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Transfer pricing policy as a tool for reducing tax risks and business planning 3/25/25

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Historically, transfer pricing in the Latvian market was usually considered from a compliance perspective. The focus has been on preparing adequate transfer pricing documentation to demonstrate that the transfer prices applied are at arm's length (market price) and making adjustments where necessary. However, there is an increasing trend for companies to develop transfer pricing policies as strategic tools that contribute not only to compliance but also to risk management and business planning.

Regardless of the specific scope of the policy, a TP policy offers significant added value for taxpayers. It can serve as a basis for analysing the value chain within a group and enables the identification of practical improvements to optimise business processes from a tax policy perspective. At the same time, it can serve as a strategic guide to support the identification and analysis of current and potential intra-group transactions.

In today's labour market, where corporations are increasingly opting to centralise business functions, transfer pricing strategies are particularly important. Their existence helps companies navigate the complex environment of related party transactions, ensure transparency and avoid common mistakes, such as the unintentional failure to document controlled transactions. This error is still widespread in day-to-day practice and often goes unnoticed until risks or consequences have already materialised.

In this context, transfer pricing planning and the control of current or planned intra-group transactions are of particular importance. Effective management of this process enables potential problems to be recognised at an early stage and avoided or mitigated in advance.

To ensure a structured approach to transfer pricing planning and control, many companies develop formal transfer pricing policies or internal guidelines that govern typical controlled transactions.

What should be included in a transfer pricing policy, and what aspects are essential?

1. Scope of TC policy

Usually, company management is aware of or able to anticipate the types of transactions planned between group companies. This means that potentially high-risk areas can be identified and clearly defined in the transfer pricing (TP) policy, indicating that specific rules and approaches to justification apply to such types of transactions.

Example:

A group of companies with a parent company in Latvia comprises several subsidiaries in Lithuania, Estonia and Poland. The parent company manufactures goods and sells them to its subsidiaries. In addition, the group companies provide management support services to each other and the parent company receives a licence fee for the transfer of intangible assets.

Based on the above example, the group can develop a transfer pricing (TP) policy that covers certain types of transactions to ensure clarity and transparency in the application of TP principles. Based on the example, such a policy could cover: 1) transactions involving the production and sale of goods, 2) the provision of management support services, 3) transactions involving licence fees.

1. Functional analysis

The next step after identifying the transactions to be included in the transfer pricing (TP) policy is to analyse the conditions and facts of these transactions, including the preparation of a description of the functions performed, the risks assumed, and the assets used, thereby creating a functional analysis. Describing the activities and levels of responsibility of the parties to the transaction is critical to accurately determining the functional profiles of the parties involved. In the manufacturing of goods, three functional profiles are generally distinguished: contract manufacturer, contract manufacturer and manufacturer with full risk. These profiles carry out significantly different activities, assume different risks and therefore differ considerably in terms of remuneration for the work performed.

1. Transfer pricing method determination

Determining the functional profile is followed by the selection and description of the TP methods used for each transaction, including variations depending on the party being analysed — typically, the tested party is the one with the simplest functional profile and for which reliable comparable data is available. Continuing with the example of a manufacturing transaction, such transactions commonly use the resale price method, the cost-plus method, or the transactional net margin method.

In practice, there are various business scenarios and circumstances that can change or significantly influence the choice of TP method used to justify the arm’s length nature of a transaction's price (or value). In some cases, due to specific circumstances, the TP method may need to be changed. It is crucial to monitor these circumstances in a timely manner and document them appropriately in the TP policy.

1. Benchmarking and the determination of the arm’s length (market) price

Once the appropriate transfer pricing method has been selected, the next step is to identify comparable transactions or companies to determine the market price (or profit level) before the transaction takes place — the so-called ex ante approach. This approach is essential to ensure that the terms of the transaction comply with the arm’s length principle from the outset and are not adjusted retrospectively.

The selection of comparable data is usually based on:

- internal comparable transactions conducted with unrelated parties, if any,
- publicly available databases (for example, Amadeus, Orbis, RoyaltyStat, etc.).

As a result of this process, a range of market prices is determined, which serves as the basis for evaluating the transaction and, if necessary, making adjustments.

1. Policy implementation and monitoring

Once a market range has been established based on the analysed financial indicator, the final step of the policy is its practical implementation within the group companies’ processes. This means:

- training employees on the application of the transfer pricing (TP) policy,
- establishing internal control mechanisms to monitor compliance of transactions with the policy,
- regularly reviewing the policy, especially in cases of changes in the group structure, market conditions, or regulatory environment.

Transfer pricing (TP) guidelines are not only an excellent tool to avoid getting lost in a maze of transactions and missing documentation of controlled transactions, but they also provide a much more detailed insight into the group’s long-term operations and help to recognise potential long-term risks related to transfer pricing in good time. This allows groups to take early preventative action to resolve issues before they escalate.

Given recent trends, we have good reason to believe that the demand for TP policies will continue to grow. If your organisation needs such a policy, remember — we're only a phone call away!