Transfer pricing regulations in the Baltic States

Aija Lasmane, SORAINEN senior associate

Aina Bambāne, SORAINEN associate

Based on our practice in assisting clients with transfer pricing (**TP**) matters in the Baltics, we have prepared a short overview of the most significant features of TP regulations in these three countries. Although the TP regulations of all three Baltic States are based on the principles set by the Organisation for Economic Co-operation and Development (**OECD**) in its TP guidelines[1], local rules reveal certain differences.

- ***Mandatory TP documentation criteria differ between the Baltic States***

Beyond certain thresholds, corporate income tax (**CIT**) payers in each Baltic State must prepare TP documentation with content specified in tax law. The thresholds are as follows.

<u>*Estonia*</u>

A group of companies including the particular Estonian taxpayer has:

- annual turnover of EUR 50 million; and
- total assets of EUR 43 million; and
- at least 250 employees.

<u>*Lithuania*</u>

The annual turnover of a resident company or a permanent establishment (**PE**) of a non-resident company amounts to LTL 10 million (EUR 2.9 million).

<u>*Latvia*</u>

A Latvian CIT payer has:

- annual turnover of EUR 1.43 million; and
- total value of a related party transaction amounting to EUR 14,300.

According to mandatory TP documentation criteria, the TP issue in Estonia is treated in a wider context, ie instead of imposing criteria solely on the Estonian company the criteria are set for the whole group to which the Estonian company belongs. Therefore the TP documentation is not mandatory for Estonian companies belonging to relatively small groups. At the same time, these criteria do not favour large multinational groups, whose operations in Estonia are rather limited, eg during the start-up stage of their activities.

In contrast, the criteria in Latvia and Lithuania apply to specific local CIT payers in those countries. In Latvia, two thresholds apply, ie criteria as to turnover and value of related party transactions. The Latvian turnover threshold of EUR 1.43 million is lower than the Lithuanian turnover threshold of EUR 2.9 million. However, in addition, the other threshold, ie the value of related party transactions, is rather low in Latvia, and constitutes merely 1% of the turnover criterion (14,300 / 1,430,000 = 1%). For instance, if a Latvian company receives services or purchases goods from related parties and the transaction amounts to EUR 14,300, the CIT risk from the potentially largest possible TP adjustment is EUR 2,145 (14,300 * 15%).

[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

In contrast, Lithuanian companies with turnover higher than the threshold must prepare TP documentation notwithstanding the value of related party transactions. This means that TP documentation is also required for smaller related party transactions.

Thus the requirements for mandatory TP documentation in each country have their advantages and drawbacks. Above all, companies not exceeding the thresholds must still prove that their TP is consistent with the arm's length principle. In this case, tax law does not specify the content of TP documentation.

In any case, the content of TP documentation is similar in all the three Baltic States, as their tax law provisions are all harmonised with the OECD guidelines.

- ***TP rules for transactions with companies operating in specific territories and industries***

In Latvia, all transactions with low-tax or zero-tax territories are subject to TP rules. In contrast, specific TP regulations apply in Estonia and Lithuania to financial and insurance companies, as well as publicly listed companies.

In Estonia, financial institutions, insurance companies and publicly listed companies must follow additional TP documentation requirements. These additional requirements also apply to transactions with companies based in low-tax or zero-tax territories.

In Lithuania, the mandatory TP documentation requirements apply to financial institutions as well as to lending and insurance companies irrespective of any criteria.

In Latvia, however, no additional TP rules apply to financial and insurance companies; nevertheless due to their volume of operations, most companies from these sectors are likely to meet the general criteria and thus be required to prepare TP documentation under general tax law provisions.

- ***Recent TP audit practices in the Baltic States***

The tax authorities in all three Baltic States are mainly interested in auditing large taxpayers, as well as thoroughly examining selected comparable companies to test whether a company should be excluded from selection.

<u>*Estonia*</u>

The Estonian tax authorities assess the following four factors in order to evaluate potential TP risks and decide on a TP audit:

- continuous losses incurred by companies which generate revenues solely from related party transactions;
- continuous profits but no dividend payments (issuing loans instead);
- insufficient information about related party transactions in financial statements;
- company financial results significantly differ from industry averages.

Recent TP audits in Estonia reveal the following three conclusions:

- terms of agreement, eg loan maturity, should be considered when substantiating interest rates for financing transactions;
- the benefit test must be performed when analysing TP for management services received; if not, these may be considered a non-business expense for tax purposes;
- adequate reasoning must be presented if a company incurs continuous losses from sale of goods to a related party.

<u>*Lithuania*</u>

The Lithuanian tax authorities mainly focus TP audits on the following related party transactions:

- loans and interest payments;

- management services;
- providing/receiving services and purchase/sale of goods.

Additionally, the Lithuanian tax authorities tend to inspect and challenge thin capitalisation calculations.

In a recent TP court case the Lithuanian tax authorities stressed the need to perform a careful comparability analysis. In the particular case, the audited company was a supplier of black metal, while the selected companies were involved in supply of minerals containing metals. Due to such differences the court concluded that the taxpayer's selected companies were not comparable.

Latvia

The Latvian State Revenue Service (**SRS**) carefully inspects the following aspects of related party transactions:

- whether the service was actually provided/received;
- whether relevant costs, for example interest expenses, qualify as business-related for tax purposes;
- the soundness of the TP approach in all kinds of related party transactions;
- the quality of comparable transactions and data, in particular whether they are comparable to the taxpayer's related-party transactions.

With regard to TP in practice, in a recent TP court case[2] the Supreme Court held that a board member's authority to independently represent a company does not indicate a decisive influence on the company. The board member was one of three board members in the company and held 25% of the company's shares, while his mother held the other 75%. The court concluded that the board member was not a related party with regard to the company as he did not have a decisive influence on the company. In the same case, the court also reviewed compliance of TP with market prices and quality of comparable transactions on the sale of an apartment with defects. The hearing on this issue is still in progress.

In another case reviewed by the Administrative District Court in 2013[3] the court emphasised the need to explain acceptance or rejection of a specific TP method, as well as to substantiate the choice of criteria in a benchmarking study. In this case, the SRS disregarded the TP method selected by the taxpayer and performed an alternative TP analysis. The court revoked the SRS decision on the grounds that the SRS had:

- not sufficiently substantiated its choice of TP method;
- selected the profit indicator without justification;
- selected wrong comparable companies due to incorrect functional analysis of the taxpayer's transactions.

Additionally, there are known cases in TP practice when having verified compliance of loan interest rates with TP rules the SRS decided that the interest costs were non-business expenses. Therefore we recommend that Latvian taxpayers should also carefully consider and substantiate their TP strategy for inter-company financing transactions.

---

[2] Judgment of 12 March 2014 by the Administrative Cases Department of the Supreme Court in case No. A42994709.

[3] Judgment of 22 May 2013 of the Administrative District Court in case No. A420496211.

- ***Advance pricing agreement (APA) is a less frequently used option by taxpayers***

While Estonia has not introduced the APA, the SRS in Latvia offers this option for a fee of EUR 7,114 to a limited range of taxpayers, ie companies with related-party transactions amounting to at least EUR 1.43 million a year.

In this respect Lithuanian tax law is relatively more liberal in that any Lithuanian CIT payer can conclude an APA with the tax authorities free of charge. Despite the rather cost efficient approach to APA, Lithuanian companies are not eager to use it as, similarly to Latvia, entering into an agreement requires submission of a large package of information, including the requirement to substantiate TP.

- ***Conclusions***

International groups operating in the Baltic States should consider the slight differences between the TP regulations across the three countries when analysing and preparing TP documentation for pan-Baltic transactions. However, as TP regulations in all three Baltic States are based on the OECD approach, existing differences are not extremely substantial. Therefore TP documentation prepared in one Baltic State may often also be used in another unless it causes significant tax risks to a taxpayer of the latter country.