

Penalty for failure to file transfer pricing documentation: assessment of proportionality

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In statutory cases, the taxpayer is liable to prepare transfer pricing (TP) documentation and file it with the State Revenue Service (SRS). An examination of TP documentation helps the SRS monitor the correctness of corporate income tax (CIT) payments because the difference between a controlled transaction's value and market price must be included in the taxable base under the CIT Act. If the taxpayer defaults on the obligation to prepare and file TP documentation, then in addition to the opportunity to start an audit and assess the correctness of the CIT calculation, the SRS may start a data assessment in the field of tax revenue risks and charge a hefty fine on the company if an offence is found. This article explores what offences relating to TP documentation permit the taxpayer to be fined outside an audit and how the SRS should evaluate and justify the size of fine.

The substance of the offence

First of all, we need to understand what the SRS may fine the taxpayer for.

Section 15.2(14) of the Taxes and Duties Act authorises the SRS to fine the taxpayer up to 1% of a controlled transaction (which requires preparation of TP documentation) that must be reported under the taxpayer's annual revenues or expenses in the relevant period but not to exceed EUR 100,000 if the taxpayer has failed to observe the time limit for filing the TP documentation mentioned in the clause, and if the taxpayer has substantially breached the statutory requirements for preparing TP documentation – several statutory components are missing from it (the required information is not given) so that examining the TP documentation prevents the SRS from being satisfied that the price (value) of the transaction is arm's length.

It follows from this provision of law that a penalty is applicable for two independent offences:

- For non-compliance with the time limit for filing TP documentation (this offence means that the taxpayer has never filed any information at all)

or

- For a substantial breach of the requirements for preparing TP documentation – failure to disclose the required information prevents the SRS from verifying that the transaction is arm's length (this offence means that the information filed cannot be used or is not sufficient to achieve the statutory aim of verifying that the transaction is arm's length)

In deciding to fine the taxpayer under section 15.2(14) of the Taxes and Duties Act, the SRS is required to state which of the two offences has been committed. This gives the taxpayer an idea of the grounds for charging the fine.

Yet in practice we see cases where the motives part of the decision to charge a penalty contains arguments that fail to make it clear what the company has done wrong because those arguments in fact relate to both offences mentioned above. For example, we have recently dealt with a situation where an SRS decision essentially implied that the taxpayer has been fined for non-compliance with the time limit for filing TP documentation, i.e. it was never filed at all, but the decision also stated that the

documentation filed by the company does not include sufficient information and so the SRS is unable to verify that the price (value) of the transaction is arm's length. On the one hand, we can say that both offences result in the SRS being unable to verify that the controlled transaction is arm's length. On the other hand, such confusing arguments are not permissible because the decision fails to give the company a clear picture and understanding of the grounds and usefulness of the penalty, and in the cases specified under sections 65, 66 and 67 of the Administrative Procedure Act, this alone could be a sufficient basis to recognise the decision as unlawful.

Assessing the proportionality of fine

Section 15.2(14) of the Taxes and Duties Act has been changed by amendments of 25 October 2018 to the Taxes and Duties Act. It follows from an annotation to the amendments that the lawmaker has in principle considered the proportionality of fine (up to 1% of the controlled transaction but not to exceed EUR 100,000), as he has stated that the risk of unpaid CIT depends on the amount of the controlled transaction. At the same time, both the annotation and the amended clause make it clear that the stated size of fine (up to 1% of the controlled transaction but not to exceed EUR 100,000) is the maximum the SRS can charge the taxpayer for each of the offences stated in the clause. Thus, when assessing each situation on its merits, the SRS should evaluate the size of fine within the statutory range, and the motives part of the administrative instrument should state why the chosen size of penalty applies in this particular case. This helps individualise the fine, or make it proportionate to the offence.

Section 13 of the Administrative Procedure Act states that the benefit the public receives through restrictions imposed on the addressee must be greater than the restriction of his rights or lawful interests, and that any significant restrictions of a private person's rights or lawful interests are justifiable only by a significant public benefit. As recognised in legal literature, the principle of proportionality is one of the principles of universal law applicable in administrative proceedings, which is recognised as a key principle of EU and public law. The proportionality principle plays an important role in all stages of administrative proceedings, especially at the stage of obtaining information and issuing or reversing an administrative instrument. In any case, where an agency is given discretion, its decisions and actions must be proportionate. In the case of a mandatory administrative instrument, the proportionality principle must first of all be followed in interpreting the provision of law, especially when using the systemic method and the teleological method. Examining the general understanding of the proportionality principle leads to the conclusion that it aims to restrict an agency's discretionary power by ensuring that an individual's rights and interests are not restricted more than is necessary to achieve the stated goal. The proportionality principle provides that if public authority restricts the person's rights and statutory interests, then a reasonable balance must be maintained between the person's interests and those of the state or the public. Proportionality cannot be assessed on the basis objective criteria only. Subjectivity is one of the features of the proportionality principle. To prevent the proportionality principle from being manipulated, it is very important to ensure that the considerations made in applying it appear in the administrative instrument or court ruling.¹

Unfortunately in practice the proportionality of fine rarely receives a clear evaluation and the arguments rarely appear in the decision. At the same time, if the decision is silent as to why the chosen size of fine is applicable in the particular case, this is definitely a basis for challenging the fine, and for demanding an assessment of the proportionality of fine and a reduction according to the gravity of a breach if one has been committed to any extent.

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¹Briede J. (zin. red.). Administratīvā procesa likuma komentāri. A un B daļa. Rīga: Tiesu nama aģentūra, 2013, 185.–186., 191.–192. lpp.