

# Latvian developments

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## Documentation must substantiate transactions, APAs are introduced

2013 has brought new amendments to the law “On Taxes and Duties” (TD Law) imposing new requirements on pricing transactions with related parties, which we report in this article.

The TD Law amendments introduce a requirement on transfer pricing (TP) documentation serving as proof that arm’s length prices have been applied in transactions with related parties. However, since 1995 the Corporate Income Tax Law (CIT Law) has contained the TP requirement that taxable income must be increased by unrealised profit where the market price has not been applied to a transaction with a related party. Starting from 2007, the Latvian State Revenue Service (SRS) has been actively auditing compliance of related parties’ transaction prices with arm’s length prices. So we are ready to share our experience of taxpayers’ frequent mistakes which increase the risk that in an audit the SRS will adjust related party transaction prices for tax calculation purposes.

### I. New regulations from 2013

#### A. Definition of transfer price and audit

The transfer price definition included in the TD Law provides that this is the price (value) applied in a transaction between a Latvian company and its related foreign enterprise according to the related definition of enterprise under the CIT Law. Note that the requirements of the CIT Law on application of arm’s length prices refer not only to transactions with related foreign companies, but also to transactions with:

- related persons (owners and their relatives);
- business entities in the same group for tax loss transfer;
- business companies that receive CIT allowances under the laws of the Republic of Latvia; and
- persons and companies established or incorporated in tax havens.

The term “transfer prices” introduced in the TD Law is used primarily to extend the term when the SRS is

allowed to perform tax audits. So far, the TD Law allowed the SRS to perform a tax audit within three years after the tax due date, but the rule included in the TD Law from 2013 allows the SRS to verify compliance of transfer prices with arm’s length prices and to adjust the taxable income for five years after the tax due date. As a result, the SRS is allowed to inspect prices (transfer prices) of company transactions with related foreign companies for five years after the tax due date, but in relation to other transactions under the CIT Law that are subject to the arm’s length requirement, the statute of limitations of three years remains.

#### B. Documentation substantiating prices

The largest upheaval is caused by the so-called transfer pricing documentation requirements introduced in the TD Law. The CIT Law rules on transactions with related parties were present since 1995, and explanatory Cabinet Regulations No. 556 of 2006 specify five methods for determining the arm’s length price and factors to be taken into account upon applying these methods. From 2013, the TD Law contains a requirement for taxpayers with an annual turnover exceeding LVL1 million (approx €1.4 million) and having transactions with specified transaction partners exceeding LVL10,000 (approx €14,229) to prepare a document substantiating compliance of these transaction prices with arm’s length prices. This must include specific information. Note that the documentation must cover not only prices in transactions with related foreign companies (transfer prices), but also prices in transactions with all the previously named transaction partners under the CIT Law requirements.

The document substantiating prices of transactions between related parties must include information that we could group into the following analytic types in line with international practice:

- *industry analysis*: providing information about tendencies in the industry the taxpayer operates in,

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about such factors affecting operations of industry players as legal regulation, economic conditions, role of intellectual property, competition conditions and others;

- *enterprise (company) analysis*: providing information about the taxpayer, its related persons and companies, their legal and organisational structure, operational strategy, financial information and other factors affecting transaction prices;
- *functional analysis*: providing an overview of the functions the company performs, the risks it undertakes, and the assets it invests in transactions with related entities and persons;
- *economic analysis*: of transactions between related parties, including:
  - transaction description, including a description of agreement conditions;
  - arguments for choosing a particular method as the most suitable to determine the arm's length price;
  - benchmarking study – analysis of unrelated party transaction prices or of uncontrolled companies' profit indicators according to the chosen transfer pricing method.

The taxpayer must store this document for five years after the taxation period and must submit it to the SRS within a month after receiving a request. Although the legislation does not set an administrative penalty for failing to submit the documentation, failure to submit allows the SRS to recalculate prices for the taxpayer's transactions with the persons and companies mentioned based on the available information and understanding of the transaction.

### C. APAs with the SRS

Starting from this year, taxpayers whose annual turnover exceeds LVL1 million have the option to enter into an agreement with the SRS (an Advanced Pricing Agreement – APA) on determining the market price for a transaction with a related foreign company if the transaction value exceeds LVL1 million a year. If the taxpayer has set and applied market prices in compliance with the agreement, in the case of an audit the SRS cannot review and reassess transfer prices for tax calculation purposes.

Under Cabinet Regulations No. 16 "Procedure for entering into a prior agreement between a taxpayer and the tax administration to determine the market price (value) of a transaction or type of transaction" of January 13, 2013, payment for entering into an agreement is LVL 5,000 (approx €7,114), of which the taxpayer must pay 20 percent to the SRS before submitting an application for an agreement, and the remaining amount is payable after the SRS starts the agreement negotiation procedure. Note that making payment before launching the agreement negotiation procedure does not guarantee that the taxpayer and the SRS will enter into an agreement. If the taxpayer and the SRS cannot reach agreement within a year, the SRS can terminate the agreement negotiation procedure.

Taxpayers who consider applying for an APA should take into consideration that together with the application for starting the agreement negotiation procedure they should submit broad information to the SRS re-

garding their operations and transaction(s) with a related company subject to the planned agreement. This information exceeds the information to be included in the previously described transfer pricing documentation. Thus the agreement serves as a means to decrease and manage transfer price risks of large and complicated transactions between related parties rather than as a replacement for TP documentation.

## II. Mistakes in TP substantiation

### A. Documentation requirements

Starting with the most important – typical deficiencies of TP documentation giving the SRS arguments to reject this proof and to determine arm's length prices at its discretion.

Under the requirements of the TD Law, normally the burden of proof lies on the taxpayer. Thus even before the TP documentation requirements introduced in 2013 in the case of tax audit the taxpayer had to be able to prove that it applies market prices in transactions with related parties.

Under generally adopted international practice a number of factors affecting market prices of transactions are evaluated in the TP documentation. Usually the structure of the documentation and considered analyses are similar to TP documentation requirements under the TD Act described above. The following three mistakes are often made with regard to drafting TP documentation.

### B. Timely analysis and documentation

Preparation of TP documentation or at least the TP analysis of a transaction should not be postponed until the SRS sends a notice to commence a tax audit. If a transaction is performed at a price that does not correspond to the arm's length price, it may be difficult or even impossible to prove in the TP documentation that the price is still arm's length. Thus the best approach would be to determine the arm's length price of a transaction before commencing the transaction and to use that analysis to prepare TP documentation after the end of a taxation year.

### C. Group documentation must comply with Latvian requirements

Sometimes company groups prepare TP documentation centrally for a group (master file). Latvian companies often translate these documents and use them as proof of compliance with Latvian TP requirements. However, before taking this option, these group documents should be carefully assessed because group TP documentation often includes only an industry analysis, company analysis and functional analysis of the most typical transactions, but lacks an economic analysis of related party transactions, which is left to the discretion of individual group companies.

Risk arises because the economic analysis of transfer pricing substantiation is the most important part assessed most scrupulously by the SRS during an audit. If the documentation lacks analysis of *all* the most significant transactions of a Latvian taxpayer with its related parties and fails to identify the most

suitable TP methods and comparable transaction data, the SRS is free to calculate the market price for the transaction at its own discretion and according to the information it has.

#### D. Documentation must be updated regularly

Another factor increasing the risk of tax charges is the use of out-dated TP documentation, that is, the documentation has not been reviewed and updated for more than two or three years. Taking into account that a benchmarking study (for example, in the AMADEUS database) could be quite expensive, this element of TP documentation is sometimes older than five years. In today's world, both the market situation and transactions between parties are rapidly changing. This causes a risk that a situation described in the TP documentation no longer reflects the actual operations of the company and the true essence of transactions with related parties. In this situation the SRS may reject the TP documentation submitted by the taxpayer as being outdated, and recalculate the market prices for transactions at its own discretion.

#### E. Choosing and substantiating the most appropriate method

Five methods are available for a taxpayer to choose for calculating the market price of a transaction:

- Comparable uncontrolled price method
- Resale price method
- Cost plus method
- Transactional net profit method
- Profit split method.

Moreover, the latter two methods may be used only when none of the first three methods can be used to determine the arm's length price. Criteria in selecting the most appropriate TP method for particular circumstances and situations are explained by OECD Guidelines.<sup>1</sup> Frequently, taxpayers make the following mistakes when choosing the most appropriate TP method:

- If a company has not timely analysed the transfer pricing (the ideal time would be before starting a transaction or at least after the end of a financial year), it cannot indicate in appendix 2 of the corporate income tax return the TP method applied to calculate the arm's length price. Sometimes companies indicate a TP method in the return, although this method is very unlikely to be used to substantiate a particular transaction. To a competent third party (SRS) this indicates that TP analysis has not been performed or that it is incorrect, and thus provokes an audit, in particular to analyse related party transaction pricing and TP documentation if it has been prepared.
- The documentation fails to present arguments why the particular TP method has been chosen to be the most appropriate of the five TP methods. This may result in the SRS disputing the method chosen by the taxpayer as the most appropriate and choosing another TP method to recalculate the arm's length price for the transaction.

- Sometimes the comparable uncontrolled price method, as well as the cost plus method and resale price method are formally rejected in the TP documentation on the ground of insufficient data on prices for comparable transactions or gross profit level. Lack of time or experience and information sometimes causes ignorance of internal comparable transactions or similar transactions that a company or its related company performs with unrelated parties. Having assessed whether transactions with unrelated parties are sufficiently comparable with a transaction between related parties or having adjusted the price on transaction differences, it is sometimes possible to apply one of the first three TP methods. Furthermore, this approach is also cheaper because no need arises to search for comparable data in commercial databases such as AMADEUS or Orbis.

#### F. Are comparable data really comparable?

Although it has been mentioned before that using internal comparable uncontrolled transactions could be the best approach, it should still be taken into account that whether transactions with unrelated parties are sufficiently comparable with the intra-group transaction under consideration should be carefully assessed. It would be a mistake to compare, for example, prices for sale of goods (or mark-up of production costs) in a single transaction with an unrelated party and prices (or mark-up of production costs) for long-term supply of goods to a related company, especially if the functions performed or risks undertaken by a company in these transactions significantly vary and substantiated price adjustments cannot be performed to account for these differences.

Another approach that may cause difficulties in a Latvian benchmarking study to determine the arm's length profit indicator is to use competitor companies as comparable companies. Sometimes these competitor companies belong to international groups of companies and most often no confidence can be placed in their financial results not being distorted by transacting with related companies or that these transactions are performed at market prices. Thus competitor companies cannot be used as independent comparable companies. In an audit, the SRS also excludes these companies from the comparable companies' sample, which may significantly shift the interval of market prices or the profit level indicator determined as a result of the study.

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#### NOTES

<sup>1</sup> Organisation for Economic Co-operation and Development "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations"