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NEWSLETTER LATVIA

SETTING ACCENTS

Issue:
3 April 2020

Covid-19: Transfer pricing during crisis

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→ Transfer pricing during crisis

Latvia law provides obligation to impose the corporate income tax if, as a result of the transfer pricing transactions, expenses of the Latvian company are too high or revenue is too low, provided that such expenses would have been lower or such revenue would have been higher was such transaction effected between unrelated persons. Restrictions imposed on Latvian companies during COVID-19 Emergency Situation have led to a decrease of revenue, to a decrease of payments from customers, as well as to an increase of receivables and account payable. Some of these related effects may be mitigated by support mechanisms provided by the State of Latvia (tax holidays with a rate of zero percent, down time compensations, guarantees and loans). However, it is still important whether, in a crisis situation, under the regulations of Latvia related parties may reduce their total costs or receive lower income in transfer pricing transactions.

TRANSFER PRICING REGULATION AND REALITY

After introduction of the latest OECD transfer pricing practice, Latvian law provides a good opportunity for a company to examine the conditions under which it would have to pay tax for a violation of transfer pricing regime, and to reduce or eliminate it after determining such tax risk timely. In other words, expenses and revenues of the Latvian company must be in line with the results of the functional analysis, secondly, such expenses and revenues must be based on the transfer pricing method, thirdly, a transfer pricing method shall reflect the comparability of expenses and revenues of related person with the expenses and revenue of unrelated and comparable commercial operators in a reasonably reliable way.

Latvian companies are makeing strategic decision on decrease of their prices of goods or services in order to maintain relationships with their customers and partners, in order to maintain development cycle, and in order to not hinder growth as a whole (by taking into account five basic indicators: turnover growth, profit growth, the accounting equation, cash flow increase and liquidity).

In a multinational group of enterprises some entities assume risk of selling goods or services (i.e. it will be possible to sell in the preplanned quantity and time) and credit risk (i.e. there will be sufficient working capital to settle debts). Risk management may be entrusted to other entity of the multinational group of enterprises or may be outsourced to an unrelated party.

A counterparty of transaction would, for its benefits in the course of the crisis, seek remuneration which covers the risks financed in order to maximise the continuity of economic activity. Consequently, funding and liquidity play an important economic role in time of crisis, as opposed to other risks which could be looked as secondary. Such legal concept allows an enterprise not only to exploit survival opportunities during crisis.

CRISIS STRATEGY AND TRANSFERPRICING REGULATION

In carrying out a functional analysis, the Latvian regulatory enactments provide a wide leeway in choosing the strategy of an international company and in applying transfer pricing methods in order to justify the size of expenditure and revenue, taking into account the economic conditions resulting from the restrictions imposed in an Emergency Situation:

- a reduction in market sales (with the view that it is necessary to return to pre-crisis figures in such a way as to enable future growth to be increased at or close to the conditions preceding the crisis);
- a reduction in the growth (with the view that the necessary pace should be maintained to overcome the effects of the constraints of the crisis and to continue economic activity).

The easiest but less prudent decision could be to recognise the debts or claims of the related party and not to require payments, nor pay accordingly. Sucha decision could counter to the basic issue of debt funding, which shall be resolved sooner or later. Moreover, if there is a significant increase of such debt and claims, then transfer pricing risk for such funding risks will likely to increase.

A more prudent decision would be to choose a strategy for a certain period of time to achieve a reasonably certain result, by following predetermined consistency and by avoiding significant deviations from the chosen strategy (hindsight). Such decision provides possibility to manoeuvre in line with market changes and to set the calculation of expenses and revenue for transfer pricing transactions in order to achieve the said strategic objective. You will ask whether the State Revenue Service will be able to identify such strategic choices in real time. The answer is no, because the Latvian tax administration does not have such capacity, nor it is expected have in short term. The State Revenue Service will only be able to review the company` s strategy in 2022, when it will receivethe company` s mandatory transfer pricing documentation for 2020. You will ask again, whether the State Revenue Service will be able to contest such a strategy. The answer again is no, unless the State Revenue Service can demonstrate with sufficiently reliable industry information that such a strategy does not correspond to market practices during crisis. Therefore, for the sake of security of Latvian company and the group of related companies comprehenisve and contemparenous transfer pricing documentation is required.

JUSTIFICATION OF TRANSFER PRICING METHODS

Let us address the possible justification of the selection of the transfer pricing methods during the crisis, in line with the requirement of the regulations that both the sales risk, which affects the size of expenses and revenue in transfer pricing transactions, and the credit risk alike, shall be justified with a certain transfer pricing method. In times of crisis, it is necessary to compare not only the amount of expenses and revenue, that generate profit, but also the rate approximating overcome of the crisis based on 3 financial indicators, which have leeway in manoeuvre:

- turnover;
- profit;
- balance equation.

Two additional financial indicators – cash flow and liquidity – have less room for manoeuvre, since the factors affecting prices are better known already.

With respect to the comparable uncontrolled price method, it should be noted that during the crisis funding is available at a rate of zero percent (tax holiday) or within 1-3 percent (financing from state aid), or at worst at a rate of 4.65 percent (according to general tax holiday arrangement). Regulations allow those figures to be used as a price influencing factor in order to justify the transfer price.

As regards to the resale price method and the cost plus method, it should be noted that, in line with the chosen strategy, the calculation of these methods should take into account the planned selling price, the cost of the goods sold (variable costs), gross margin, fixed costs and the point of no profit (break-even point).

As regards to the transactional net margin method, it should be noted that by integrating the marketing risks and credit risks into the group of companies, the calculation of the costs of the goods (or close to it) in transfer price can be justified in order to ensure against a drop in turnover of 20 percent, 30 percent or even 50 percent, which is a well-known negative market rate recognised by the Cabinet of Ministers. At the given moment, each commercial company has the data necessary to determine and monitor the rate approximating overcome of the crisis for 2020, 2021 and subsequent years.

As regard to the profit split method, there may be a share of risk of decrease in sales between related parties, which is used in transactions during the crisis to regulate the amount of expense and revenue in transfer pricing transactions. Risk sharing factors could be the resources invested in crisis management, which impacts reimbursement (i.e. one has an expense, the other has an revenue) for the related company.

In conclusion, it should be noted that the Latvian commercial company has the right to request a consent from the State Revenue Service regarding the conformity of the chosen strategy with the law five years forward with the possibility to update a standing each year. If a reasoned request was submitted by the end of April 2020, the State Revenue Service would have issued response to the said request no later than 4 months, that is, by the end of August 2020. Such an objective may be pursued in the framework of advance pricing agreement procedure which is available from 2013.

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