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Preparing financial statement for transfer pricing: analytical segmentation options 1/10/23

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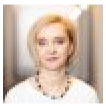

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Our professional experience suggests that paragraph 3.3.2 of the Cabinet of Ministers' Rule No. 802, "Transfer Pricing Documentation and Procedures for Entering Into an Advance Pricing Agreement Between the Taxpayer and the Tax Authority for a Transaction or a Type of Transactions", which states that the taxpayer's transfer pricing (TP) documentation should include financial information and tables showing how the financial data used in applying the TP method is linked to the financial statements, has taxpayers confused as a maze of legal interpretation.

Everything turns out to be quite straightforward. The above formulation applies to the taxpayer's aggregated financial data for the financial year and to the need to prepare a TP financial statement, i.e. to carry out an appropriate profit & loss account data segmentation for benchmarking purposes, showing separately the financial information that applies to controlled[1] transactions.

This article explores a *simplified* financial data segmentation and a new trend – the need to prepare a *detailed* financial data segmentation:

- This allows the taxpayer to mitigate TP adjustment risk.
- This segmentation may be a valuable tool for the taxpayer when it comes to evaluating the relationship with particular suppliers and deciding about continuing to do business with them, or considering the need to revise certain terms of the transaction.

Guidance on financial data segmentation risk

As we have written earlier, the State Revenue Service (SRS) has pointed out a key risk associated with providing incomplete information. A taxpayer's TP documentation that gives information to show that his controlled transactions are arm's length suffers from two significant errors:

- Lack of financial data segmentation where a local taxpayer is chosen as a tested party[2]
- Lack of financial statements where the tested party is a related foreign company

It is important to note that section 15.2(14) of the Taxes and Duties Act authorises the SRS to fine the taxpayer (up to EUR 100,000 for each controlled transaction) if his TP documentation fails to provide the required information. This includes a lack of financial information.

Is a simplified financial data segmentation enough?

Our experience suggests that more taxpayers are now confused about statutory requirements and consider the significant errors pointed out by the SRS. So the TP documentation includes financial data relating to controlled transactions (TP financial statements), including a financial data segmentation that shows the total profitability in the analysed transaction with related and unrelated parties (a simplified financial data segmentation).

However, considering the events we have seen globally over the last three years and the implications of the Covid-19 pandemic that have adversely affected the economic situation of various countries and industries and consequently the taxpayer's profitability in transactions with suppliers, including related parties, this raises the question of whether preparing a simplified financial data segmentation only to meet the statutory requirement is sufficient and does not create TP adjustment risk for the taxpayer.

Let us look at a theoretical example. A taxpayer provides comparable (similar) construction services to related and unrelated parties. To measure the profitability (operating profit markup) in his controlled transactions and to conduct a benchmarking study, the taxpayer has prepared a *simplified* financial data segmentation:

Financial indicator	Total (EUR)	Services (EUR):	
		to related parties	to unrelated parties
Net revenue	10,000	6,500	3,500
Cost of goods sold	8,000	5,300	2,700
Gross profit	2,000	1,200	800
Selling costs	1,200	780	420
Administration costs	700	455	245
Total service costs (operating costs)	9,900	6,535	3,365
Result of service	100	–35	135
Operating profit markup (result of service / total service costs)	1.01%	–0.54%	4.01%

The simplified financial data segmentation shows that the taxpayer faces TP adjustment risk when assessing the result (operating profit markup) in his transactions with related and unrelated parties, because he failed to gain arm's length income from his services to related parties and the difference[3] must be included in the taxable base under section 4(2)(2)(e) of the Corporate Income Tax Act.

In such situations the taxpayer often tries to ensure his TP documentation includes a statement that the negative indicator results from the market conditions. However, such a general statement will not be sufficient, should the SRS decide to assess whether the controlled transaction is arm's length. The situation could be saved by a detailed, well-grounded explanation of the factors having affected the taxpayer's related-party transactions, as well as a detailed financial data segmentation that substantiates those factors.

How do I benefit from a detailed financial data segmentation?

The taxpayer's financial result in transactions with related and unrelated parties may be affected by a variety of internal and external factors. In each particular case, this impact may vary according to the facts and circumstances of the transaction – its type, where it is performed, and the taxpayer's strategy for a particular market (e.g. investing in market penetration or carrying out a customer winning/retention strategy).

As stated above, the impact of various factors on taxpayers' business has been especially relevant in the last three years:

- Restrictions imposed to minimise the spread of Covid-19, with the following consequences:

  – It was totally or partially impossible to trade and perform services face-to-face, with additional idle-time costs arising from quarantine rules that had to be observed before services could be started in a particular country, etc.

– Transport costs were affected by higher fuel prices and supply chain disruptions.

– USD exchange rate fluctuations, etc.

- Russia's invasion of Ukraine and the resulting sanctions brought significant volatility to the global economy.

When it comes to assessing the total profitability in controlled transactions, it is not possible to show the factors having affected particular transactions, so it is advisable to carry out a detailed financial data segmentation, for instance, to assess transactions by related party, by engagement, or by geographical market.

Let us again look at a theoretical example. The taxpayer's situation is the same, but to measure the profitability in his controlled transactions, he has prepared a *detailed* financial data segmentation for related-party transactions:

Financial indicator	Total (EUR)	Services (EUR):			
		to related parties			to unrelated parties
		No. 1	No. 2	No. 3	
Net revenue	10,000	1,200	2,700	2,600	3,500
Cost of goods sold	8,000	1,250	2,050	2,000	2,700
Gross profit	2,000	–50	650	600	800
Selling costs	1,200	150	200	430	420
Administration costs	700	84	189	182	245
Total service costs (operating costs)	9,900	1,484	2,439	2,612	3,365
Result of service	100	–284	261	–12	135
Operating profit markup (result of service / total service costs)	1.01%	–19.14%	10.70%	–0.46%	4.01%

The detailed financial data segmentation shows that the operating profit markup for related parties is not always lower than the markup in transactions with independent parties. And the detailed financial data segmentation for transactions with related parties No. 1 and No. 3 shows which cost items mainly affected the end result, so we may assess in detail the factors that increased the costs. In case No. 1, for example, the cause may be idle-time costs arising from Covid-19 restrictions, while in case No. 3 this could have been an aggressive marketing strategy focused on market penetration/ market share retention.

Conclusions

A detailed financial data segmentation shows the actual results of related-party transactions more accurately and allows the taxpayer to mitigate TP adjustment risk. This is especially important where the total results are negative or where there are legitimate grounds for certain controlled transactions being out of line, which is not so easy for the SRS to see when assessing the taxpayer's financial data for the year in general.

We believe that the results of a detailed financial data segmentation will make the SRS unlikely to claim that the controlled transaction made in the financial year (the service rendered in our theoretical example) is not arm's length, thereby eliminating TP adjustment risk.

And, as stated above, a detailed financial data segmentation allows the taxpayer to obtain a more comprehensive understanding of doing business with certain suppliers, agree on additional compensation to cover losses, revise the remuneration mechanism, or decide on doing business in the future.

We invite you to PwC's Academy webinars "Intragroup services – a potentially expensive transfer pricing risk" on 11 April and "Transfer pricing in loan transactions and their stumbling blocks" on 18 April.

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[1] Transactions with a related party

[2] The party whose financial indicators are assessed to show that the controlled transaction is arm's length

[3] The income differential has been calculated on the basis of profitability in a transaction with independent parties.