

Commissionaire structure: transfer pricing, accounting and tax implications (1/16/18)

The commissionaire structure is a well-known operating model around the world, but not so widespread in Latvia, thus raising many questions about accounting, taxation, and transfer pricing (TP). This article explains the TP and corporate income tax (CIT) treatment of commissionaire arrangements and inherent risks.

Commissionaire

The commissionaire business model is widely used by multinational groups of companies selling and distributing tangible goods. A commissionaire can be described as a hybrid between a full-risk distributor and an agent. The commissionaire operates in his own name but on behalf of the principal and does not, therefore, take title to the goods sold.

Overview

The general legislative framework for commissionaire arrangements in Latvia is contained in the Commercial Code. The TP rules and the CIT Act as well as international tax rules prescribe the tax treatment of such structures. As a general structure described in the Commercial Code, a commissionaire operates on behalf of the principal under a commercial commission contract. A commissionaire sells goods to independent customers in his own name but on behalf of the principal. The commissionaire does not take title to the goods sold, as title passes directly from the principal to the commissionaire's customers under the commercial commission contract.

Commissionaire arrangements are popular with multinational groups. If the principal and the commissionaire operate within the same group, the commission qualifies as a related-party transaction. As a result, there are several CIT and TP aspects the group needs to consider when setting up or running a commissionaire structure:

- the commissionaire's fee;
- the accounting principles; and
- the permanent establishment risk.

Remuneration

If the commissionaire and the principal are related parties, the commissionaire's fee is a related-party transaction governed by the overall TP rules. The OECD Guidelines provide that a commissionaire is entitled to a commission proportional to the functions he performs. To understand the functional profile of the parties to a transaction, it is important to understand which related party performs value-driving functions (considering the assets used and risks controlled and assumed) within the business value chain. In analysing risks, the OECD Guidelines emphasise the need to assess not only the contractual assumption of the risk but also the entities' actual capacity to control and assume the risk. Where it is found that a related party contractually assumes a risk but does not control it, or does not have the financial capacity to assume it, that risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. The allocation of profits is proportional to the significance of a risk.

A commissioner usually acts as a limited risk entity and does not, therefore, perform any value-driving functions or control significant risks. As such, it does not recognise revenues from sales and costs of goods sold. Usually, the commission is linked to the profitability of the principal's sales. It is important to note that the commissioner as a limited risk entity does not take market risk and cannot, therefore, be in a loss-making position, nor should it take gains from successful sales. The principal takes market risk and is entitled to excess profits in the case of a market upturn as well as losses arising from adverse market fluctuations.

When evaluating the functional and risk profile of the commissioner it is very important to assess whether the functions performed and risks assumed by the commissioner could not in substance be treated by the tax authorities as a distributor's functions, which require a higher remuneration than the commissioner's fee.

Accounting

Guidelines and accounting principles for the commissioner structure are laid down by the Cabinet of Ministers' Regulation No. 775 (Application of the Company and Consolidated Accounts Act), under which the commissioner should not recognise in its revenue any amounts collected on behalf of the principal. The commissioner's revenue therefore consists of fees he charges for his services. Revenues from third parties arranged by the commissioner can flow either –

1. directly into the principal's account, or
2. to the principal through the commissioner's bank account.

In the former case, the payments from third parties do not flow through the commissioner and need not be reported in his financial statements.

In the latter case, however, the commissioner collects revenues from third-party customers in his bank account and then transfers the money collected to the principal. It might not be clear at first how accounting should be handled. While the sales will not be recognised in the commissioner's profit or loss, they will still flow through the commissioner's balance sheet. The sales made by the principal through the commissioner will be recorded on his balance sheet under a separate entry *Principal's Trade Receivables* and offset against accounts payable. Also, in notes to the financial statements, the commissioner may provide details of the principal's trade receivables (outstanding balances and movements). The transfer of funds to the principal will be based on his decision made in line with the Latvian Accounting Act.

Please note that this is only one of possible accounting settings of the commissioner structure. We do not suggest this setting is the best practice or a mandatory obligation to follow.

Permanent establishment (PE)

Since the commissioner's activities are closely linked to sales, he risks being considered a dependent agent in Latvia, thus creating a PE risk for the principal under the Latvian Taxes and Duties Act and international law such as the model tax convention and double tax treaties. For example, one of the PE criteria a commissioner structure may fall under is the habitual exercise of the right to conclude contracts or a role leading to the conclusion of contracts in the name of the principal. A principal who meets these criteria may be considered to have a PE and liable to register it. After registering a PE, the

principal will have to allocate revenues and expenses associated with the activity performed in Latvia in order to tax in Latvia the profit an independent entity would gain in comparable circumstances.

However, there are some other conditions for the existence of a PE, and PE risk should therefore be assessed on a case-by-case basis in the light of international tax rules, national legislation, and effective double tax treaties.