

Insights from Regional Administrative Court ruling on related party loans 2/15/23



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On 5 July 2022 the Regional Court passed ruling No. A420275316 on whether interest rates charged on loans between related parties are arm's length. The ruling emphasises the significance of the economic substance approach and strengthens the understanding of whether the Bank of Latvia (BOL) statistics are suitable for analysing transfer prices (interest rates).

Background

In 2013 and 2014 a Latvian-registered taxpayer borrowed from related non-Latvian companies at a fixed interest rate of 6%. Seeking to demonstrate the arm's length nature of the transaction in his transfer pricing documentation, the taxpayer chose the external comparable uncontrolled price method and selected statistics posted on the BOL website for short-term and long-term rates that credit institutions had charged on various loans made to non-financial companies.

During a tax audit, the State Revenue Service (SRS) found that in his financial transactions with related parties, the taxpayer had unjustifiably recalculated the data posted on the BOL website, computing average arithmetic quantities from the weighted average rates the BOL had already computed for various sets of loan transactions. And in selecting his comparables, the taxpayer had failed to consider significant lending factors such as the amount and timing. So the SRS adjusted the taxpayer's comparables by selecting statistics from the BOL website that match the economic substance (the actual term and amount) of the transaction, and lowered the interest rate of 6% charged on the taxpayer's controlled transactions to 3.66% and 4.14%, with adjustments being made to his corporate tax return.

The case involved a dispute over which of the BOL statistics compare with the taxpayer's transactions and whether the rate of 6% charged on them is arm's length.

Insights from the court ruling

According to the ruling, the SRS must accept the taxpayer's chosen method unless he has made significant mistakes in choosing it. BOL statistics for bank loan interest rates may be used where the comparable uncontrolled price method is applied.

Using the external comparable uncontrolled price method requires a critical assessment of the economic substance of the transaction. The taxpayer had incorrectly chosen his comparables, given the duration and amount of the transaction. In both loans the term exceeded one year, so short-term interest rates couldn't be used as comparables. And the BOL's weighted average rates already reflect the average, so the taxpayer didn't have to compute those values.

In view of this, the court found the SRS had correctly computed the taxpayer's related-party interest rates and validly adjusted his corporate tax return.