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Unfair trading is increasingly often characterised as the cause of crisis in the full spectrum of sectors. We can go as far as to say that it is the Achilles' heel of the European agriculture, the reason for the decline of Croatian food industry, and the obstacle to growth of small and medium companies. The practice of selling at lower retail prices than the competition is often inconsiderably defined as predatory pricing. Unfair competition, or unfair trading that inhibits competition, is usually mentioned in the same context. However, the legal meaning of the terms above is not always clear, which misguides entrepreneurs to quote off-target legislation documents and approach inadequate authorities. The protection of entrepreneurs' interests in this case is relying on the precise definition of the terms and the proper identification of applicable rules.

The competition effects of under-priced goods are to a certain extent regulated both by the Trade Act and by the Competition Act. In addition, the respective issue has recently become subject to tax audits. In the text below, we will explain the differences between unfair trading under the Trade Act versus matters regulated by the Competition Act, as well as give an overview of tax implications concerning unfair trading.

The Trade Act: Selling below the purchase price

The practice of selling at lower prices than the competition is not forbidden per se. On the contrary, lower prices can be considered a positive competition effect. Lower prices encourage other entrepreneurs to compete with better quality and/or with even lower prices, what ultimately benefits the end-consumers. Nonetheless, the practice of selling of under-priced goods in certain cases is defined as forbidden unfair trading under the Trade Act. One of the examples is selling below the purchase price plus VAT.

This rule has exemptions: selling goods nearing their expiration date, withdrawing products from assortment, total sale due to store closing or due to bankruptcy / liquidation of the company / closing down a trade. We can say that these exemptions are plausible and the entrepreneurs should not be sanctioned if their intention is to minimize losses and not to limit or eliminate competition.

Besides the mentioned exemptions, the Trade Act generally allows for the sale of goods below its purchase price plus VAT (i.e. such situation is not considered to be unfair trading) when this is done in a manner, which does not hinder, limit or inhibit competition.

The law therefore allows the sale of goods even below its purchase price if there are certain reasons for this and the entrepreneurs do not hinder, limit or inhibit competition by doing so. Although this solution might be considered positive, it is the audit authorities who decide whether the reasons are justified or not. Since we depend on evaluation and not on a set of rules, we cannot be certain that all market participants are being treated fair and equally.

Considering the fact that the Trade Act uses the term of unfair trading, referring to a certain extent to the competition, it comes as no surprise that entrepreneurs sometimes approach the Competition Agency, which is wrong. The Competition Agency is not the competent authority for breaches of the Trade Act. Administrative control is performed by the Ministry of Economy, Entrepreneurship and Crafts, while the authorized inspectorate of Ministry of Finance performs the inspection (of the correct application of the Trade Act).

The Competition Act: Predatory pricing

The so-called predatory pricing is actually a form of abuse of a dominant market position, which is regulated by the Competition Act, and the application of which is controlled by the Competition Agency. The entrepreneur is considered to be using predatory pricing when they sell at prices below the purchase price only temporarily, in order to squeeze out the competition or prevent its market entry and then aiming to increase the prices afterwards. This, however, is not enough to determine the existence of breach of the Competition Act. Predatory pricing strategy requires a dominant market position and a market strength that allows the entrepreneur to act independently of competitors and consumers. In other words, in order to determine that there has been a breach, it is not enough to point out that an entrepreneur sells under-priced goods. The analysis performed by the Competition Agency is much more complex and requires the previously mentioned determination of a dominant market position (based on the market share, financial strength, connection to other entrepreneurs etc.).

Tax implications of unfair trading

The ban of unfair trading pursuant to the Trade Act should be taken seriously, especially when we know that during their control of the Trade Act application the inspectors of the Ministry of Finance also analyse transfer prices. As we have already said, it is the inspectorate of the Ministry of Finance that is authorised to control the Trade Act application.

In addition to pecuniary penalties for unfair trading according to the Trade Act (up to HRK 300,000 for legal persons and up to HRK 70,000 for responsible persons), unfair trading, once determined, can result in significant additional tax liabilities. The application of the Trade Act regulations is commonly checked within tax audits, and 'unfair trading' gets associated with the transfer pricing rules. The transfer pricing rules refer to prices and conditions applied to transactions within multinational corporations, and represent prices that are charged between affiliated companies. It is the companies themselves that determine the transfer prices, so there is a reasonable risk that they are not in line with market prices. This is in the first place a tax issue since there is a possibility that multinational corporations use their transfer prices for cross-border transactions with the aim of decreasing their taxable profit or moving the profit from one jurisdiction to another. Since trading within a group is regulated by internal policies (i.e. internal pricing policy), being a part of a group is one of the elements for determination of unfair trading. If unfair trading is determined, it leads to further analysis of transfer prices i.e. conditions applied in the group transactions.

As of recently, the inspectors of Ministry of Finance include the fact that unfair trading has been determined in their transfer prices findings. They determine that prices applied are not in line with the arm's length principle and adjust the company's tax base. Tax base can be adjusted on both income and expenses side, because inspectors can dispute either expenses (arguing that costs of goods were too high) or income (arguing that selling prices were too low). Either way, the effect on the corporate profit tax base and profit tax is negative for companies. Inspectors go as far as adjusting the prices in transactions between non-affiliated companies by combining the unfair trading and the transfer pricing rules. Namely, based on the disputed conditions and prices (costs) applied in the transactions between affiliated companies, the inspectors adjust company's income from transactions with non-affiliated companies by comparing it with the average competitors' net margin. Significant differences (in functions, assumed risks and assets used in transactions) between the company and its competitors are often disregarded in this process.

Unfortunately, other reasons why companies sell goods below the purchase price plus VAT are usually ignored during inspections. The entrepreneurs then unsuccessfully explain that the purpose of special sale prices is to stimulate the sale of certain products or to enhance the product market entry or that

some supplementary product is for the use of a main product. It is clear that the above reasons do not hinder, limit or inhibit competition and therefore should not be characterised as unfair trading.

Effects of unfair trading i.e. selling goods below the purchase price plus VAT are commonly associated with business profitability and cost-effectiveness. In this regard, the risk of determining unfair trading and adjusting the transfer prices/tax base is higher if the company continuously generates losses and has the right to carry forward tax losses.

Companies that experienced tax audits are aware that a Tax Authority's conclusion (decision) triggers long and unpredictable procedure of proving otherwise or of referring to a separate set of applicable rules. Usually, administrative courts and procedures for final resolution of tax matters take from three to five years (or even longer).

While unfair trading is a threat to the market and consumers' trust, it may also expose companies to significant fines and tax audits if the authorities treat one company's transactions as unfair trading. The ban of unfair trading should therefore be taken seriously and companies should take preventive measures carefully and regularly.