Hallmarks of reportable cross-border arrangements in transfer pricing (1/29/20)

The Cabinet of Ministers' Regulation No. 210 on the automatic exchange of information on reportable cross-border arrangements came into force on 1 July 2020. The new rules basically require providers of tax, legal and any other type of consulting services who meet the criteria laid down by paragraph 3.5 of the rules, to provide the tax authority with information on any designed, marketed, organised or made available for implementation or manages the implementation a cross-border arrangement between a taxpayer registered in Latvia and a taxpayer registered in another tax jurisdiction known to them. In this article, we explore the hallmarks of cross-border arrangements for transfer pricing purposes and make recommendations that can help taxpayers making cross-border related-party transactions to objectively support their economic substance and avoid concerns about implementing them for aggressive tax planning and profit shifting purposes.

The scope of the rules

The cabinet rules define the hallmarks of cross-border arrangements (see chapter 3 of the rules) that may require the parties to provide information to the tax authority. The duty of notification is the personal responsibility of consultants (intermediaries as specified in the rules). The reporting aims to prevent aggressive tax planning, i.e. unreasonable profit shifting to other tax jurisdictions with a more generous tax regime. So the taxpayer should carefully evaluate any intended transactions that might have particular hallmarks and their consistency with the duty of notification and should duly prepare all possible evidence that the cross-border transaction is not associated with aggressive tax planning.

Hallmarks of cross-border arrangements in transfer pricing ("TP")

The hallmarks of cross-border arrangements relevant to TP are listed in paragraph 34 and its subparagraphs.

The table below summarises information on the hallmarks of cross-border arrangements relevant to TP and any additional information the taxpayer should be aware of, disclose or include in its TP documentation in order to efficiently defend the economic need for and implementation of controlled transactions linked to these hallmarks in terms of promoting the business of the local company or the group as a whole, rather than carrying out any aggressive tax planning and thus unintentionally putting the taxpayer at risk:

Hallmark of a cross-border arrangement	Recommendation for proving that the transaction is not conducted for aggressive tax planning

• An arrangement that involves using a unilateral safe harbour as defined by the OECD TP guidelines	Under the guidelines, a safe harbour means conditions that create a simplified TP obligation. Even though the safe harbour is a set of conditions that each member state may incorporate in its national TP rules and which is recognised and applied by the national tax authority, the safe harbour brings with it not only mutual advantages for the taxpayer and the tax authority but also certain shortcomings and possible adverse consequences. The taxpayer should initially assess whether entering into in a transaction covered by the safe harbour will indeed provide the expected benefits, whether the benefits will exceed the potentially adverse consequences and whether the taxpayer will be able to prove that the outcome of using the safe harbour is arm's length. This assessment may help the taxpayer avoid a unilateral safe harbour, which automatically excludes this hallmark of a cross-border arrangement and the duty of notification.
• An arrangement involving a transfer to related parties of intangible assets that are difficult to value or the right to use them	Transfers of intangible assets or of the right to use them are among the most complicated transactions between unrelated and related parties. Under the Latvian TP rules, the TP documentation must include information on any activities related to intangible assets. Providing objective information on the intangible assets transferred (including the expected income from the transfer, the expected cash flow etc) plays an important role. The taxpayer also needs a valuation of intangible assets based on clear assumptions, which together with the above information would give a sufficiently clear picture of the expected result and the economic rationale for the intangible asset transfer to help avoid the duty of notification according to this hallmark of a cross-border arrangement.
• An arrangement involving an intragroup transfer of functions, risks or assets that leads to a reduction of over 50% in the transferor's annual EBIT profits (within three years after the transaction) compared to EBIT profits before the transfer of functions, risks or assets	Multinational enterprises often carry out intragroup transfers of functions and associated risks and/or assets. This can have a number of economic reasons, and the transaction per se is not considered a dubious one or one aimed at aggressive tax planning, yet this should be demonstrated by supporting documents, calculations and other evidence. Otherwise, according to this hallmark, this may be considered aggressive tax planning and require the intermediary who provides assistance in preparing the company's TP documentation to report a cross-border arrangement. The economic rationale for such transactions should include calculations and the long-term business strategy that gives good reasons for shifting resources and assets to another territory (e.g. with lower costs of labour and other production resources or a better geographical location). A redistribution of functions, risks and assets may also be due to a centralisation of services (in particular IT, support and other services) rendered by the group companies, which is a reasonable economic decision. The transfer of key functions, associated risks and assets to another group company is likely to cause a profit reduction in the local company, but again this is not a factor associated with aggressive tax planning because giving an objective rationale is what matters. And the company's profit reduction after the transaction may be due to some other reasons unrelated to TP, which should then be mentioned in a description of the controlled transaction.

The information provided in the table leads to the conclusion that all of the hallmarks of cross-border arrangements relating to TP are indeed essential and may suggest aggressive tax planning. However, this assumption is not so clear because TP is based on proven facts and economic circumstances rather than general assumptions. It is therefore crucial to provide supporting information and communicate with the tax authority skilfully.

The obligation to report cross-border arrangements should not be an obstacle to implementing economically sound transactions.