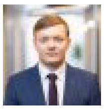
PricewaterhouseCoopers SIA - MindLink.lv. Published: 05.09.2023

Determining amount of controlled financial transaction – eternal headache? 2/36/23


Senior Consultant, Transfer Pricing, PwC Latvia
Elvijs Logins


Director, Transfer Pricing, PwC Latvia
Tatjana Koncevaja

Latvia's current transfer pricing (TP) rules came into force back in 2018, bringing changes to the structure of TP documentation (TPD) and to materiality thresholds that require taxpayers to prepare a specified form of TPD. Many taxpayers are still confused about the right way to measure the amount of a controlled financial transaction, which results in an obligation to prepare, or to prepare and file, a specified form of TPD if the taxpayer has no other types of controlled transactions. This article explores the procedure for determining the controlled transaction amount (CTA) for various types of financial transactions according to Latvian TP rules and international law, as well as looking at the practice in Lithuania and Estonia, the most similar economies to Latvia.

An overview of Latvian TP rules

Although the current rules have been in force and applicable to financial years from 2018 onwards, by the end of 2019 taxpayers did not have access to details of how to determine CTA for financial transactions. All they basically knew was that a financial transaction, just like other controlled transactions, is subject to a materiality threshold of EUR 20,000 and exceeding this requires the taxpayer to document the transaction (verify the TP is arm's length). Of course, this should be considered together with a materiality threshold of EUR 250,000 that requires the taxpayer to prepare a local file. So, even if the CTA for a financial transaction exceeds EUR 20,000 and this is considered a material transaction, the taxpayer is liable to document it only if the total CTA exceeds EUR 250,000.

In late 2019, the State Revenue Service (SRS) published its TPD guidance commenting on CTA for financial transactions. This document accentuates a key principle derived from the OECD and introduced into the Latvian rules, underpinning the procedure the SRS proposes for computing CTA for financial transactions. This principle dictates that CTA comprises not only interest charges but also the loan as a factor that significantly affects the price of the transaction. We must admit that this principle is mainly geared towards assessing the TP of particular transactions and thin capitalisation (the taxpayer's ability to take on particular liabilities), yet this is a cornerstone also in computing the transaction amount.

Let's now look at the procedure for computing CTA for various types of financial transactions.

A loan and a typical credit line

Short-term and long-term loans as well as typical credit lines are the functionally simplest financial transactions, so the CTA calculation under Latvian TP rules is not complicated:

CTA = financing received or provided in financial year + interest charged in financial year

This formula includes financing received or provided and interest agreed or charged in the financial year. If the transaction is a long-term loan or a credit line and no additional financing is provided or received under the agreement but interest is charged for use of capital in the financial year, then CTA will be this interest only. However, if financing is provided or received but the agreed interest is not to be recognised in the financial year, then CTA will be the principal.

A cash pool and a credit line with a large number of transactions

For cash-pool transactions and a credit line where the financial flow is very intensive in both ways and the formula cannot be objectively applied, the CTA calculation offered by the SRS is a bit more complex:

> CTA = liabilities at start of period + financing received in financial year – financing repaid in financial year + interest charged in financial year

The biggest drawback of this formula is that the SRS guidance fails to define a "large" number of transactions under a credit line or cash pool. For some, this could be three cash-flow transactions a year, while for others – ten, hundred, or even more transactions involving funds received or provided under the agreement, depending on the group's financial policy, on the contractual terms of the transaction and on the business being conducted. So the taxpayer should independently assess his financial transactions with related parties and try to find the most objective approach to computing CTA.

Let's now examine how Lithuania and Estonia compute CTA for financial transactions.

Lithuanian practice

Overall, the Lithuanian tax system is fairly comparable with the Latvian system, yet for TP (including CTA for financial transactions) there are significant differences based on the principle that requires the taxpayer to prepare a specified form of TPD. As stated above, in Latvia this obligation is based on the taxpayer's total CTA for the financial year. On reaching materiality thresholds, the taxpayer is liable to prepare a specified form of TPD. In Lithuania, however, the first condition to consider is the taxpayer's net revenue. If this exceeds EUR 3 million or 15 million, the taxpayer is liable to prepare a local file or a master file respectively. Of course, this should be viewed together with the materiality threshold for a material controlled transaction, which compared to Latvia is considerably higher – EUR 90,000. So, even if a company qualifies for the obligation to prepare TPD by revenue, it has to prepare a specified form of TPD only for material controlled transactions, if any.

An evaluation of how CTA is computed for financial transactions shows that Lithuanian TP rules provide for a considerably simpler procedure, as the calculation includes only the current loan balance for the financial year regardless of the type of transaction:

> CTA = balance of borrowed funds in financial year

This simplified procedure might initially seem to ease the administrative burden, and in certain controlled financial transactions (particularly short-term) this is really the case. Yet, for example, long-term loans repayable on maturity will have the entire principal in the CTA calculation for each year of the loan transaction. In most cases this exceeds the materiality threshold for the transaction and will each year require the taxpayer to evaluate the controlled transaction for arm's length compliance even if the facts and circumstances of the transaction remain unchanged, and to prepare a specified form of TPD – often for a single static transaction.

Estonian practice

Estonian TP rules are significantly different from those in the two neighbouring countries. The main difference is that Estonian TP rules don't prescribe any materiality thresholds for the obligation to document controlled transactions and prepare a specified form of TPD. This principle applies to controlled financial transactions as well. Essentially the taxpayer can choose to prepare TPD or a controlled financial transaction analysis for preventive purposes, and is free to decide and calculate what he finds to be the most objective CTA for financial transactions.

Conclusions

If we look at Latvian TP requirements for computing CTA for financial transactions, we can see that they are generally consistent with the OECD guidelines and are reasonable and transparent at least for functionally simpler types of transactions. For more complex ones, a more detailed explanation of variables would be necessary to make it easy for taxpayers to interpret section 15.2 of the Corporate Income Tax Act based on the facts and circumstances of the transaction.

A comparison of the Baltic rules for computing CTA for financial transactions shows a lack of consistency. Estonian TP rules are quite flexible and don't make significant requirements for the taxpayer's obligation to document transactions and prepare TPD. The rules in both Latvia and Lithuania are quite concrete and stringent, with each county using its own calculation procedure and putting a considerable administrative burden on the taxpayer. So a multinational enterprise group operating across the Baltic States, which is often seen as a single region in terms of economic conditions, tax systems and legal aspects, needs to make a great effort and devote significant resources to ensure compliance with pan-Baltic TP requirements, including for controlled financial transactions.