

Loss-making companies: transfer pricing case law

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Companies that operate at a loss for an extended period of time remain in the sights of tax administrations, including the Latvian State Revenue Service, especially if these companies are part of a multinational group of companies and carry out controlled transactions.

This article looks at a number of court cases in European countries that show how complex and difficult it is for companies and tax administrations to scrutinise the transfer pricing of loss-making companies.

Current guidelines

In the past year, Denmark, France, Hungary, Slovakia, Spain and many other countries have seen court proceedings related to significant transfer pricing adjustments by tax administrations to correct the profitability of loss-making companies. In Latvia, the State Revenue Service ("SRS") is also taking an increased interest "in the appropriateness of the transfer pricing ("TP") determination of such companies and the corresponding controls. When checking compliance with the CIS, the SRS primarily examines whether the loss-making companies have not unjustifiably passed on profits to group companies based in other countries in the controlled transactions.

Since compliance with the arm's length principle is verified by comparing the profits of the counterparty (the parties under review) with a comparable range of profitability of independent companies, loss-making companies attempt to use methods of TP analysis that do not lead to a verification of the profitability of the loss-making company, such as:

- a comparable uncontrolled price (CUP) method that compares the prices charged in comparable controlled and unrelated transactions; or
- profit analysis based methods, choosing as the tested party the party to the transaction that has not made a loss in the analysed transaction.

As part of the audit, the tax authorities analyse in particular whether the TP method used was applied correctly. If significant errors are found in the application of the method, the tax authorities carry out an independent analysis, which in most cases results in the profitability of the loss-making company being adjusted to the profitability of the market level.

Ongoing litigation

1. **IHLE ESPAÑA S.L. vs. Spain:**

IHLE ESPAÑA S.L. (IHLE ESP) is active in the wholesale of tyres, brake discs and accessories, mainly in Spain and Portugal. It purchases goods from a related German company, IHLE BB, which acts as the

Group's central purchasing service provider. The companies applied the SNC method by analysing the correspondence between the transfer prices of the goods sold to each other and the market price, claiming that IHLE BB sells the products to IHLE ESP at the purchase price. In addition, IHLE BB applied a 3% mark-up to cover its logistics and administrative costs. Following an inspection of IHLE ESP, the Spanish tax authorities found that the company was already making losses at the gross profit level: when reselling the tyres and accessories purchased by IHLE BB, it did not even cover its cost price.

As a result of the transfer pricing audit of IHLE ESP, the Spanish tax authorities:

- Rejected the application of the CUP method on the grounds that the prices of goods purchased by IHLE BB from unrelated companies were variable and the company was unable to track the purchase price of each individual product sold by IHLE ESP and therefore used average purchase prices;
- The average pricing method was rejected as it was considered insufficiently detailed and therefore unusable; instead
- The transaction net profit method (TNPM) was applied by adjusting IHLE ESP's loss-absorbing profit at market level.

The court agreed with the tax administration's approach, leaving its decision in place.

1. SAS Roger Vivier Paris vs. France:

SAS Roger Vivier Paris (RVP) has a luxury retail shop in Paris where it sells shoes and luxury goods under the Roger Vivier brand, although it does not own the brand. RVP purchased luxury goods under the Roger Vivier brand name from the related Italian company Tod's, which manufactures these goods. In selling the goods, RVP was responsible for the marketing and promotion of the Roger Vivier brand in the market for its shops. This included significant spending on merchandise marketing, shop advertising and maintaining the prestige of the retail location. Some of RVP's marketing and advertising expenses were absorbed without mark-up by its subsidiary Gousson, the owner of the brand at the time. In reviewing the purchase prices of merchandise, RVP had applied the resale price method by comparing RVP's gross profit from the resale of merchandise purchased from Tod's with the gross profit margin of comparable unrelated companies. RVP was carried forward at a loss at the net profit level.

As a result of the transfer pricing audit of RVP, the French tax administration:

- Determined that RVP returned the slow-moving goods to Tod's at a 65% discount, which is considered non-arm's length;
- Found that the losses at the net profit level were caused, inter alia, by excessive marketing and advertising costs to promote the Roger Vivier brand name, which were borne by RVP and partially and inappropriately offset by Gousson;
- Applied the TNMM by comparing RVP's net profitability with comparable net profit levels of independent companies and found that RVP's discounts and brand promotion activities were not arm's length;
- RVP's loss was adjusted accordingly to the established level of arm's length profit.

The court agreed with the tax administration's approach and left its decision in force.

(to be continued)