KPMG

Tax and Legal Newsletter

In this newsletter the following subjects are covered:

Compensating adjustment of transfer prices

In this article we describe the compensating adjustment of transfer prices – what it is, when it corresponds to the arm's length principle and when it contradicts transfer pricing principles.

Often there are situations when Latvian commercial companies make compensating adjustments to transfer prices, i.e. they adjust the total price of transactions carried out in the previous year (or a different period) based on an invoice or credit invoice, in order to ensure that transfer prices comply with the arm's length principle. Sometimes these adjustments are made several months after the financial year end, and price adjustments affect the company's profit level. Unfortunately, the laws and regulations in Latvia do not cover compensating adjustments. Therefore, additional information should be sought in international guidelines and EU recommendations.

In the document "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" issued by the Organisation of Economic Co-operation and Development (hereinafter – OECD Guidelines) the compensating adjustment is defined as a price adjustment, which is made by the taxpayer prior to submission of the tax return in order to report about the transaction's arm's length price for tax purposes, because it differs from the original amount of transaction. This adjustment is made by adjusting accounting entries after the transaction is carried out (usually at the end of the financial year or even later), but prior to submission of tax returns. Although the OECD Guidelines have defined this adjustment, they do not provide any further information on when the compensating adjustment is acceptable and when – not. Therefore, the European Union Joint Transfer Pricing Forum issued a report on compensating adjustments (hereinafter - Report) which includes recommendations that are summarized below.

The report finds that the compensating adjustment approach differs in various EU Member States. The reason for different approaches is due to different understanding of transfer pricing principles which include time gap, data access restriction and the quality of comparable data studies from commercial data bases such as AMADEUS. National perception of what can be considered as an acceptable and unacceptable evaluation of transaction price, after it has been implemented, is also different.

Subsequent adjustment to prices applied in the original transaction relates to an important transfer pricing issue as to which of the two should be applied by the taxpayer:

1) ex-ante or transaction price application approach where the taxpayer demonstrates that at the time of the transaction he has attempted to set market level prices based on the information available at the time. In countries that follow ex-ante approach it is expected that when the

prices were set similar to the way how it would be done by unrelated parties, based on the information at their disposal, these prices would be binding on the parties (i.e. it would not be necessary to adjust them later).

2) ex post or transaction result substantiation approach under which the taxpayer is required to check the actual outcome of related party transactions to demonstrate that their transaction conditions (price) corresponded to the arm's length principle. In countries that apply this approach it is expected that at the end of the financial year the taxpayer will check the outcome of related party transaction and make price adjustments, if necessary. When applying this approach it is often permissible to use the data for the time when the transaction was carried out, but which were not available at the time of transaction (for example, profit ratio of unrelated comparable commercial companies for the given financial year).

Use of different approaches in various countries may lead to double taxation. For example, while one country follows the ex-ante approach and precludes compensating adjustment, the country of the counterparty uses the ex-post approach which requires the taxpayer to make profit adjustments. Thus, the Report includes recommendations on application of compensating adjustments in EU Member States.

Firstly, profit generated from intra-group transactions must be calculated symmetrically, i.e. intra-group transactions of the same kind are subject to a single price (i.e. price that is set based on common methodology and is not substantially altered, without any changes in external conditions affecting the price). Secondly, a tax administration must accept the taxpayer's compensating adjustment if the following criteria are met:

• Prior to the particular transactions the taxpayer has made a reasonable effort to ensure that the business transaction price is at arm's length. This is usually laid down in the transfer pricing documentation;

• Taxpayers from both Member States make symmetrical adjustments to their accounting (i.e. one taxpayer increases the taxable income, and the other decreases it by the same amount);

• The taxpayer applies the same method consistently from year to year, meaning that by applying the ex-post approach, it must be applied also in the future, regardless of whether it is beneficial in a given year or not.

• The taxpayer makes the compensating adjustments prior to submission of its corporate income tax declaration;

• The taxpayer is able to explain the reasons why the previously estimated prices did not correspond to the arm's length principle, in case such condition is required by the laws and regulations of at least one Member State concerned.

Based on these criteria it follows that the taxpayer is obliged to estimate the initial market price for intra-group transactions and apply it during the financial year. It is unacceptable when related parties carry out transactions at deliberately incorrect prices which at any given time cannot be considered as market prices, and at the end of the financial year they make price adjustments by issuing an invoice for the difference between the market price and the price actually applied.

Latvian legislation does not directly define which of the two approaches should be applied. However, we have encountered a situation where during an audit the SRS has made a surcharge, considering that the compensating adjustment should have been made. In particular, a Latvian company had issued invoices to its related party for management services where the fee was determined, based on estimated costs and additional market premium. Nevertheless, actual costs turned out to be higher than expected. In this situation the SRS took the view that the Latvian company had to make a compensating adjustment by issuing an invoice for the difference between the service fee that is based on actual and estimated costs.

In practice the SRS accepts and even insists on compensating adjustments which increase the profit of a Latvian taxpayer, so, by analogy, the SRS should allow a downward adjustment to be made. In the dispute between the taxpayer and the SRS, where a Latvian manufacturing company made a profit-decreasing compensating adjustment, in the judgement SKA-134/2011 of 15 April 2011 the Supreme Court rejected the argument raised by the SRS that the adjustment is unacceptable, as the credit invoice of compensating adjustments does not indicate any specific transactions for which adjustments are made, instead the total profit from supplies made to a related party was adjusted. In particular, the court drew attention to Paragraph 1.42 of OECD Guidelines where it is indicated that in situations where certain transactions are linked so closely or they are so continuous that it is impossible to assess them separately (for example, long term supply contracts), such transactions require an overall assessment instead of looking at individual parts.

Although it seems as if Latvian practice accepts ex-ante approach, it is worth emphasising that when deciding on the acceptance of downward or upward adjustments the tax administration auditors will assess arguments raised by the taxpayer on why the price actually applied differs from the market price. In addition, for the purpose of making compensating adjustments the taxpayer must carry out a transfer pricing analysis which must be described in the transfer pricing documentation, which will also include the selected transfer pricing methods and comparable data analysis used for determination of the price, as in the case of profit-decreasing adjustment the SRS will pay more attention to the reasonableness and amount of the adjustment.

Denomination of share capital of companies

As the Euro was introduced in Latvia, amendments were made to the Commercial Law, effective from 1 January 2014, requiring companies to restate their share capital and the nominal value of shares in euros. It is primarily the responsibility of the management board to fulfil this requirement. The date by which these changes must be registered with the Enterprise Registry is 30 June 2016 and this deadline is approaching quickly. This is the time for the companies that have not yet made these changes to start recalculating their share capital and drawing up the required documents.

The recalculation should be made according to the Law on the Procedure for Introduction of Euro and the Commercial Law. The key requirement is to retain the existing proportion of shareholding between the shareholders of the company and make sure that the amount of share capital remains the same to the extent possible (the permitted change is below 1.6%). The nominal value of a share derived from denomination should be rounded down; however, it is possible to set a different nominal value of a share if required so to comply with this key requirement. The residual value of shares resulting from the denomination, which cannot be translated into new shares, should be disbursed to the shareholders in proportion to their holding or, where this is impossible - transferred to reserves.

The following documents are required to register the recalculated share capital with the Enterprise Registry:

- application (form 18);

- minutes or an excerpt from the minutes of the shareholders meeting or a decision of the sole shareholder;

- updated version of the articles of association;

- amendments to the articles of association;

- the shareholders' register section (applicable only to limited liability companies).

Until 30 June 2016, the denomination of share capital is registered according to simplified rules, namely, there is no requirement to have a notarised confirmation of signatures on the documents submitted to the Enterprise Registry (minutes of the shareholders' meeting, articles of association and the shareholders' register) and no fee should be paid for the registration of these changes or for publication of the changes in the official newspaper Latvijas Vestnesis. These simplified rules will no longer apply if the registration is made after 1 July 2016.

If a company fails to submit denomination documents by 30 June 2016 the Enterprise Registry will recalculate the registered share capital to whole euros at the lat exchange rate vs the euro. However, the Enterprise Registry will make recalculation automatically and it will not update the information in the company's Articles of Association or shareholder's register – the company will have to perform these changes itself. It is possible to do it at a later time, when the company informs the Enterprise Registry of any other changes. In that case, the company simultaneously will have to denominate its share capital and the value of one share according to the law and at its own discretion.

As the foundation documents of companies which will not have made the denomination themselves by 30 June 2016 will be non-compliant this will present technical grounds for the Enterprise Registry to file a claim to the court to terminate the operations of the company by giving three months advance notice, which will be the time provided to resolve the matter. Consequently, it makes sense to recalculate share capital into euros and register these changes with the Enterprise Registry as soon as possible.

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