Benefit test in transfer pricing analysis (3/20/19)

The benefit test is one of the key areas the State Revenue Service (SRS) will examine when reviewing intragroup services and assessing whether the costs of receiving such services are related to the taxpayer's business. To prove that a benefit has been received from the service, it is important to take precautions for mitigating transfer pricing (TP) risks. The benefit test depends on facts and circumstances, so it is not possible to define intragroup services that are clearly treated as low or high value adding services. This article explores the benefit test and ways of checking whether a service has provided its recipient with any economic or commercial benefit.

Taxpayers' simplified TP documentation for low value adding services should include the benefit test under the Cabinet of Ministers' Regulation No. 802 effective from 1 January 2018. Although Latvian legislation is silent on this term, it is described in the OECD TP guidelines, which Latvian taxpayers are allowed to use as a helpful source[1] in their TP analysis.

The guidelines explain that in applying the benefit test to find out whether a service has been supplied, we should assess whether the recipient needed an intragroup service, whether he has gained any economic or commercial benefit, and whether this has helped him strengthen his business.

Proving receipt of services

Before taking the benefit test, and in order to mitigate the risk of the SRS claiming the service was never received, we should gather evidence confirming receipt (such as contracts, their amendments, email correspondence, meeting minutes and notes, instructions received and reports). It is important to note that payment made to the group company is not enough to confirm that the service has been actually supplied. Confirming receipt of services might initially seem a simple task, but we should remember that a TP audit may cover, and evidence of receipt may be requested for, the last five years.

Benefit from service

It is often difficult to measure the economic or commercial benefit for the recipient of a service the parent company or a shared service centre supplies to some or all group companies. It is advisable to conduct an early analysis of such centralised services by taking the benefit test and answering the following questions:

1. Would an independent entity in similar circumstances acquire this service from another independent entity and be willing to pay the service costs?
2. If an independent entity would not acquire this service from an external supplier, would that entity provide the service using its internal resources?
3. Is there a link between the acquired service and the benefit received or expected?

If an independent company would choose neither of the alternatives mentioned in the first two questions, or if the answer to the third question is "no" then we find that the intragroup service provided no benefit to its recipient and was not necessary for the company to operate successfully.

Where it is difficult to understand and demonstrate the benefit from the service, it is worth describing the value chain (listing all the activities the company needs to operate successfully, from devising its strategy to organising its day-to-day business). Once we have a clear picture of the company's business, then we can objectively assess what functions the company lacks internal resources for, and what services and benefits it receives from related companies. For example, the company does not have an in-house financial analyst for evaluating financial data, making forecasts and adjusting strategy, so the company acquires management services from a group company that fulfil the functions related to financial analysis.

Duplication of functions

It is also important to assess whether the acquired service duplicates the company's own functions and whether the company acquires the same kind of service from an independent entity. If the analysis finds that the service duplicates the company's own functions or any service acquired from a third party, this might suggest that the intragroup service was not necessary. Only if the service has provided a benefit to its recipient and does not duplicate should we assess it for arm's length purposes.

[1] Paragraph 19 of Cabinet Regulation No. 677 of 14 November 2017, *Applying provisions of the Corporate Income Tax Act*