Issues covered by voluntary transfer pricing risk reviews (1) (1/6/19)

The State Revenue Service (SRS) has been implementing *Voluntary Transfer Pricing Risk Review*, a new control process they call a consulting audit. This process follows from a memorandum on the *Advise First!* principle signed by the business community and regulators on 15 June 2017 that provides for a customer-focused government.

The *Advise First!* principle

The main aims of adopting this principle are –

- customer-focused activity, which means openness, accessibility and comprehensibility, and
- more efficient regulation, which means proportionality, consistency and purposefulness.

For transfer pricing (TP) purposes this principle has been passed into law. Section 15.2(6) of the Taxes and Duties Act (the version effective from 28 November 2018) gives the SRS the power to request TP documentation and any other information required for defending the arm's length price of a controlled transaction also to examine and advise the taxpayer on potential TP adjustment risks, to suggest voluntary adjustments to the tax return, or to ask the taxpayer to initiate an advance pricing agreement procedure.

While the SRS attempts to approach it as a consulting service agency, this review basically helps them understand whether a particular Latvian company faces any TP adjustment risks, and if so, have the company pay more corporate income tax (CIT) either voluntarily after the company agrees to adjust its CIT returns, or compulsorily after a tax audit.

Potential TP risks

The SRS commonly focuses on the following financials that point to TP risks:

- Losses, especially continuous;
- Profit fluctuations over a number of years;
- Fluctuations in certain financial indicators (e.g. considerable year-on-year fluctuations in revenue or various costs);
- Cost of services acquired from related companies;
- Interest charges on borrowings.

Let us now consider some TP risks we commonly see during SRS control processes.

Losses or profit fluctuations

Losses and profit fluctuations are common reasons why a company has been chosen for a voluntary TP risk review. If a company has incurred losses and considerable profit fluctuations, the SRS will assess whether this situation results from controlled transactions, i.e. whether the Latvian company has bought goods or services from related companies above market prices, or whether it has sold goods or services to related companies below market prices.

So we suggest that all companies having suffered losses or considerable profit fluctuations in the last five years should pay special attention to their causes.

Our experience suggests the following causes for a loss or diminished profit:

- a drop in revenue (might stem from unfavourable market conditions);
- an increase in certain operating costs, for example, a one-off outlay to expand business, the company invests more funds in one of the functions it performs (such as marketing activities), labour costs go up, or a supplier raises his prices.

After establishing the cause of losses or profit fluctuations, the next step is to understand whether the Latvian company could afford to take that risk. Risk control is a very important concept in controlled transactions. In other words, a loss or a drop in profit is a risk taken by the local company, and an independent trader will agree to take that risk only if he is able to control it.

For example, if a loss or a drop in profit comes from a drop in revenue, but the local company has done everything possible to prevent it (the company searched for customers and determined the range of goods for sale and their selling prices) but the market conditions prevented the company from selling the agreed (expected) quantities, the company controlled this risk and could afford to take it. However, if the company sells all goods to a related company that is involved in sales and determines selling volumes, the local company is unlikely to be able to control market risk and cannot accept a loss or a rapid drop in profit.

In the case of an increase in cost, it is important to understand what caused it and who made the decision to incur such extra cost. For example, if a local company acquires support services from a related company, and a particular year sees a doubled service fee with no explanation from the service provider and without the local company being able to object to the fee increase or reject the services, this is certainly a TP adjustment risk. However, if a company has bought an expensive piece of software that will help it operate far more efficiently in the future or expand its range of goods or services, and the software purchase is the local company’s decision even though it was bought from a related company, this is unlikely to create a TP adjustment risk, assuming the software price is arm’s length.

While situations may vary, the company should see and be able to explain the causes of losses or profit fluctuations in order to make it more likely that the company’s voluntary TP risk review will end without the SRS recommending an increase in taxable income or requiring payment of more CIT.

(to be completed)