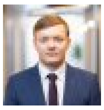
Tax authority’s guidance on transfer pricing during Covid-19 pandemic (2) 3/12/22



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In last week’s article on the guidance issued by the State Revenue Service (SRS), we looked at the first two of five key factors the SRS highlights as noteworthy in transfer pricing (TP) determinations for periods affected by the pandemic. This article explores the remaining three factors that are no less important.

A benchmarking study

To demonstrate that your controlled transaction is arm’s length, you need to find as accurate and relevant comparables as possible. The data has to be true and appropriate for the chosen TP method.[1] Data can be sourced from publicly available databases, the taxpayer’s internal data, or any other data available to the taxpayer and the tax authority.

Your benchmarking study should use the most relevant information to show precisely how the pandemic has affected the industry players and their financial data. If you decide to use comparables for multiple years, your decision needs a strong rationale. The SRS also points out that data on the 2008/2009 global financial crisis cannot be used objectively, given the different economic implications of the pandemic and of the global financial recession.

When it comes to setting an arm’s length price, remember that any value (from min to max) that fits the chosen data of comparable unrelated companies is considered to be equally reliable and may serve as a basis for your TP – the pandemic has not changed this. If you find any comparability defects that cannot be eliminated otherwise, you may consider applying statistical methods to your selected data set in order to determine a central trend that can be used as a market price indicator (the interquartile range and percentiles).

The price of a controlled transaction is invariably based on its functional analysis, an appropriate TP method, and a comparability analysis. The SRS emphasises that in analysing a controlled limited-risk transaction, you need to assess whether an unrelated company would accept losses during the pandemic and on what terms, and whether it would agree to restructure the transaction and amend the agreement.

Special one-off costs and their intragroup reallocation

The pandemic has led to a lowered demand for goods and services in many industries, causing companies and groups to suffer a drop in revenues and an extraordinary one-off rise in costs likely to trigger financial losses. Such extraordinary costs are often allocated to companies within the multinational group, which significantly affects their financial indicators. To make sure that such costs can be objectively allocated to your local group company in Latvia, attention should be paid to three key questions:

1. Can the one-off business costs caused by the pandemic be split between the group companies? This assessment should be based on how independent companies would operate

under these conditions.
2. Has the pandemic created circumstances that are consistent with *force majeure*? What are the restrictions and the aid provided in the countries where the selected comparable companies are registered?
3. What financial accounting does the national law prescribe for unexpected costs in each of the countries where the group companies operate? This assessment allows you to determine whether the costs caused by *force majeure* should be reported in your financial statements before or after the operating profit level.

Performing your advance pricing agreement (APA)

A taxpayer that has entered into an APA with the SRS has to continue performing it during the pandemic. If the taxpayer is unable to honour his obligations because of the consequences of the pandemic or any other circumstances, he has a right to file a reasoned proposal with the SRS for:

- Amending the APA – the parties agree to amend its terms, critical assumptions and business periods;
- Terminating the APA – the parties agree to terminate it on an agreed date, as they believe that the economic conditions make it impossible to fulfil the APA terms in future periods because they are substantially out of line with the taxpayer's future business.

It is important to remember that if the taxpayer defaults on the APA or agrees with the SRS to terminate it, the SRS may adjust the arm's length price for the transaction or type of transactions covered by the APA on a tax audit.

In summary, our analysis of the SRS guidance leads to the conclusion that it is based on international practice and contains essential mechanisms for TP treatment during the pandemic.

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[1]The Cabinet of Ministers' Rule No. 677 of 14 November 2017, *Application of Provisions of the Corporate Income Tax Act*, paragraphs 13–17