

What to be ready for as new transfer pricing rules come to Russia

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At present there are no specific transfer pricing regulations in Russia. However, articles 20 and 40 of the Russian Tax Code describe the related issues.

Transactions between the related parties, barter operations and foreign-trade transactions are under control of tax authorities.

Article 40 of the Tax Code provides for a general rule according to which a transaction price is deemed to be the market one. The safe harbour of price deviations is limited within 20% from the market price.

Article 20 of the Tax Code contains a list of related parties. They are companies holding directly or indirectly more than 20% of shares, employers and employees, relatives. Besides, courts are entitled to treat persons as related if it is stated that the relationship between them may affect the result of the transactions, irrespective of the criterion provided by the Tax Code.

Application of transfer pricing rules at the moment is problematic because of a lack of information about determination of market prices, the wide list of controlled transactions and poor regulations of tax control in the event of a 20% deviation from own prices.

The main changes

The draft law on transfer pricing was accepted by the State Duma in the first reading on February 19 2010. The amendments are proposed to be introduced from January 1 2011 and will significantly change the current rules and bring Russian transfer pricing regulation closer to European practice. Namely the proposed changes are:

- 1) List of transactions under transfer pricing control of the tax authorities will be shortened;
- 2) List of related parties for tax purposes will be extended and specified;
- 3) New market price determination methods will be adjusted in accordance with international practice;
- 4) An obligation to submit to the authorities documents supporting controllable transactions realised in the reporting period will be introduced;
- 5) The list of informational sources for determination of the market price will be extended;

- 6) Liability for unjustified non-submission or submission of false data on the controllable transactions to the authorities will be established.

Due to the expected introduction of the new rules, companies which carry out activity in Russia should revise the transfer pricing policies they apply. Adapting to the proposed novelties may require considerable time since the changes to the current rules will be considerable (for example, companies may have to restructure supply chains, change pricing mechanisms and implement new compliance processes).

New controllable transactions

If introduced, the transfer pricing law will expand the list of transactional items that are subject to control. In addition to goods, works and services, the amended transfer pricing rules will also cover transactions involving property rights, intellectual property (IP) rights and financial transactions.

At the same time, this law will reduce the types of the transactions subject to transfer pricing control focusing more on related-party transactions, and will include only certain types of third-party transactions.

This narrower focus means that barter transactions and domestic third-party transactions where the price deviates in excess of 20% within a short period of time no longer will be subject to transfer pricing control.

Moreover, transactions between members of a domestic consolidated group of taxpayers will not be subject to transfer pricing control as well. According to the preliminary draft law on consolidated groups of taxpayers, consolidated groups of taxpayers can be comprised by organisations where one organisation directly or indirectly participates in the other organisation, and the participation share is at least 90%.

In the domestic context, only related party transactions will become subject to transfer pricing control and only if one or more of the following criteria is fulfilled:

- The total amount of income/expenses within a calendar year exceeds RUR 1 billion (\$34.5 million);
- The object of the transaction is subject to mineral extraction tax;
- The counterparty is a taxpayer of unified tax on imputed income or unified agricultural tax;
- The counterparty is a resident of special economic zone with special tax relief.

In relation to cross-border transactions the following will be subject to transfer pricing control:

- Transactions which are accomplished between the related parties;
- Transactions where the subject is oil and oil products, ferrous and non-ferrous metals, precious metals and stones;
- Transactions where the counterparty is located in the states (territories) indicated in the list of the Russian Ministry of Finance or where the transaction's beneficiary is located in the abovementioned states (territories).

Related parties

The draft law proposes to broaden the definition of interdependent (related) parties. Related parties will be determined based on the following criteria:

- Parties, where one entity or individual (together with its respective related parties) has direct and/or indirect participation exceeding 20% in another entity;
- Entities, where one party (together with its related parties) owns more than 20% interest in each entity;
- A parent company and its subsidiaries;
- Companies where the extent of the direct participating interest held by each preceding entity in each successive entity exceeds 50%;
- Companies where the powers of the individual executive body are exercised by the same person, for example, the same CEO;
- Parties of a trust management agreement (a trust or a trust-fund established in accordance with foreign legislation), namely: a founder and a trustee/beneficiary, a trustee and organisations managed by the trustee.

Aside from this list, other criteria will define how individuals may be declared as related parties and how companies may be declared as related through the individuals representing them. It is also noted that courts will be able to label companies and/or individuals as related on any other reasonable grounds.

In Russia the threshold of 20% is lower than the usual rates across Europe. Accordingly, foreign companies have to consider this when planning business transactions through Russia. Also this low threshold may cause significant difficulties in searching for comparable companies/transactions, as most of the European data bases provide for the lowest threshold of 25% of participation for the parties to be treated as related.

New market price range

The transfer pricing law may abolish the current allowable 20% fluctuations from the market price and introduce a market price range instead. The market price range will be established by using a statistical approach.

However the overall outcome of this statistical approach is expected to be broadly in line with the result of the interquartile range. When computing the market price range the draft law requires that no less than four comparable transactions or companies are available. But the draft law is, however, silent on what to do if less than four comparable transactions or companies are available. Possibly these clarifications will be introduced to the transfer pricing law as well.

The computed market price range will serve as a safe harbour, which is also different from the OECD rules. As regarding the domestic existing practice, the new market price range is expected to be significantly narrower than the 20% deviation allowed at the moment. For taxpayers, it is therefore important to establish the target price/profit range before the new rules will be introduced so they can be sure they are within the safe harbour market price range once the law is in force.

Price determination methods

The current transfer pricing rules provide for three price determination methods: the comparable uncontrolled price (CUP) method, the resale price method and the cost plus method. These methods are also stipulated in the draft law but they differ from the current versions significantly.

The comparable uncontrolled price method will still have top priority. It will be used if more than four transactions meeting the specified comparability conditions occur on a particular market for goods, works or services, and sufficient information is available on those transactions.

The resale price method will be used to determine the market conformity of the price at which a product is acquired by a purchaser from a related party and resold to a third party.

The cost plus method, which will be used in cases of rendering services (works) to related parties; the sale of raw materials or semi-finished products to a related party and the sale/provision of goods, work or services under long-term agreements with related parties.

The additional methods stipulated in the draft law are:

The product processing sale price method will be used if the purchaser sells a product (secondary product), which is obtained from processing the purchased goods.

The comparable profits method (CPM) will be used in case of purchasing goods from a related party and reselling these goods to an unrelated party and vice versa. It relates to asset intensive manufacturing processes. Taking into consideration that this method is more often used in, for example, US practice, but not provided for in the OECD rules, application of this method may cause problems for non-Russian parties.

The profit distribution method will also be included in the new rules, this will be applicable where the parties have joint ownership of rights to use intellectual property, or when a taxpayer provides asset management or undertakes broker and dealer activities on behalf of a related party.

Finally, it will be possible to establish the transactions price/value by means of an independent appraisal (only where the other methods cannot be used for determining the market price of one-off transactions).

Notwithstanding the fact that officially there is no hierarchy in order of application of these methods, the draft law is very prescriptive. It determines which method is relevant for certain types of transactions. Besides, among the six transfer pricing methods available, the CUP method would continue to have the first priority whereas the profit split method will serve as the method of last resort.

Despite all these methods being used worldwide, taxpayers should bear in mind the specificity of Russian legislation. Global companies which have internal transfer pricing policies need to check whether the existing methods are compliant with the new Russian transfer pricing rules when the latter come into force.

Sources of information

Along with official sources of information, the draft Law proposes the following new sources of information which may be used to determine the market price:

- Information on global exchange prices and quotations;
- Customs statistics published;
- Information on prices and exchange quotations taken from, authorised state government bodies, official foreign sources of information and international organisations;
- Other publicly available publications and information systems;
- Accounting data and statistical reports on companies' activity;
- Information on the market value established by independent appraisals;
- And any other information relevant for determining the market price or profitability in accordance with the permitted transfer pricing methods.

There will be no hierarchy among the information sources and the list of sources is open.

Taxpayers may still have problems while using the public databases however, due to the threshold of 20% lower than provided in most of them.

Pricing control

The draft law also aims to update tax control procedures.

Notification on controlled transactions means that taxpayers would be required to prepare a statement of controlled transactions and to file it with the tax authorities on an annual basis.

Detailed description of transactions stipulates the necessity to submit upon the tax authority's request a certain set of documents justifying the pricing method used in controlled transactions where the amount of income or expenses exceeds the threshold of RUR 100 million in a tax period.

Specific tax audit (independently from regular tax audits) may be conducted by the Federal Tax Service in respect of prices used in controlled transactions.

Specific penalties (a fine equal to 40% of the tax assessed and interest) for non-payment or underpayment of taxes due to the application of transfer prices, accompanied by the non-submission of information on the controlled transactions

However, the deputy minister of finance announced that no penalties are expected during the transition period (approximately, for the first two years the law in force).

Symmetrical adjustments

It is thought the draft law will introduce the right for taxpayers to obtain corresponding adjustments in case one party to a domestic controlled transaction is adjusted and the additional tax charged is paid. Still, the law does not provide any description of the mechanism of accomplishing such an adjustment (legal basis for adjustment, officials authorised to approve it and so on.)

Advance pricing agreements (APA)

If the draft law comes into force, the taxpayers classified as major taxpayers, will have an opportunity to conclude an APA where the methods for determining the market prices are stipulated.

It is stated that an APA application shall be concluded within one year and will be valid for a period up to three years with the potential for a two-year extension.

State duty for arrangement of an APA is to be RUR 1.5 million. The new proposed transfer pricing rules will also open up the possibility to conclude bilateral APAs where the transactional counterparty is located in a jurisdiction with which Russia has a double tax treaty. Though not explicitly mentioned in the Draft law, this presumably means the maximum time period for conclusion of the APA would not apply.

Companies must act

Practically, due to the possible introduction of the new rules companies need to review their business in order to define controllable transactions, to re-arrange business relations' structures, and to make a detailed analysis of the market price range.

Also taxpayers will need to draft the documentation package (number of templates) which will support the chosen pricing methods as well as arranging time-effective and comprehensive procedures for producing documents' to support the application of prices for tax purposes.