

# *Transfer pricing bill passes second and third readings in Russian Parliament*

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## **Transfer pricing bill passes second and third readings in Russian Parliament**

*On 7 and 8 July, a bill setting new transfer pricing rules in Russia was passed after its second and third readings by the lower chamber of the Russian Parliament, the State Duma. Since the first reading on 19 February 2010, the bill has been updated by the Russian Ministry of Finance and the State Duma Committee on Budget and Taxes after adopting certain proposed amendments.*

### **Key points**

Compared to the current Russian transfer pricing rules, the new ones appear to be more technically elaborate and, to a certain extent, better aligned with the international transfer pricing principles developed by the Organisation for Economic Cooperation and Development (OECD).

The main changes are as follows:

- ❖ Significant reduction of the list of transactions where the Russian tax authorities may control prices for tax purposes;
- ❖ Expansion of the list of related parties;
- ❖ Burden of proof that prices of controlled transactions do not correspond to the market will rest with the Russian tax authorities;
- ❖ Introduction of the arm's length principle as the fundamental principle of Russian transfer pricing rules;
- ❖ Abolishment of the "safe harbour" provision (the 20% fluctuation of controlled transaction prices from market prices that is currently allowed);
- ❖ Expansion of the list of sources of information for determining market prices;
- ❖ Formally introducing a functional analysis as one of the comparability factors;
- ❖ Introduction of new methods for determining market prices, i.e. transactional net margin and profit split methods;
- ❖ Introduction of reporting and transfer pricing documentation requirements;
- ❖ Introduction of special transfer pricing audits to be performed by the Federal Tax Service;
- ❖ Introduction of penalties for non-compliance with reporting and transfer pricing documentation requirements. However, for the transitional period of 2012-2013, no penalties can be assessed in case of transfer pricing adjustments;
- ❖ Introduction of unilateral and multilateral Advance Pricing Agreements (APAs) for Russian companies registered as "largest" taxpayers.

According to the bill, it is due to come into effect on 1 January 2012. The introduction of new transfer pricing rules will require that companies doing business in Russia analyse and tailor their transfer pricing policies to comply with the new rules. Since preparing for new legislation is likely to be time-consuming, we recommend that taxpayers begin doing so well before 1 January 2012.

### **Related parties**

The ownership ratio necessary to declare the parties as being related is 25%. A company can be also declared a related party due to control in the board of directors, provided that (i) more than 50% of the directors of these companies are the same individuals and (ii) not less than 50% of the directors are appointed/ chosen by the same individual.

Courts will have the right to recognise parties related for reasons other than those stipulated in the bill if the relationship between the parties may have an impact on the conditions and outcome of a transaction performed by these parties or the results of their economic activity.

The economic interdependence of the parties to a transaction, arising, for instance, due to one party's dominant market position, is not to be used as grounds for declaring that the parties are related.

### **Controlled transactions**

The bill provides for the following list of controlled transactions:

(1) Cross-border transactions between related parties (regardless of any minimum financial threshold).

(2) Transactions between related parties in the Russian domestic market:

(a) Such transactions will be subject to control if their amount exceeds:

- in 2012 - RUB 3 billion (approx. USD 105 million),
- in 2013 - RUB 2 billion (approx. USD 70 million) and
- starting from 2014 - RUB 1 billion (approx. USD 35 million).

Transactions concluded between profit-making Russian companies registered in the same administrative region that do not have any subdivisions in other administrative regions within Russia or abroad are exempt from transfer pricing control. In addition, transactions concluded between members of the same consolidated group of taxpayers will also be exempt from transfer pricing control.

(b) Certain types of transactions which qualify for at least one of the following conditions and whose aggregate income exceeds RUB 60 million per calendar year (approx. USD 2 million):

- If one party to a transaction is subject to mineral extraction tax and the goods are subject to the above tax at a percentage rate;
- One party to a transaction is exempt from profits tax or applies a 0% tax rate, while the other party is a profits taxpayer in Russia and does not apply a 0% tax rate;
- One party to a transaction is resident in a special economic zone, while the other is not resident in that special economic zone; these provisions are effective from 1 January 2014.

(c) Transactions where one party applies the unified agricultural tax or a unified imputed income tax (regarding certain type of activities), while the other party pays profits tax under the general rules. Such transactions are subject to control starting from 1 January 2014 if the aggregate income (prices) exceeds RUB 100 million per calendar year (approx. USD 3.5 million).

(3) Foreign trade transactions with exchange traded commodities, if the aggregate income of such transactions exceeds RUB 60 million per calendar year. Exchange traded commodities include: crude oil and oil products, ferrous and non-ferrous metals, fertilisers, precious metals and gemstones.

## **More details (con.)**

<sup>1</sup>. "Work" is a term used in the Russian tax code which includes the services which may result in a tangible product.

<sup>2</sup>. "Service" in the Russian tax code generally refers to a process that does not result in a tangible product.

(4) Transactions with parties incorporated (domiciled, tax-resident) in a state or territory included on the Finance Ministry's list of offshore zones that grant beneficial tax regimes and do not share information during financial audits; a financial threshold of RUB 60 million per calendar year has been established for such transactions.

(5) Transactions between related parties if they are carried out via unrelated intermediary companies, where such intermediary companies do not perform any additional functions, do not assume any risks and do not employ any assets.

Based on the current wording of the bill, it could also be concluded that the new transfer pricing rules will only cover transactions involving goods, work<sup>1</sup> and services<sup>2</sup>. Transactions with property rights (e.g. provision of rights to use intangibles) and other objects of civil rights, as well as transactions where price is determined as a rate (e.g. interest rate), are not subject to transfer pricing control. However, it is possible that this fall, the State Duma could approve amendments to the bill under which transactions with certain property rights become subject to transfer pricing control.

### ***Permanent establishments***

Chapter 25 of the Russian Tax Code has been amended to require that income of foreign companies' permanent establishments (PE) in Russia is allocated and taxed taking into account PEs' functions, assets and economic/commercial risks.

### ***Data sources***

The list of information sources that can be used to determine arm's length prices is open, i.e. is not exhaustive. However, the list is divided into a two-level hierarchy of data sources. It is required to use publicly available data, but there is no clarity what constitutes "publicly available data".

Data on comparable transactions between taxpayers and third parties may serve as the data source for determining arm's length prices.

Foreign comparables may be used to determine the arm's length range of profit margins, provided that there are no comparable Russian companies. A Russian comparable search should be completed first, but if such a search did not result in any acceptable comparables, then foreign comparables can be used.

### ***Methods for determining arm's length prices***

The bill outlines five methods for determining arm's length prices:

1. Comparable uncontrolled price (CUP) method
2. Resale price method
3. Cost plus method
4. Transactional net margin method
5. Profit split method

The Russian Ministry of Finance will develop regulations on the application of the transfer pricing methods.

### ***Self-maintained transfer pricing adjustments***

The bill has been amended to allow taxpayers to make self-initiated adjustments of income at the end the calendar year if the prices used in a transaction between related parties are not arm's length. However, such adjustments can be made only if tax liabilities were understated.

### **Notices and documentation on controlled transactions**

The bill establishes the required content of annual notices that companies will be required to file with their local tax offices by 20 May of the year following the calendar year when a controlled transaction occurred. Such notices should only indicate the subject of the transaction, information on the parties to the transaction, and aggregate amount of income and/or expenses. No requirement is established to disclose in annual notices information on prices, transaction terms, and the procedure for determining transfer prices.

Taxpayers will be also required to prepare transfer pricing documentation supporting the arm's length nature of prices applied and transfer pricing methods used in controlled transactions. The tax authorities cannot request such documentation until 1 June of the year following the calendar year when the controlled transactions took place. Taxpayers will have 30 days following the tax authorities request to provide transfer pricing documentation.

The bill exempts the following types of controlled transactions from transfer pricing documentation requirements:

- ❖ Transactions where prices are used in compliance with anti-monopoly rulings;
- ❖ Transactions if prices are regulated by the Russian authorities and certain other conditions set by the new rules are met;
- ❖ Transactions concluded with unrelated parties;
- ❖ Transactions with listed securities and derivatives;
- ❖ Transactions covered by an APA.

The financial threshold for filing notices and documenting transactions will be RUB 100 million (approx. USD 3.5 million) for the first year after the new law takes effect. It is intended that the above threshold will be gradually decreased.

### **Tax audits**

The Federal Tax Service may charge profits tax, personal income tax and mineral extraction tax, following the findings of a tax audit. VAT may be accrued only provided a party to a controlled transaction is not a VAT payer (or is VAT-exempt).

The bill contains transitional provisions for audits of transfer prices. Thus, a 2012 audit may only be initiated before 31 December 2013, while a 2013 audit may only be initiated before 31 December 2015. After the above provisions expire, a transfer pricing audit may cover three years preceding the year when the audit was initiated.

### **Penalties**

The bill provides for a transition period during the first years after the law takes effect. In particular, the bill exempts any transactions that occur in 2012–2013 from transfer pricing penalties. A penalty of 20% will apply to the 2014–2016 tax periods. Starting from 1 January 2017, 40% penalty will be imposed in case of a transfer pricing adjustment even if the adjustment results in a reduction of net operating losses (provided an underpayment of taxes occurs). The Russian tax authorities will impose the above penalties only if the taxpayer did not provide the transfer pricing documentation prepared in accordance with the new rules.

No exemption is established in relation to late payment interest to be accrued due to underpayment of taxes.

## **Are the new transfer pricing rules in line with OECD transfer pricing principles?**

Initially, it was thought that the bill would bring the Russian transfer pricing rules closer to OECD transfer pricing principles. While these rules do in fact do that, there are still many differences. Multinationals will still have to consider whether their global transfer pricing policies will be acceptable and whether they need to tailor their documentation for use in Russia:

- There is a two-level hierarchy of information sources to be used to determine the arm's length level of prices.
- Information from financial statements of foreign companies can only be applied to determine arm's length profitability ranges if the respective ranges cannot be calculated based on the Russian comparable data.
- Data on the market level of prices and market quotations, as well as pricing agencies' information on market prices of identical / similar goods, can be used for the purposes of applying the resale minus and cost plus methods. This approach differs from the mechanism of applying the aforementioned methods under the OECD transfer pricing principles.
- Current provisions describing the profit split method contain certain inconsistencies that could create difficulties when attempting to apply this method.
- The concept of cost contribution / cost sharing arrangements is not explicitly provided in the bill although this concept is widely applied by multinational corporations. However, it is expected that cost contribution / cost sharing arrangements be introduced by a different bill in future.
- Self-determined adjustments to decrease the taxable base are not allowed.

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If you would like to discuss this or any other transfer pricing matter, please contact one of our dedicated transfer pricing professionals listed below or your regular PricewaterhouseCoopers contact

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