Low value adding services: simplified transfer pricing approach (1/46/18)

Proposals for amending articles 1 and 15.2 of the Taxes and Duties Act to lay down new transfer pricing (TP) rules were passed by Parliament in their third reading on 25 October 2018. This article explores a proposal presented by the State Revenue Service (SRS) for adopting best practice – a simplified approach to the arm's length pricing of low value-adding intragroup services – aimed at easing the TP compliance burden on taxpayers.

Once announced in the official gazette *Latvijas Vestnesis*, the amendments will apply to transactions made in the reporting period starting in 2018 or later, but taxpayers will be permitted to apply them retrospectively.

The simplified approach provides for adding a 5% markup to the service provider's cost without invoking paragraphs 7–18 of the Cabinet of Ministers' Regulation No. 677, *Application of provisions of the Corporate Income Tax Act*.

Simplified arm's length pricing and TP documentation

The amendments permit a taxpayer not to prepare a local TP file for transactions that qualify for the simplified arm's length pricing and documentation. The taxpayer should prepare a simplified TP file within 12 months after the end of the financial year and submit it to the SRS within a month after receiving a request. The Cabinet of Ministers will prescribe details the taxpayer should include in the simplified TP file.

According to our information, the SRS has presented proposals to the Ministry of Finance for incorporating alternative solutions that provide for the simplified arm's length pricing of low value-adding services (LVAS) unless identical services are rendered also to unrelated parties. We have written about LVAS in our Flash News article titled "Low value adding intragroup services."

SRS criteria for LVAS

A service is treated as LVAS for simplified purposes if it involves a multinational enterprise group related to the taxable person, or one or more related parties providing a support service that benefits one or more related parties and meets the following criteria:

An arm's length fee

LVAS fees should be uniformly priced across the group to ensure they reflect the benefit received by the LVAS recipient, and the fee should be calculated as follows:

So the simplified approach provides for a 5% markup on LVAS cost.

Contents of the simplified TP file

The SRS proposals for simplified contents are in line with the OECD's TP recommendations and provide for giving key details of LVAS (a description of the benefit each party has received or expects to receive from each type of LVAS, an explanation of why those apportionment criteria reflect the most reasonable apportionment between the parties, methods of recording and calculating service costs etc).

The SRS proposals recommend that the provider’s invoice describing the type of service should also describe the benefit received from that service.

The simplified approach to transactions from 2018 onwards and retrospectively combined with simplified contents will significantly ease the TP burden on taxpayers and give them comfort that a markup on their LVAS costs meets the national TP requirements. This also means that the economic analysis of those transactions does not need an external or internal benchmarking study.

It is important to note, however, that the simplified approach involves compliance risk, and the parties will have to provide appropriate documentation and carefully evaluate whether the tested controlled transaction meets the LVAS criteria.