

Tax authority lists common errors in transfer pricing documentation 3/40/21



Manager, Transfer Pricing, PwC Latvia
Liga Dobre-Jakubone



Senior Manager, Transfer Pricing, PwC Latvia
Zane Smutova

Transfer pricing (TP) rules laid down [by section 15.2 of the Taxes and Duties Act](#) effective from 1 January 2018 require that a taxpayer's master file and local file, or only his local file, provide evidence that the TP applied in a related-party transaction (the "controlled transaction") is arm's length. Although there is no publicly available information about amounts the State Revenue Service (SRS) has charged for the lack or incompliance of TP documentation/ analysis of controlled transactions over the last three years, we are aware that those are being evaluated, mainly as part of the "Advise First!" principle, as we have [written earlier](#). This article explores common substantial errors in TP documentation pointed out by an SRS official who attended a seminar the Latvian Chamber of Commerce and Industry organised in May 2021.

No financial data segmentation

A substantial error pointed out by the SRS is a lack of information and tables to reflect how the financial data used in applying the TP method is linked to financial statements. In other words, a segmentation of the taxpayer's financial data showing the profitability of the controlled transaction is missing from the TP documentation filed. Instead the taxpayer assesses his total profitability, which is a mistake because the TP documentation should only deal with the profitability of related-party transactions.

To understand why financial data needs segmenting, let us take a look at a theoretical example:

Profit and loss item	Total, EUR	Sales of goods	
		To related party	To unrelated customers
Net revenue	100	20	80
Cost of goods sold	70	17	53
Gross profit	30	3	27
Selling costs incl.:	15	3	12
Administration costs	5	1	4
Operating profit	10	-1	11
Operating costs	90	21	69
Markup on operating costs	11.11%	-4.76	1.45

↑
↑
 Result of unsegmented financial data Result of segmented financial data

The example clearly shows that unsegmented data fails to provide true information about the profitability of the controlled transaction. This disclosure is required [by paragraph 3.3.2 of the Cabinet of Ministers' Rule No. 802](#).

No financial statements for the tested party¹ if that is a foreign person

Another substantial error pointed out by the SRS is that the TP documentation fails to give information about the financial data of the tested party if that is a related foreign company.

For example, the taxpayer has bought goods from a related foreign company, their price being set as the cost plus a markup. The related foreign company has been chosen as the tested party because it has financial data on the cost of goods. However, when preparing the TP documentation, the taxpayer does not have access to the tested party's financial data that proves the markup.

The example suggests that the taxpayer is unable to defend the TP actually applied in the controlled transaction and consequently fails to demonstrate it is arm's length.

The foreign related company's entire profit and loss account will not help because the financial data must be segmented to show the profitability of the controlled transaction (the markup).

No benefit test for the recipient of services

The benefit test is a set of questions that must be answered with facts and documents to demonstrate that intragroup services were actually received, were useful, and gave the recipient an economic and commercial benefit. This information in the form of a description with attached evidence should be included in the TP documentation. It is important to note that when it comes to intragroup services, the first thing to be examined is the existence of services, not TP compliance.

So, failure to include the benefit test is another substantial error pointed out by the SRS.

For example, the taxpayer acquires services such as human capital management, accounting support, legal support or management consulting services from group companies. The taxpayer only has a written contract and periodic invoices from the group companies to prove the existence of and the benefit derived from those services. The taxpayer has no other information to prove his economic and commercial benefit from the services.

Such services may be treated as a paper transaction. We have seen in practice and relevant case law suggests that the SRS may treat fees paid for paper services as unrelated to the taxpayer's business and increase the taxable base.

No information about capacity at key points of service

Another substantial error pointed out by the SRS is a lack of information about the service provider's capacity.

This risk arises because the service provider in fact lacks the capacity (human resources with appropriate expertise and various tangible assets) to provide intragroup services. So, although the taxpayer describes the acquisition of services and applies the benefit test in his TP documentation, the SRS has information that those grounds are false because the service provider is in fact a shell company. In that case the SRS may challenge the fees paid for the shell company's services and add those to the taxable base.

It is important to note that EU tax authorities are working closely together, and the SRS may ask the

competent authorities of member states and of third countries that have entered into international agreements to check who is in fact providing services to the Latvian taxpayer. Also, Latvia and other countries have adopted the Country by Country Report effective from 2017, which aims to improve the transparency of multinational enterprises by providing the tax authorities of various countries with information about group operations. This report is automatically exchanged between the tax authorities of the countries the group operates in. So the SRS has a range of opportunities to discover information about the business of the Latvian taxpayer's related party.

Any of the errors described above may be a red flag for the SRS to launch an in-depth TP assessment. We recommend paying attention to the errors already pointed out by the SRS and keeping in mind the deadlines for preparing and filing TP documentation and the requirements for information it should disclose.

¹The tested party is the company whose financial indicators are analysed to check that the controlled transaction is arm's length.