

Loss-making companies: transfer pricing case law

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This article concludes the discussion from last week's article.

Ongoing litigations

3. "Metal Kft" vs. Hungary:

Metal Kft (Kft) is primarily involved in the production of metal and powder metallurgy at its facility in Moore, Hungary. The company markets its products to both related parties (54%) and independent customers. Additionally, Kft pays royalties for trademarks and brand names, interest on loans and cash pool accounts, and utilizes management services within the group. While the group as a whole reported a profit, Kft itself incurred a loss. In analysing sales to related parties and applying the Transactional Net Margin Method (TNMM), Kft segmented its financial data, excluding extraordinary costs related to inefficient plant operations and quality issues with the goods.

As a result of Kft's transfer pricing ("TP") audit, the Hungarian tax authorities:

- did not accept such segmentation, arguing that Kft's functional profile corresponds to the functions of a low-risk contract manufacturer, and all decisions concerning Kft's operations and pricing methodology for both related and unrelated customers are made by a parent company based in Spain, which should accordingly have compensated for all exceptional costs;
- drew those conclusions on the basis of several interviews with Kft's staff;
- the total loss of Kft was adjusted in line with the established market level profit.

In this case, however, the Court identified deficiencies in the tax administration's analysis, particularly regarding the definition of transactions and the application of transfer pricing (TP) methods. The Court has requested a reassessment of the transactions between the related parties, based on a clearer factual foundation.

4. Illichmann Castalloy s.r.o. vs. Slovakia:

Illichmann Castalloy s.r.o. (IC), an Alicon Group company, is active in the production and sale of aluminium foundry and sand moulds and kernels. It operates under Alicon Castalloy limited, headquartered in Vienna. The company mainly carried out transactions related to the sale of aluminium foundry products to related parties in Austria and Germany. Given that the group was loss-making, it used the profit-sharing method (PSM) when examining the transfer pricing methodology for the sale of goods, distributing the total group losses to all companies in the group, including Illichmann Castalloy s.r.o.

As a result of IC's transfer pricing test, the Slovak tax administration:

- found that IC's functional profile corresponded to a limited-risk producer as IC did not make

- strategic decisions, plan or carry out marketing activities;
- by applying PSAs and attributing some of the group's losses, IC was exposed to risks beyond its control;
- rejected the use of PBMs and carried out its analysis on the basis of DTPM by establishing a market-level profit margin for comparable independent producers, excluding loss-making companies from the sampled set of comparable companies;
- adjusted the losses of IC to the established market level profit.

In this case, the court ruled in favor of IC, rejecting the tax administration's approach to the transfer pricing (TP) analysis. The court argued that low-risk companies could also incur losses. Additionally, inconsistencies were identified in the comparability analysis conducted by the tax administration.

Conclusions:

The proceedings at issue call into question several important aspects in defining the TP for loss-making companies and in describing the analysis carried out in the TP documentation:

- **The choice and justification of the method:** Choosing the correct transfer pricing (TP) method and justifying it based on the nature of the business (functions, risks, and assets) is a critical aspect. To effectively defend its position before both the tax administration and the court, the company must provide strong factual evidence supporting the appropriateness of the selected method, the tested party in the transaction, and the comparability of uncontrolled companies.
- **Accuracy of the analysis of comparative data:** The independent comparables selected to support the transfer pricing (TP) analysis should be chosen with the utmost care. When using the Comparable Uncontrolled Price (CUP) method, it is essential to ensure that all data is accessible, comparable, and easily traceable. In selecting comparable companies, loss-making entities should only be included if justified by market conditions or strategic decisions. Special attention should be given to the chosen profit level indicator, especially in cases where profits are assessed at the gross level, but the company's operating surplus results in a net loss.
- **Justification for deviations:** Companies should provide a detailed explanation for any deviations from the arm's length principle, citing specific strategies, additional functions and risks, or exceptional expenses. It is important to note that an entity can only bear additional costs or losses if it can control the risks, meaning it can make independent decisions regarding loss-making activities. From the case law discussed above, it can be inferred that tax authorities also assess the decision-making power of companies, which may include interviews with employees, who are not necessarily part of the management team, and whose perspectives on the company's operations may differ from those of management.
- **Documentation and evidence:** The justifications must be sufficient and detailed enough to support the transfer pricing (TP) methodology applied and to prevent its rejection by the tax administration. If the justification is inadequate, the tax administration is entitled to conduct its analysis.