Dispelling myth: transfer pricing as cause of taxpayer loss 1/23/24


Senior Manager, Transfer Pricing, PwC Latvia
Zane Smutova


Director, Transfer Pricing, PwC Latvia
Tatjana Koncevaja

Taxpayers sometimes report an operating loss at the end of the financial year. The State Revenue Service (SRS) perceives this as a key risk that gives grounds for launching a control measure, particularly for taxpayers within a multinational group, citing the transfer pricing (TP) impact on profitability as the main cause of the loss. This article discusses the idea that losses may have an objective economic justification and other legitimate business strategy reasons, with associated risks materialising in the financial year, as well as looking at ways to offer explanations and dispel the myth that TP is the cause of the taxpayer's operating loss.

The main principle of business

In general, the main goal of every business is to make a profit. Businesses usually want to make a profit regularly, but sometimes the result is a loss.

Notes to the accounts

Adding notes to its financial statements allows the company to focus on evaluating its result for the year. By disclosing statutory information in the notes, the company can draw up a complete annual report that offers a true, fair and comprehensive business analysis with a concise explanation of the financial result for internal and external users.

Taxpayers do not often use many words to explain the cause of a loss for the year, with the explanation probably saying that next year's profit will be used to cover the loss.

Unfortunately, such a description of the loss will not be sufficient for the SRS to have a clear picture of the causes, all the more so if the company trades with related parties.

Thus, in the notes to the accounts, the taxpayer can concisely present key facts and arguments to avoid arousing suspicion *prima facie* and to encourage the SRS accept the transfer prices.

Information to be given in the TP file

Information on the reporting period in which the taxpayer made an operating loss that is clearly set out in the TP file will help explain to the SRS that the transfer prices are arm's length and the loss was due to a variety of preconditions and factors and has an objective economic justification and other legitimate business strategy reasons, with associated risks that consequently materialised.

The TP file should include a summary of financial information on the TP methodology. First of all, we need to analyse factors that have adversely affected the business, the financial result for the year and the overall profitability and should be considered in examining the taxpayer's related-party transactions for arm’s length compliance.

Recommended explanations of the financial result

Notes to the accounts should indicate adverse external market conditions if such exist in reality, with a more detailed explanation in the TP file, for example:

- *New legislation being enforced in the taxpayer’s sector* during the reporting period led to an unexpectedly low demand for goods in the taxpayer’s main markets, which significantly affected the net revenue and operating profit figures.
- *Annual inflation* during the reporting period was mostly responsible for increasing certain costs related to the taxpayer’s business as a result of the global geopolitical situation due to sanctions against Russia and Belarus, with adverse economic consequences such as increased energy prices, rising inflation, more expensive financing, and changes to the flow of goods and services.
- *One-off costs* were due to starting a new line of business, increasing production capacity, or relocating to new facilities.

It’s advisable to provide information on the taxpayer’s internal factors, i.e. business considerations – strategies, strategic activities carried out, and their impact on the financial result, for example:

- *A labour provision strategy* – stating that a qualified and experienced workforce with their professionalism and skills are a key asset in the ongoing conduct of the taxpayer’s business, and the company pursues a policy of monitoring its staff remuneration to reflect market conditions, including the rising inflation, and regularly (annually) revises its salary levels.
- *A sales strategy* – stating that in the reporting period, the taxpayer continued to employ an individual sales strategy with special trade terms to (i) enter new markets, (ii) increase the share in an existing market, (iii) launch new goods on the market and (iv) fight off the growing competition, and this strategy caused the taxpayer to incur additional expenses on promotions and advertisements, which reduced the profit accordingly. To encourage consumers to continue choosing the goods distributed by the taxpayer, the company’s business strategy provides for running discount sales and publicly offering reduced prices over a specified limited period, as well as applying various other discounts to those goods.
- *A portfolio strategy* – stating that in the reporting period, the taxpayer sold certain goods at a small profit or even below cost to drive demand for the company’s other goods.
- *A governance strategy* – stating that in the reporting period, goods were sold to certain customers for reduced prices (slow-moving inventories with a short shelf life) and consequently transactions made a loss even at gross level in the belief that the terms are appropriate for the situation on the open market, and this reduced the taxpayer’s inventories, which would otherwise need to be written off.

Explanations of the taxpayer’s result should be supported by financial data, e.g. making a reference to the company’s policy of monitoring staff remuneration to reflect market conditions, including the rising inflation, with salary levels being regularly (annually) revised, and stating that total labour costs rose in 2023 because external service provider costs were reclassified as labour costs.

Changes in labour costs and headcount

	2022	2023	Rise/Drop
Labour costs	692,341	1,142,275	↑ 449,934

Average headcount	22	21	↓	-1

If you need help with any of the aspects mentioned in this article, please let us know.