

# ***Tax Newsletter***

New transfer pricing rules come into force on 1 September 2013

18 July 2013



# New transfer pricing rules

On 4 July 2013 the Parliament of Ukraine passed in the second reading the Law 'On Changes to the Tax Code of Ukraine in respect of transfer pricing rules' (hereinafter – the Law on TP). The Law is currently awaiting the President's signature and is expected to come into force on 1 September 2013.

Further to our previous communications, below we list the most important provisions of the Law on TP.

## I. Controlled transactions

TP rules apply only to controlled transactions.

According to the Law on TP, the list of controlled transactions will include:

- Transactions of the taxpayer with related parties-non-residents of Ukraine.
- Transactions of the taxpayer with related parties-residents of Ukraine that:
  - ✓ declared tax losses for the previous tax year;
  - ✓ apply special tax regimes as of the beginning of the tax year;
  - ✓ apply CPT and / or VAT rates other than the standard rates at the beginning of the tax year;
  - ✓ are non-CPT and / or non-VAT payers at the beginning of the tax year.
- Transactions with residents of low tax jurisdictions (where the corporate profits tax rate is less than the Ukrainian rate by 5%). The list of the low tax jurisdictions will be set by the Cabinet of Ministers of Ukraine (CMU).

The threshold for controlled transactions will be UAH 50 million, net of VAT (will apply cumulatively for all transactions with one counterparty per year). It is unclear how this rule will apply in case of loan and agency arrangements.

The contracting price in uncontrolled transactions should be accepted by the tax authorities.

## II. Previous rules

The following current rules are removed:

- The allowed 20% deviation of the contract price from the usual price ("safe harbor" rule).



- The requirement that, for corporate profits tax purposes, costs of goods sold to related parties cannot be recognised in excess of the income from such sale.
- The requirement that the usual price for imported goods cannot be less than the customs value of such goods.
- The requirement that, for VAT purposes, any sale should be recognised at not less than the market price and any purchase at not more than the market price. This requirement will be relevant only for the controlled transactions that are discussed in section I of this newsletter.

## III. Transfer pricing methods

The Law on TP provides five methods for determining the market price.

1. Comparable uncontrolled price (CUP) method (based on the price of identical/similar goods).
2. Resale price method (based on the price in a resale to a non-related party).
3. Cost plus method (based on the cost of a purchase from a non-related party and a sale in a controlled transaction).
4. Net profit (margin) method (used in the absence/lack of information for the application of other methods).
5. Profit split method (in cases of interdependent controlled transactions and/or essential intangible assets owned by the parties).

The CUP method is the primary transfer pricing method to be used over all other methods. If this method is not relevant, the taxpayer is entitled to

chose the most appropriate method. This should be accepted by the tax authorities provided the choice of the method is justified.

The taxpayers are entitled to use the combination of two or more than two methods provided in the Law on TP. Using methods or combinations of methods that are not prescribed in the Law on TP is not allowed.

For the purpose of applying the chosen TP method to a particular transaction, the taxpayer should compare the price or profit indicators prescribed in the Law on TP in a controlled transaction with those in transactions between non-related parties.

The tax authorities should use the same method (combination of methods) used by the taxpayer, unless it is proven that the taxpayer chose an incorrect method.

The criteria of comparability are listed in the Law on TP. In particular, they include:

- the characteristics of the goods (works, services) that are the subject of the transaction;
- the functions, assets, risks and benefits distributed between the parties of the controlled transaction (functional analysis);
- the existing practice of the relationship and the contract terms of the transaction that significantly influence the price;
- economic conditions, including an analysis of the respective markets;
- business strategies of the parties to the controlled transaction.

#### IV. Sources of information

For TP control purposes, the authorities shall use the “official sources of information” set by the CMU. In cases where there is an absence/lack of information in the official sources, the following sources of information can be used:

- prices of public auctions, tenders and exchange quotations;
- statistical data from state authorities;
- prices published in specialised commercial mass media (including Internet media), including electronic and other databases, informational programs and other public sources of information;
- information about prices, inter-quartile range of prices / profitability and quotations published in mass media;
- information from accounting and statistical reporting of taxpayers published in mass media;

- results of independent evaluation of property and property rights; and
- information about other controlled transactions conducted by the taxpayer.

In case the information on comparable transactions of the taxpayers with non-related parties is available, such information should be used only for determining the range of the market prices.

The tax authorities should use the same sources of information as the taxpayer uses, unless it is proven that taxpayer should have used other official sources of information.

In other countries, taxpayers use international financial information databases (AMADEUS, RUSLANA) that have been accepted as official sources of information. We would expect similar confirmation from the CMU/tax authorities.

#### V. TP documentation and reporting requirements

All affected taxpayers should file a report on controlled transactions by the first of May (each year) of the year following the reporting year. The format of the report should be introduced by the Ministry of Revenues and Duties.

The documentation on TP, substantiating the market level of prices, should be submitted only upon the request of the tax authorities based on the conditions for an unscheduled tax audit (Article 78 of the Tax Code).

Taxpayers (except for large taxpayers) should provide primary documentation and other documentation on TP upon the tax authorities request within one month from the day of obtainment of the request. TP documentation can be prepared in any format.

Large taxpayers (as a general rule a large taxpayer is a company that has UAH 500 mil revenues in prior year) should provide TP documentation upon the tax authorities request within two months. TP documentation can be prepared in any format, but should include the following:

- information about related parties;
- information about the group, including the legal structure, description of the activities, as well as the group’s TP policy;
- description and conditions of the transaction;
- description of the goods (works, services);
- terms and conditions of settlement;
- factors that influenced the price determination;



- information about functions performed, assets used and economic risks assumed by the parties of the controlled transaction;
- an economic analysis including a benchmarking study, substantiation of the TP method(s), amount of income (profit) and/or expenses related to the controlled transaction, its profitability, source of information used;
- a comparability analysis;
- information about the proportional TP adjustment performed by the taxpayer (if any).

The request on provision of TP documentation can be sent to the taxpayer only after the first of May (each year) of the year following the calendar year in which the controlled transaction was performed.

If the prices of the controlled transaction do not correspond with the market level, the taxpayer performs the respective TP adjustment and pays the additional tax. The other party of the controlled transaction is entitled to perform a proportional TP adjustment after receiving the respective approval from the tax authorities. A proportional adjustment is also allowed in case of TP assessments by the tax authorities and based on the provisions of double tax treaties.

## VI. TP audit procedures

According to the Law on TP, the tax authorities will monitor the TP documentation provided without the involvement of the taxpayer.

The Law on TP introduces a specialised TP audit, which will be conducted in the following cases:

- non-filing of TP report and/or TP documentation;
- provision of TP documentation with violations that were not amended at the request of the tax authorities;
- identification of the deviation of the prices in controlled transactions from the market level based on the results of monitoring conducted by the tax authorities.

The duration of a TP audit cannot exceed 12 months.

The tax authorities will not be allowed to examine pricing in controlled transactions during normal full-scope tax audits.

## VII. Penalties for non-compliance

The Law on TP establishes the following penalties for non-compliance with the TP rules, including:

- 5% of the controlled transaction value - for failure to file a report on controlled transactions;
- 100 minimum monthly salaries (UAH 114,700 based on the minimum salary as at 1 January 2013) - for failure to file TP documentation.

## VIII. Advance pricing agreements

Large taxpayers have the right to agree in advance on the prices in controlled transactions with the Ministry of Income and Charges. The subject of the advance pricing agreement may include:

- types and/or list of goods (works, services);
- prices of goods and/or list of methods for price determination;
- sources of information used for price determination
- terms on which prices are agreed;
- acceptable deviation from the established level of economic conditions for carrying out the controlled transactions; and
- the conditions, terms of provision and the list of documents, which will confirm the taxpayer's adherence to the prices agreed upon in the advance pricing agreement.

The procedure for the conclusion of bilateral and multi-lateral agreements will be developed by the CMU. The procedure for conclusion of unilateral agreements is currently not defined in the Law on TP.

## IX. Transitional provisions

The Law on TP prescribes transitional provisions for a five year period for foreign trade transactions with residents of low tax jurisdictions in respect of the prescribed types of commodities, such as agricultural, metal, iron ore and chemical products.

Taxpayers performing these transactions shall use at own choice the following two options for the determination of prices for tax purposes:

- use the information about the prices of the stock exchange (for commodities traded on the stock exchange) or prices published in the official sources of information set by the CMU (for other commodities) and adhere to the permissible deviation percentage of up to 5%; or
- justify the prices by using one of the methods set by Article 39 of the Tax Code and disclose copies of the contracts for subsequent sales of commodities to unrelated parties.

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## **X. Coming into force**

The Law on TP provides that it will come into force from 1 September 2013.

The Law on TP establishes a penalty of 1 Hryvnia for each violation of the new rules during the first year of their application, except for the violations outlined in Section VII of this Tax Newsletter.

As the Ukrainian tax authorities increase their focus on transfer pricing, taxpayers should address the pricing and documentation of their related party transactions with careful consideration.

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