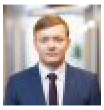
Transfer pricing case law gathers momentum as tax authority scrutinises intragroup services 2/14/24



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Recent years have seen the State Revenue Service (SRS) increasingly focus on transfer pricing (TP) risks, particularly management services and business support services rendered within a multinational enterprise (MNE) group. These services between related companies aim to promote a group member’s business, to cut costs it would have incurred in performing the particular functions on its own, or to offer some other comparable benefit from the synergy of doing business together. Yet there is also the other side of the coin – TP and corporate income tax (CIT) risks may arise if the recipient of services is unable to prove they were actually received and the fee was justified.

To find out how such risks can materialise in practice, let us now explore a recent court case that saw a ruling made on 12 February 2024.

The substance and cause of the dispute

A company operating in Latvia is a member of an MNE group. Its core business activity is manufacturing goods according to a production plan, volumes and sales organised by the group. To remunerate a group company for business support, in 2015 the Latvian company started receiving capacity management services from a related company in the same group. The services included production capacity planning, financial analysis and planning, preparation of reports, advice on decision making, etc. The company paid a quarterly fee based on a profit margin that matches its functional profile. The margin should not exceed 2.7% as per a benchmarking study analysing profit margins earned by comparable manufacturing companies.

In 2019 the SRS launched a CIT and a TP audit of the company for the period from 2015 to 2017. The audit found the service fees had been taken to the company’s profit and loss account as administrative costs and significantly reduced its taxable income, with the transactions exceeding EUR 10 million in each of the financial years being audited.

The SRS found a lack of sufficient and reliable evidence to prove the company had received the services and derived a commercial benefit from them. The SRS also found the services were used to shift the company’s profits away to the related foreign service provider. The audit was completed on 26 May 2021 and the head of the SRS Tax Compliance Promotion Board decided to assess CIT of EUR 5.65 million, plus a late fee of EUR 0.98 million and a penalty of EUR 0.85 million.

The company asked the District Administrative Court to reverse the SRS General Director’s decision.

The company’s arguments in court

The company challenged the SRS General Director’s decision and offered the following key arguments to support its position:

1. Receipt of services is confirmed by a service agreement between the parties, which creates the legal framework for unique and complex capacity management services reflecting a new business model being implemented in the MNE group to make the manufacturing companies more efficient and profitable.
2. The company received valuable services that helped it optimise its production, cut costs and increase sales.
3. The company paid an arm’s length fee that was defined and justified in the TP files prepared by the company and by the group.
4. The SRS did not consider the company’s arguments properly and did not evaluate the arm’s length nature of the fee.

The SRS arguments in court

During the litigation, the SRS did not change its position and claimed the capacity management services were a fictitious transaction that allowed the company to siphon its profits off to another tax jurisdiction. The main SRS arguments were as follows:

1. The company has been unable to provide any reliable evidence to prove receipt of services and any resultant economic benefit.
2. Instead of being based on costs actually incurred in providing the services (market value), the fee calculation aims to leave the company with a hypothetical 2.7% arm’s length margin that is determined subjectively, and to shift all the remaining profit away from the company.
3. The intragroup agreements and details submitted by the company show it also received management and business support services from another member of the group and paid a fee to its parent company for using intangible assets in the relevant financial years. This confirms that the company’s claim about having received capacity management services is not true and even if it had received such services, it would not have received any unique or valuable services capable of giving it any significant commercial benefit.

The court ruling

Having heard both sides and perused the evidence over a period of several years, the court found the SRS had correctly concluded that the capacity management service agreement was a fake after carefully and objectively checking all the evidence and circumstances. The company did not offer any evidence to allow a third party to verify the company had received the services and derived a commercial or economic benefit from them. The fee is not based on the market value of services but rather on the margin the group has determined the company should earn, thereby significantly reducing its taxable income.

Accordingly, on 12 February 2024 the District Administrative Court dismissed the company’s application seeking reversal of the SRS General Director’s decision of 29 September 2021.

Harsh lessons

This case shows the SRS is increasingly focusing on intragroup services because they may pose significant TP and CIT risks. Related companies that perform such controlled transactions in practice, especially with a high materiality threshold, should be able to provide robust evidence that proves receipt of services and the resultant commercial or economic benefit, eliminating duplication with functions the company performs on its own or with other similar services received from third parties or related companies. Another point to note is that justifying intragroup service fees will be the last stage of a tax audit. If the company is unable to prove it actually received services and they were truly necessary, the consequences may significantly exceed a potential TP adjustment.

What makes this case stand out is how the fee was calculated. The SRS challenged receipt of services mainly because the fee calculation was not based on the cost plus a markup, which is the generally accepted practice in intragroup service transactions, but rather on the profit arising from the value added by the group's business. In fact, this approach to calculating service fees is fairly common elsewhere in Europe and tends to show up in the TP policies of certain Latvian companies, as it's in line with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Given the Latvian CIT system, however, this approach leads the SRS to believe the Latvian taxpayer is making a deemed profit distribution that escapes CIT.

Since services with a similar fee calculation often have a high materiality threshold that may result in substantial CIT assessments, penalties and late fees being charged during a tax audit, plus potential litigation costs, we recommend that Latvian taxpayers making controlled transactions with a similar pricing mechanism should evaluate the need to alter the fee structure.