63.

Russian Federation

Introduction

Russian transfer pricing provisions have been in force since 1 January 1999. Under the headings Principles of Determining the Price of Goods, Work or Services for Purposes of Taxation (Article 40 of the tax code) and Interdependent Parties (Article 20 of the tax code), the rules provided a basis for the tax authorities in certain circumstances to challenge transfer pricing arrangements. The provisions also set out the basic rules for determining market prices against which the prices used by taxpayers were compared. The general rules for determining prices for tax purposes were expanded by the Profits Tax chapter of Part II of the tax code, which came into force as of 1 January 2002 and contained some elements of transfer pricing to deal specifically with individual situations.

In July 2011, the law on the new Russian transfer pricing rules (the new law) was approved by the Russian Parliament and signed by the President. The new Russian transfer pricing rules became effective from 1 January 2012.The new law aims to make Russian transfer pricing rules work in practice and bring them closer to the Organisation for Economic Co-operation and Development (OECD) Guidelines. The new Russian TP provisions give the tax authorities more information about the transfer prices applied and the methods used in intragroup transactions (by introducing transfer pricing reporting and documentation requirements).

The following briefly summarises the new transfer pricing rules which apply from 2012.

Controlled transactions

The new rules cover the following types of controlled transactions:

- Domestic transactions between related parties (*see below*) if they meet one of the following criteria:
  - The amount of transactions exceeds 1 billion Russian rubles (RUB) (approx. 35 million United States dollars [USD]) per calendar year. According to transitional provisions of the new law, in 2012 this threshold will be RUB 3 billion (approx. USD 105 million); in 2013 – RUB 2 billion (approx. USD 70 million).

    Transactions concluded between 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 (provided none of these companies has tax losses). In addition, transactions concluded between members of the same consolidated group of taxpayers will also be exempt from transfer pricing control.

  - Certain types of transactions which meet 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 based on sales price.
    - One party to a transaction is exempt from profits tax or applies 0% tax rate, while the other party is a profits taxpayer in Russia and does not apply 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.
  - Transactions where one party applies the unified agricultural tax or a unified imputed income tax (regarding certain types 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).
- Cross-border transactions between related parties; under a general rule, no threshold is established for such transactions.
- Cross-border transactions with certain types of commodities: (1) oil and oil products, (2) ferrous and nonferrous metals, (3) fertilisers and (4) precious metals and stones. The list of commodities is to be established by the Russian Ministry of Industry and Trade. A financial threshold of RUB 60 million per calendar year is established for such transactions.
- Transactions with parties incorporated (domiciled, tax-resident) in a state or territory included in 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 applies). The list of such territories is already approved by the Russian Ministry of Finance for the purposes of applying a participation exemption on dividends. The list includes such jurisdictions as the British Virgin Islands, Cyprus (to be excluded from the list from 2013), Hong Kong, Gibraltar, Liechtenstein and certain other territories.

Under transitional provisions of the new law, in 2012 cross-border controlled transactions will be subject to transfer pricing audit by the Federal Tax Service provided the amount of controlled transactions exceeds RUB 100 million; in 2013 – and RUB 80 million. Please note that the Russian tax authorities confirmed that for the purposes of financial threshold calculation, taxpayers should add up the value of all transactions with a particular counterparty during one calendar year.

According to the new law, if prices are regulated by the Russian authorities or established in accordance with Russian anti-monopoly law, the Russian tax authorities will accept such prices for tax purposes.

To conclude, the new Russian transfer pricing rules are, to a certain extent, aligned with those of the OECD, whose pricing controls focus solely on transactions between related parties. Nevertheless, by including cross-border transactions involving certain types of commodities and transactions with residents of low-tax jurisdictions in the list of controlled transactions, the tax authorities have in effect incorporated certain elements of anti-avoidance rules in the new Russian transfer pricing rules.

Interdependent parties

Under the new law, the following parties are recognised as being related under the tax code:

- Entities where one party (the party and its related parties) has more than a 25% direct or indirect participation in these entities.
- Entities where (i) more than 50% of the directors of these companies are the same individuals or (ii) not less than 50% of the directors are appointed/ chosen by the same individual.
- Entities, where the same individual/entity acts as the sole executive body; and on the basis of some other criteria.

Courts also have the right to recognise parties related for reasons other than those stipulated in the tax law 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.

Basis for transfer pricing adjustment

The Russian tax authorities are allowed to make transfer pricing adjustments in relation to: (i) corporate profits tax, (ii) individual income tax (for individual entrepreneurs only), (iii) mineral extraction tax (if goods are subject to the above tax at a percentage rate), and (iv) VAT (if the counterparty is exempt from Russian VAT or is not a VAT taxpayer in Russia).

The new law introduced the concept of a market price (profitability) range (i.e. effectively the concept of inter-quartile range of prices or profit level indicators). The tax authorities will be able to adjust prices for tax purposes if the price applied in a controlled transaction or its profitability is not within the determined market range of prices (profitability).

Please note that the formula of the market range is slightly different from the interquartile range formula traditionally applied by OECD member countries to determine market prices. Moreover, when determining the market profitability range on the basis of the financial data of comparable independent companies, the new law establishes a number of criteria to be followed for selecting such comparable companies.

The new law have introduced a correlative adjustment mechanism for Russian companies in order to avoid double taxation with respect to domestic transactions. Provided that the tax authorities adjust the tax base of a Russian taxpayer and the latter pays the tax, the other party to the controlled transaction – a Russian company will be entitled to claim a corresponding adjustment to its tax base. The wording contained in the new law refers to correlative adjustments relating to Russian domestic transactions only. Furthermore, the correlative adjustments are possible if they result from a tax authorities' audit, rather than self adjustment by one of the counter parties.

Some Russian tax treaties provide for correlative adjustment provisions in respect of cross-border transactions. However, in practice we have not come across such occasions where the Russian tax authorities have applied transfer pricing treaty protection for transfer pricing cases.

Transfer pricing methods

The transfer pricing methods are as follows:

- Comparable uncontrolled price (CUP).
- Resale price.
- Cost plus.
- Transactional net margin (comparable profits method).
- Profit split.

The law contains the best-method rule, coupled with a certain hierarchy in the methods' application. The CUP method remains the primary transfer pricing method to be used over all other methods (except for a case when a company purchases goods from a related party and resells them to independent parties; in this case, the resale minus method is given the priority). If the CUP and Resale Minus are not applicable, the taxpayer is free to choose between the remaining methods, although the profit split method should be used as 'the method of the last resort'. The choice of a particular transfer pricing method should be supported with due consideration of the functions performed, the commercial (economic) risks assumed and the assets employed in a controlled transaction. It is also possible to establish the transaction price/value by use of an independent appraisal, in the case of one-off transactions when none of the above TP methods can be applied.

The new rules contain quite brief provisions on application of the transfer pricing methods. It is expected that the new rules would be supplemented by clarifications detailing how the methods should be applied. Please note that the tax code does contain guidance in relation which comparability factors are important for a particular transfer pricing method. As a result, disputes with the Russian tax authorities may arise in relation to the choice of a transfer pricing method. The new law allows taxpayers to make self-maintained adjustments of tax amounts at the end the calendar year if the prices used in a transaction between related parties are not at arm's length. However, such adjustments can be made only if tax liabilities were understated. Self-determined adjustments to decrease the taxable base are not allowed.

Safe harbours

The new law extends the list of comparability factors to be considered during the transfer pricing analysis; in particular, the company's functional and risk profile and business strategy will be introduced as comparability factors. However, there are no special safe harbours in the new law (the old law which was effective before 1 January 2012 allowed 20% deviations from the market price).

Securities and derivatives

The Profits Tax chapter of Part II of the tax code came into force on 1 January 2002 and introduced special transfer pricing rules for securities and derivatives. At the end of 2009, the Russian Parliament passed Federal Law No. 281-FZ of 25 November 2009, which introduced a number of important changes to the tax treatment of securities and derivatives. The rules establish the conditions that should be met so that the actual

price of a transaction is deemed to be the market price and therefore may be used as a basis for the calculation of taxes by the tax authorities.

Other regulations

On 12 January 2012 the Russian tax authorities issued special regulations on Advance Pricing Agreements; on 27 July 2012 – regulations on preparation of notifications on controlled transactions; and on 30 August 2012 – regulations on preparation of transfer pricing documentation.

There are a number of clarifications on the application of the new transfer pricing rules issued by the Russian Ministry of Finance/Federal Tax Service (e.g. about how to calculate the financial threshold).

Legal cases

Although case law does not exist in Russia, the vagueness of tax laws and the inconsistency that exists between the laws and their broad interpretation by the tax authorities means that the courts play a vital role in developing tax law interpretations in Russia. That is, in particular cases the law is construed by the decisions of various courts. However, for the reasons discussed, these decisions often serve only as a general guide in disputes between the tax authorities and taxpayers, where situations are similar.

An analysis of current Russian arbitration court practice in relation to transfer pricing cases shows that hot topics *inter alia* include challenging:

- deduction of intercompany management charges
- export sales at prices lower than prices for the domestic market
- trademark/franchise fee royalty deduction
- the use of European comparables from the foreign database to support profit attribution to a permanent establishment
- the sale of goods through intermediary companies (rather than directly to customers), and
- understatement of lease payments between related parties.

Burden of proof

In the new law, the burden of proof that the prices of controlled transactions do not correspond to market prices formally rests with the Russian tax authorities. However, during a tax audit the tax authorities are well equipped, since formal reporting and transfer pricing documentations requirements are introduced (*please see below*).

Reporting requirements

The new law have introduced reporting requirements for taxpayers, who will be required to submit certain information on controlled transactions no later than 20 May of the calendar year following the year when a controlled transaction was performed.

Such reporting requirements apply, provided the amount of controlled transactions concluded with the same entity exceed the threshold of RUB 100 million (approx. USD 3.3 million) in 2012 calendar year. It is intended that the above threshold will gradually decrease to RUB 80 million (approx. USD 2.6 million) in 2013 and to nil in 2014. By decreasing the threshold, the authorities anticipate covering a wider range of transactions in terms of reporting requirements.

The notification form includes the following sections:

- Information about the transaction, including the amount of income derived and expenses incurred (disclosure of the pricing method and information sources used is optional).
- Information about the subject of the transaction, including the relevant contract number, the amount and the price, as well as the delivery terms.
- Information about the company / individual that is a party to the transaction.

In our view, the scope of information to be disclosed in the notification form exceeds the requirements of Russian tax code. The fiscal authorities treat transaction as each separate operation, e.g. each delivery of goods, rather than each contract. Thus, filling out a notification could prove to involve significant administrative costs.

Documentation requirements

The new law has formally introduced transfer pricing documentation requirements and provides that the tax authorities may request transfer pricing documentation during a tax audit, but not earlier than by 1 June of the calendar year following the year in which a controlled transaction was performed (e.g. transfer pricing documentation for 2012 would be required not earlier than 1 June 2013). Taxpayers will be required to present transfer pricing documentation within 30 working days of receiving a tax authority's request. Documentation can be prepared in a free format (provided there is no legislative requirement for a specific format) and contain the following information:

- Description, nature and terms of the controlled transaction.
- Functional analysis: Assets employed, functions performed, risks assumed by each party to the controlled transaction (although it is listed as an optional component, it is strongly recommended to include functional analysis in order to support the choice of the transfer pricing method).
- Transfer pricing method(s) used.
- Description of comparables: Sources of information and other data used and calculating the range of the arm's-length prices/profitability.
- Financial analysis: Calculations showing how the method has resulted in arm's-length terms, calculation of income (profit) to be received, and the economic benefit obtained in the controlled transaction (for transactions with IP rights).

For the purpose of applying transfer pricing documentation requirements, the threshold on income and expenses from controlled transactions is the same as for reporting requirements.

In cases where taxpayers have complied with the above procedure in a timely manner, the tax authorities will release taxpayers from penalty in the event of a tax adjustment. In these circumstances, taxpayers will have to pay tax calculated in addition to what they have already paid, plus late payment interest.

Russia's Federal Tax Service (FTS) has published Letter No. OA-4-13/14433 of 30 August 2012 (the Letter) 'On Preparing and Filing Documents for Tax Control Purposes'. The Letter explains the rules governing the preparation of transfer pricing documentation, specifically which transactions require documentation, the level of detail, the filing deadline, the archiving period, and other related information. The Letter contains two appendices. The first appendix recommends the content of the

documentation, while the second recommends the stages to be followed in preparing the relevant documents.

The Letter also says that a taxpayer's document filings will be used for conducting a pre-audit review and selecting an entity to undergo tax control measures. This could imply that the tax authorities are planning to request transfer pricing documentation before commencing a transfer pricing -related tax audit (although such approach is not in line with tax code provisions).

According to the Letter, economic analysis findings, i.e. a benchmarking study, should be revised annually not only for updating prior information about comparable companies, but also so as to include information about new comparable organisations in the marketplace, which may have emerged during the year, have a comparable profile and were not included in earlier samples.

Tax audit procedures

The new law introduced special transfer pricing audits which will be performed by the Transfer Pricing Unit of the Federal Tax Service.

The new TP audit-related rules will be enforced according to the following timetable:

- For transactions completed in FY12 can be initiated only until 31 December 2013.
- For transactions completed in FY13 can be initiated only until 31 December 2015.
- The standard three-year period available for audit will apply only from 1 January 2014.

During transfer pricing audits, the tax authorities will have the right to request information from both parties of a controlled transaction. A transfer pricing audit should last no longer than six months, but in exceptional cases, it can be extended up to 12 months. Further extensions are also possible, e.g. extensions may be necessary if information from foreign tax authorities is requested or there is a need to involve an expert.

Additional tax and penalties

The tax authorities may charge additional tax and late payment interest on underpaid tax. Interest should be charged in accordance with the general rules at a rate of 1/300 of the Central Bank of Russia refinancing rate (e.g. on 1 October 2012 this rate was set as 8.25% per year).

The new law has introduced penalties of up to 40% of the transfer pricing adjustment for underpayment of tax liability as a result of applying prices which do not comply with the arm's-length principle in the event of the non-submission or submission of incomplete, untimely or inaccurate transfer pricing documentation. The new law also provides for a transition period during the first years after the law takes effect. In particular, the law exempts any transactions that occur in 2012-2013 from transfer pricing penalties. A penalty of 20% will apply to the 2014-2016 tax periods.

The untimely submission of a transfer pricing reporting form, or its inaccurate completion, may result in a penalty of RUB 5,000 (approximately USD 167).

Resources available to the tax authorities

In 2011, the tax authorities established a dedicated unit for handling transfer pricing issues under the new law. The tax inspectors of this unit are also responsible for concluding advance pricing agreements (APAs). In 2012 the tax authorities also established a special tax inspectorate which deals with transfer pricing issues, including economic analysis and other analytical work.

Use and availability of comparable information

The new transfer pricing rules have introduced an open list of information sources that can be used to establish the market price range. These sources include international exchange quotations, statistical data of Russian customs authorities and pricing information available from authorised state government bodies or publicly available information systems. Information from financial statements of foreign companies can be applied to determine an arm's-length profitability range for a Russian company only if the respective ranges cannot be calculated based on the Russian comparable data. To analyse Russian company's profitability, Russian GAAP data should be used.

Limitation of double taxation and competent authority proceedings

Russia is a party to around 80 double tax agreements, most of which have been concluded on the basis of the OECD model (although often with significant deviations) and therefore contain the 'Associated Enterprises' (or 'Adjustment of Profits') article. This article provides for correlative adjustments in the majority of the agreements (although primarily those concluded recently). In the older treaties, this article provided for a one-way adjustment that increases the profit of a treaty resident due to the use of nonmarket prices.

Very little information is available on the practice and procedure for invoking competent authority assistance (as no such information is published). However, the opportunity might exist, as according to informal interviews with Russian Ministry of Finance representatives, there are some cases when the mutual agreement procedure has been initiated (e.g. cases related to withholding tax application).

Advance pricing agreements (APAs)

Under the new law, only a selected group of taxpayers (the 'largest' taxpayers) are given an opportunity to conclude an APA. An APA represents an agreement between a taxpayer and the federal executive body responsible for control and supervision in the area of taxation. The term of the APA would not exceed three years, with the right being given to the taxpayer to apply for an extension of up to two years, provided that all of the APA's terms and conditions are being complied with by the taxpayer. The APA application fee is about USD 50,000. On 20 November 2012, the first APA was concluded between Federal tax authorities and a Russian oil company; the APA covers domestic transactions with oil.

Liaison with customs authorities

As noted above, the Russian tax authorities may cooperate with the customs authorities in determining comparables. The customs authorities possess certain databases for comparable prices and have certain techniques for evaluating the customs value of goods which may be used by the tax authorities when challenging prices in a controlled transaction. Moreover, the tax authorities will work in close cooperation with the

customs authorities on auditing prices in foreign trade transactions. However, it is to some extent unclear whether information provided by the customs authorities would satisfy comparability requirements for tax purposes.

Note that taxes payable on the import of goods to Russia (import VAT and customs duties) are calculated on the basis of the customs value determined by applying special rules contained in customs legislation as opposed to the general transfer pricing rules contained in the tax code. The customs pricing rules provide for six methods of determining customs values and contain a much wider definition of interdependent parties than that which is given in the tax code.

OECD issues

Russia is not a member of the OECD but is influenced by OECD Guidelines and models. In December 2007, the Ministry of Finance initiated discussions with OECD officials regarding the possibility of Russia becoming an OECD member country. Currently Russia has an observer status in some OECD committees.

Thin capitalisation

The Profits Tax chapter of Part II of the tax code, which entered into force on 1 January 2002, introduced thin capitalisation rules on debts between interdependent parties. These rules apply when the loans due to a foreign entity by a Russian entity that is more than 20% owned by this foreign entity or its affiliated parties exceeds by more than three times (or 12.5 times in the case of banks/credit institutions or enterprises engaged in leasing) the own capital of the Russian entity. These rules also apply to loans received from third parties if such loans are guaranteed by the above foreign company or its Russian affiliates. Such loans are determined in the tax legislation as controlled debts.

If the above conditions are met, the maximum deductible interest would be determined by the ratio of the interest accrued on the 'controlled debt' to a capitalisation coefficient (a ratio of the controlled debt multiplied by a percentage of the direct or indirect shareholding to the Russian entity's own capital multiplied by three [or 12.5 in the case of banks/credit institutions or enterprises engaged in leasing]). Interest in excess of the maximum interest is treated as dividends that are non-deductible for profits tax purposes and are subject to withholding tax.

In addition to restrictions imposed by thin capitalisation rules (if any), the general requirements on the deductibility of interest should be observed. Generally, interest incurred by an entity should be deductible for Russian profits tax purposes, provided such interest expenses meet the general deductibility criteria (i.e. they are economically justified, documentarily supported and relate to the taxpayers profit-generating activity).

At the same time, Russian tax legislation establishes certain limitations in respect of the level of interest deductible for tax purposes.

- For interest expense to be deductible, the interest rate should not deviate by more than 20% either way from the average interest rate on comparable loans obtained in the same calendar quarter (whereby comparable loans mean loans in the same currency for a comparable amount and against similar collateral), or at the taxpayer's choice.

- A fixed deduction threshold set in the Tax Code (these thresholds are annually revised). For loans granted during 2012, the threshold is as follows: the Bank of Russia's refinancing rate (e.g. 8.25% on 1 October 2012) multiplied by 1.8 for RUB loans and multiplied by 0.8 for foreign currency loans.

The Russian tax authorities have expressed their position that the new transfer pricing rules apply to loans and guarantees. Therefore, both transfer pricing rules and interest deduction limits should be considered for determining deductible interest expense.