a tax inspection, focusing on TP. Illichman's most significant controlled transaction concerned sales of castings to customers in other EU Member States, executed via a Vienna-based related company. In its TP-documentation, Illichman applied the PSM in order to price its transactions with the Vienna-based related company.

The Slovak tax authorities, finding that Illichman's (simplified) TP-documentation lacked a functional and risk analysis, conducted their own analysis and characterized Illichman as a manufacturer with limited functions and risks. Hence, the tax authorities rejected the PSM and instead applied the TNMM, using the 'Amadeus' database to identify potential comparables. Within the classification of economic activities, "casting of light metals" and "casting of other non-ferrous metals" were used to identify a set of comparable companies. From the resulting set of comparables, only companies marked as independent (i.e., A+, A, A-) were retained.

Under the "profitability" criteria, only companies with available financial data for 2010 to 2012 with an operating profit ('EBIT') of minimum EUR 0 were selected – effectively excluding loss-making companies. Three of the resulting eleven companies were then manually rejected for having a low turnover (i.e., below EUR 1 million). The tax authorities' benchmark/search thus resulted in a final set of eight comparable companies. Using operating margin on total costs (i.e., EBIT/total operating costs) as the profit level indicator ("PLI"), the tax authorities determined the arm's length annual range having a median of 4.98%.

Adjusting Illichman's results (i.e., -6.09%) to the median (i.e., 4.98%), the tax authorities increased the operating profit by EUR 859,705.51, turning the reported loss of EUR 562,183.94 into a profit of EUR 306,014.98. Accordingly, the tax authorities imposed an income tax of EUR 61,202.99 in respect of FY 2012-13. On appeal, the court of first instance upheld the tax authorities' assessment, reasoning that a limited-risk manufacturer is expected to earn consistent positive returns and should not bear market-driven losses.

Arguments of the tax authorities before the Administrative Court

The tax authorities stated that since Illichman's simplified TP-documentation omitted a functional and risk analysis, they had conducted their own analysis, which indicated that Illichman performed limited functions and bore limited risks with respect to its related-party dealings. They had therefore rejected Illichman's reliance on the PSM and applied the TNMM. For benchmarking, they had screened 'Amadeus' for metal casting companies, retaining only those marked independent (A+, A, A-) and excluding loss-making companies (by using the profitability filter: $EBIT \geq 0$ for 2010–2012) on the basis that a contract manufacturer should not assume market risk without compensation and should ordinarily earn a reasonable profit. From the resulting set of eleven comparable companies, three companies with a turnover below EUR 1 million had been rejected for having "incomparable financial indicators", resulting in a final set of eight comparable companies.

For this final set of eight comparables, the tax authorities explained that they had used operating margin on total costs (i.e., EBIT/total operating costs) as the PLI, yielding an interquartile range of 1.99%–12.08%; the median being 4.98%. Concluding that Illichman’s reported position (-6.09%) warranted an adjustment as it fell outside the arm’s-length range obtained (1.99%–12.08%), they had adjusted Illichman’s result to the median (4.98%), which was, according to the tax authorities, the most reliable point in the range. In support of the TP-adjustment, the tax authorities cited Para.s 1.47, 1.49, 9.22 & 9.23 of the OECD TP Guidelines. These paragraphs state (a.o.) the following:

- Where the transaction has not been formalized, all aspects would need to be deduced from available evidence of the conduct of the parties, including what functions are actually performed, what assets are actually used, and what risks are actually assumed by each of the parties.
- Changes made in the purported assumption of a risk when risk outcomes are known do not involve an assumption of risk since there is no longer any risk.
- In any analysis of risks in controlled transactions, one important issue is to assess whether a risk is economically significant, i.e. it carries significant profit potential, and, as a consequence, whether that risk may explain a significant reallocation of profit potential. The significance of a risk will depend on the likelihood of the risk materializing and the size of the potential profits or losses arising from the risk.
- If a risk is assessed to be economically insignificant for the entity, then that risk would not explain a substantial amount of the entity’s profit potential. At arm’s length, a party would not be expected to lay off a risk that is perceived as economically insignificant in exchange for a substantial decrease in its profit potential.

Arguments of Illichman before the Administrative Court

Illichman accepted the selection of TNMM in principle but disputed its application. First, it argued that blanket exclusion of loss-making comparables was not supported by the OECD TP Guidelines (citing para. 3.64¹). Illichman asserted that comparability should be determined by economically relevant characteristics rather than on outcomes, and further that the exclusion of outliers should be based on substantive review. Second, it submitted that the tax authorities’ characterization of its risk profile was inconsistent because, while labelled limited-risk, it was nevertheless said to bear market risk, yet the tax authorities had not made any comparability adjustments for differences in risk between Illichman and the selected comparable. Third, referring to relevant caselaw, ^{2,3} it contended that selecting the median overstated the adjustment and that the lower quartile within the range would require the least intervention. Finally, it argued that two comparables in the final set (MODELLERIA FERRIERI (Italy) and CASTINOX (Spain)) should have been excluded because they exhibited personal links amounting to “dependence” (i.e., they were not independent companies because they shared beneficial owners/board members with other companies).

¹ *An independent enterprise would not continue loss-generating activities unless it had reasonable expectations of future profits. Simple or low-risk functions in particular are not expected to generate losses for a long period of time. This does not mean however that loss-making transactions can never be comparable. In general, all relevant information should be used and there should not be any overriding rule on the inclusion or exclusion of loss-making comparables. Indeed, it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result.*

² The judgment of the Supreme Administrative Court of the Czech Republic No. k. 8Afs/80/2007-105 of 31.03. 2009, which stated that “prices agreed in ordinary business relations cannot be absolutized by a single number”; “it is necessary to determine it at least by the interval of the most frequently realized prices”. “The usual price can be determined by a certain amount (without a range) in cases where a specifically defined item and/or service is being evaluated, but not in cases where it is necessary to determine whether the price realized among related or close prices is a price that would also be agreed in ordinary business relations”.

³ The decision of the National Tax Court of the Czech Republic No. k. 8Afs/51/2009-61 dated 29.12.2009, according to which “by calculating the average value from the obtained data, the tax administrator acted contrary to the opinion of the Supreme Administrative Court in case no. 8Afs 80/2007”.

Decision of the Administrative Court

The Administrative Court annulled the decision of the lower court and remitted the case for further proceedings, awarding costs to Illichman. On the exclusion of loss-making companies, the Administrative Court accepted that independent parties would not ordinarily bear market risk without compensation, but held that this proposition did not justify a categorical exclusion of all loss-makers. The Administrative Court observed that the “positive EBIT filter” (i.e., $EBIT \geq 0$ for 2010–2012) functioned as a simplifying assumption and not as a comparability assessment, artificially narrowing the set of comparables. The Administrative Court concluded that the tax authorities had misinterpreted and misapplied the arm’s-length principle by failing to evaluate contractual terms, market conditions and business strategy, instead relying on outcome-based screening.

Regarding independence of the selected comparables, the Administrative Court noted that the definition of “dependent person” includes “those with economic or personal links”, and “management” encompasses “relationships of members of statutory or supervisory bodies to the company”. In this regard, the Administrative Court noted that the use of independence indicators such as A-levels (A+, A, A-) doesn’t lead to the exclusion of companies that are personally linked, as these independence indicators are based solely on the economic aspect. Accordingly, the Administrative Court held that, since Illichman had substantiated personal links/dependence in the case of two comparables in the final set (MODELLERIA FERRIERI and CASTINOX), retaining these comparables without further inquiry conflicted with the relevant law.

Owing to these legal errors that tainted the key inputs of the tax authorities’ TNMM, the Administrative Court held that the resulting interquartile range and median benchmark did not lawfully support the TP-adjustment. Accordingly, the Administrative Court annulled the TP-adjustment in favour of Illichmann’s position (i.e., that the PSM could be applied and Illichmann had a tax loss in FY 2012-13).

Key takeaways

- Given that the case relates to FY 2012-13 and the decision of the Administrative Court was published in August 2024, had the Administrative Court ruled in favour of the tax authorities, the decision would have had a severe impact on the taxpayer, especially if the ruling also applied for subsequent years. The taxpayer would have suffered significant double taxation, as the period in which the taxpayer could try to make a corresponding adjustment (via a corrected tax return in Austria) and/or make an application for Mutual Agreement Procedure (‘MAP’) would have surely lapsed.
- With regard to the benchmarking process, the case highlights the need for a well-reasoned (and properly documented) comparability analysis based on economically significant factors, such as contractual terms, market conditions and business strategy, rather than outcome-based screening of comparables.
- It also implies that loss-making comparables may be included in the final set of comparables if the tested-company can be shown to bear and/or manage economically significant risk.
- The Administrative Court’s observation regarding the independence of MODELLERIA FERRIERI and CASTINOX implies that independence indicators (A-levels) do not suffice to exclude personal links. Hence, a manual review (for the independence criteria) is always necessary.
- More generally, the case highlights the importance of thoroughly thought-through and well-documented TP-policies and methodologies, which could have, in this case, avoided years of litigation.

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