Transfer Pricing Newsletter

Issue №3
April 2019

pwc

ARE YOU ON THE RISKY SIDE OF TRANSFER PRICING?

Georgian transfer pricing ("TP") regulations aim to ensure that cross border transactions between related parties are conducted at arm's length terms. Arm's length terms is the terms which would have been determined if such transaction was between independent entities under the similar circumstances.

The concept of risk relates to those business factors that expose a company to the possibility of loss or damage. The loss or damage could be in the form of financial loss or even damage to the reputation of the company. The Organization for Economic Co-operation and Development's Transfer Pricing Guidelines ("OECD Guidelines") defined risk as the effect of uncertainty on the objective of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. As such, the concept of risk exists whether a company is entering into transactions with both independent as well as related parties.

Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return. In other words, the higher the risks, the higher the expected return. This principle does however become significantly more complex when considering transactions between related parties. This is due to the fact that risks could artificially be moved between related parties, without the corresponding remuneration. From an arm's length perspective, allocation of risks between related parties should be consistent with the economic substance of the transaction. In order to determine true allocation of risk between related parties, the conduct of the parties should be taken as the best evidence. For the detailed overview regarding arm's length principle in transfer pricing, you can refer to the first issue of our transfer pricing newsletter series.

In practice there are a number of risks affecting transactions between related parties which should be considered. These include for example market risks; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth. Below we have expanded on some of the risks mostly found in the Georgian business environment.

Market risk

Market risk is defined as the risk of changing conditions in the market in which a company operates, resulting in adverse sales on the market, or the inability to develop markets or position products to service targeted customers. This risk relates to any event in the market which could potentially effect the company, such as fluctuations in the price of a product as a result of a shift in a market as a whole. For example, the occurrence of political or economic changes could affect the demand for a specific service or product in the market, which in turns effects the price of the product.

Customer credit risk

When a firm supplies products or services to a customer in advance of the payment, the firm runs the risk that the customer will either fail to make payment or the payment is deferred. This risk is known as customer credit risk.

One of the most common examples of this risk is when a company provides products or services to the customer and allows the customer 90 days to settle the invoice. In the situation, the company runs the risk that the customer will fail to make a payment, or will make a late payment. This risk can result in disruptions in the cash flow of the company as well as losses due to the writing off of bad debt.

Foreign exchange risk

Foreign exchange risk relates to potential volatility in exchange rate if there is a difference in the currency of the intercompany transaction and the functional currency of the local company.

In case of cross-border transactions, foreign exchange is an inherent risk for MNE’s, since there is a high probability that the currency of transaction will differ from the functional currency of the local entity, which would be Georgian Lari.

Operational risk

Operational risk is defined as the risk of direct or indirect loss resulting from inadequate or failed information systems, technology failures, breaches in internal controls, fraud, unforeseen catastrophes, or other operational problems that may result in unexpected losses. Losses from operational risk includes actual loss of earnings, as well as the loss of the opportunity to generate additional revenues.

What are the risks relevant for your Georgian based company?

Whenever Georgian Revenue Services (“GRS”) initiate a transfer pricing assessment, one of the significant aspects which is considered is the risks related to the various intercompany transactions. As a starting point, the GRS would review the intercompany agreements between the parties as this generally defines how risks are allocated between the parties. Accordingly, having these intercompany agreements in place are beneficial. However, the principle of substance over form is followed in Georgia, which means what happens in practice takes precedence over what is written in intercompany agreements.

The risks discussed above are examples of some of the most frequently encountered risks however there might be different transfer pricing risks which affects your company. Accordingly it is important to analyse each intercompany transaction in detail and assess which risks might be relevant to your intercompany transactions.

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With this in mind, are the risks assumed by your company in relation to your intercompany transactions correct? Do you know which risk your company are actually assuming?

The objective of the PwC newsletter series is to raise general awareness on this moderately explored field. For this purpose, PwC will be sharing our experience on some topics and providing some insights into recent developments in the Georgian transfer pricing practice.

The newsletters will also add value to companies who are still uncertain whether their business is affected by transfer pricing. The information will assist in identifying potential transfer pricing related risks, after which a meeting can be arranged with PwC to discuss the options available in more detail.

PwC Georgia has one of the best transfer pricing teams in Georgia with an extensive experience both in the Georgian as well as international markets, which consists of a local director and two managers. Our team offers a full scale of TP consulting services to multinational enterprises operating in Georgia and arranges meetings with the companies who are still uncertain whether their business is affected by the Georgian TP regulations or not.

In case of interest, the PwC Georgia Team is ready to answer your questions:

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