Comparability adjustments in transfer pricing practice 2/15/22

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A taxpayer assessing his transfer pricing (TP) compliance might find that a transaction with a related party is not arm's length according to a preliminary comparability analysis. When analysing each case separately, however, we sometimes find that the taxpayer has failed to take all necessary preventive measures to mitigate TP risk. One of those measures involves assessing the need to make comparability adjustments.

Statutory requirements and recommendations

Comparability adjustments are explained in not only Latvian law but also international law (e.g. the OECD TP guidelines) which the taxpayer is allowed to use as an auxiliary source in assessing his TP compliance.

Paragraph 12.3 of the Cabinet of Ministers' Rule No. 677 states that in applying TP methods, the taxpayer must select, as a comparable uncontrolled transaction or a comparable unrelated party, a transaction or party for which mathematical calculations and sufficiently accurate financial data adjustments can be made to prevent any discrepancies found in the transactions or parties compared from having a significant effect on comparability.

Paragraph 3.2.11 of Cabinet Rule No. 802 requires the taxpayer's local TP file to include a description of and references to any comparability adjustment made, as well as information on whether adjustments have been made for the tested party's result or the comparable uncontrolled transaction, or both.

Paragraph 1.40 of the OECD TP guidelines recommends comparability adjustments that help the taxpayer improve the degree of comparability in assessing his TP compliance.

To provide a better picture of how comparability adjustments can drastically change the comparability analysis, let us look at a theoretical example.

Example

X Co provided organisation services to a foreign related company and unrelated parties.

Using the Cost Plus method and conducting a preliminary comparability analysis based on internal comparable data, X Co calculated a (gross) markup added to the cost of organisation services supplied to the related party and an arm's length range of (gross) markups for unrelated parties. X Co found that those markups differed significantly. The 7% markup that X Co had applied on its related-party transaction fell outside the arm's length range of markups (from 15.5% to 45.3%).

However, before conducting the comparability analysis, X Co had forgotten to evaluate the facts and circumstances of the controlled transaction (made with the related party) and of uncontrolled transactions (made with unrelated parties) and other comparability factors that may significantly affect the markup.

Aware of its mistake, X Co evaluated the functions it performed and the risks it assumed and controlled in its transactions.

The table below shows a comparison of the functions and risks between the controlled transaction and uncontrolled transactions:

	Function / Risk	Transaction with unrelated parties	Transaction with related party	Contribution rate (%) of function or risk
1.	Marketing (tendering, negotiations etc)	X	-	20%
2.	Project design and planning	X	-	25%
3.	Finding subcontractors in market	X	X	15%
4.	Negotiating better terms with subcontractor	X	-	5%
5.	Organising and managing services	X	1/2 X	25%
6.	Administration	X	X	5%
7.	Credit risk	X	-	5%
	Total contribution to transaction	100%	32.5%	

The comparison of the functions and risks showed significant differences between the controlled transaction and uncontrolled transactions. Compared with a transaction between unrelated parties, in its related-party transaction X Co performed only 2.5 functions, representing about 32.5% of the total contribution to the transaction's profitability, and took no significant risks.

This finding then served as a basis for making a comparability adjustment for the comparable uncontrolled transaction, i.e. the arm's length range of (gross) markups identified initially:

	Organisation services	
	Initial arm's length range	Arm's length range after comparability adjustment
	Markup (gross)	
Minimum value	15.5%	5.04%
Weighted average value	27%	8.78%
Maximum value	45.3%	14.72%
Number of comparable observations	47	

The takeaway

This example allows us to conclude that had X Co not found that it had failed to take all possible measures to mitigate TP risk (a comparability adjustment) the company would have been liable to make a TP adjustment on line 6.5 of the CIT return for lower income in the controlled transaction, corresponding to the criterion of deemed profit distribution.

However, making necessary and reasonable comparability adjustments mitigated the risk and helped the company avoid having to make a TP adjustment on its CIT return.