A balancing transfer pricing adjustment – a "lifebuoy" for your company? 1/3/23

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Latvian transfer pricing (TP) rules provide that a company's transactions with related parties must be arm's length, whether the parties are Latvian or foreign tax residents. The arm's length principle dictates that a company making comparable transactions under comparable conditions must receive comparable revenue, whether the transaction is with a related or an unrelated party. Basically companies know and understand this, yet there are various facts and circumstances that make this requirement difficult to enforce in real time. This is because before or during the transaction, companies often lack sufficient information on arm's length prices that unrelated parties apply in comparable transactions. This is where companies can use a TP adjustment, which is not always so painful as it might originally seem. This article explores what TP adjustment a company can make by adjusting its taxable base for corporate income tax (CIT) purposes.

The adjustment

While there are several types of TP adjustment, only one has no adverse implications (including no penalty) for the company: a balancing adjustment (true-up), aka the year-end adjustment for CIT purposes. This involves comparing and aligning the actual TP with a price (value) the company considers adequate under the arm's length principle (typically a value selected from a benchmarking study). The resulting price differential allows the company to calculate the necessary TP adjustment on line 6.5 of its last CIT return for the tax year, which will serve as a taxable base for assessing the extra tax due.

A mismatch with an arm's length price (value) may arise where the company fails to receive arm's length revenue from goods or services supplied or where the company incurs costs exceeding an arm's length level. Each of these cases has its own TP adjustment calculation. Below we will use theoretical examples to examine each case.

1) The *revenue* that Company A received from sales to related Company B is not sufficient to make an arm's length profit.

During the financial period, Company A sold goods to related Company B. When preparing its financial statements, the company found the revenue was unable to cover the cost of goods sold and led to a loss of EUR 7,000 on the transaction, i.e. a net markup of –6.54%.

Company A prepared a benchmarking study to arrive at an arm's length range of net markups charged by comparable unrelated companies in the relevant business:

Minimum value	1.98%
Bottom quartile	3.89%
Median	5.00%
Top quartile	5.78%
Maximum value	7.23%

The results of this exercise showed the related-party transaction was not arm's length because the arm's length range values were greater than the net markup charged by the company.

The company decided to make a TP adjustment for CIT purposes based on the arm's length median of 5.00%. The company found it should have received a revenue of EUR 112,350 and not 100,000 on its sale to Company B to make the transaction arm's length. So EUR 12,350 was added to Company A's taxable base on its last CIT return for the tax year and appeared on line 6.5:

Indicators	Before adjustment (EUR)	After adjustment (EUR)
Revenue from sales to Company B	100,000	112,350 (107,000 + 5.00%)
Cost of goods sold (1)	107,000	107,000
Net profit (2)	–7,000	5,350
Net markup (2/1)	–6.54%	5.00%
TP adjustment on line 6.5 of CIT return		12,350

2) Company A *incurred excessive expenses* when buying goods from related Company B (it incurred unreasonably high costs) so Company A was unable to make an arm's length profit.

During the financial period, Company A bought goods from related Company B for business purposes. When preparing its financial statements, the company discovered a loss due to the unreasonably high cost of those goods.

To find out the true market conditions, Company A prepared a benchmarking study showing an arm's length range of net margins earned by comparable unrelated companies in the relevant business:

Minimum value	1.91%
Bottom quartile	3.76%
Median	4.82%
Top quartile	5.69%
Maximum value	7.09%

Having examined the arm's length range, the company found its net margin was inadequately low (a loss). Since selling prices are driven by market mechanisms, the company found the negative net margin was due to excessive acquisition costs.

The company decided to make a TP adjustment for CIT purposes based on the arm's length median of 4.82%. The company found its actual acquisition cost was EUR 9,820 in excess, so this amount was added to the taxable base on its last CIT return for the tax year and appeared on line 6.5:

Indicators	Before adjustment (EUR)	After adjustment (EUR)
Revenue from sales (1)	100,000	100,000
Cost of goods sold	105,000	95,180 100,000 – (100,000 * 0.0482)
Net profit (2)	–5000	4,820
Net margin	–5.00%	4.82%
TP adjustment on line 6.5 of CIT return		9,820

These examples show that a balancing TP adjustment for CIT purposes can help companies follow the arm's length principle.

The Latvian TP rules are silent on which value within the arm's length range an adjustment should be made to, because each of the arm's length range values is considered an arm's length price (value). So the company can choose a baseline value to which the adjustment will be made, and state the rationale

behind this choice.

Yet the tax authority may challenge both the selected arm's length value and the benchmarking study if they believe it was selected unreasonably or if the comparable economic operators are not fully comparable with the controlled company.

Companies are advised to make a balancing TP adjustment for CIT purposes before filing their financial statements for the year because the extra tax charge may escape a late fee under section 17(8) of the CIT Act.