Transfer pricing methods

The Cabinet Regulation No. 677 “Regulation of the Application of the Provisions of the Corporate Income Tax Act” (effective from 01.01.2018) lays down the methods for determining the arm’s length value of transactions or the arm’s length price of goods (products, services), which can be applied to determine whether the commercial or financial relations between related parties (in a controlled transaction) are consistent with the arm's length principle.

There are five method, of which

- four methods are considered unilateral (comparable uncontrolled price method, the resale price method, the cost-plus method, the transactional net margin method) because the relevant financial indicator is analysed only for one of the related parties (the tested party) to the transaction; and
- one is considered a combined method (the profit split method), because according to the analysis of contribution, the combined profit is allocated among several related parties engaged in the transaction.

According to the said Regulation, the arm’s length price (value) of the related-party transaction is determined by applying one of the following methods referred to therein. The purpose of the methods selection is to find the most appropriate method for a particular case, and the choice thereof depends on the facts and circumstances of the relevant case.

In order to determine the arm’s length price more accurately, the methods can be combined.

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Comparable uncontrolled price method

Under Paragraph 13 of the Regulation, this method is applied in transactions in goods and services, the prices of which are comparable.

Using this method, the price applied in the related-party transaction is compared:

- with the price of a comparable transaction carried out between the related party and an unrelated party (the internal price); or
- with the price of a comparable transaction carried out with another unrelated person (external price) or, if it is sufficiently comparable,
- with an aggregated publicly available information on comparable transactions entered into between unrelated parties (aggregated information on external prices).

An example of the application of the method is provided in Clause 1 of Annex 2 to the Regulation.

Resale price method

Under Paragraph 14 of the Regulation, this method is applied to the related-party transactions related to the acquisition of resale goods, if the reseller sell the goods to an unrelated person.

Using this method, the resale price margin (gross profit margin) earned by the reseller in a transaction carried out between related parties is compared with:

- using the resale price margin (gross profit margin), the reseller earns on the goods purchased and sold in comparable uncontrolled transactions (internal comparable transactions);
- or using the resale price margin (gross profit margin), earned by unrelated parties in uncontrolled transactions (external comparable transactions).

An example of the application of the method is provided in Clause 2 of Annex 2 to the Regulation.

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Cost-plus method

Under Paragraph 15 of the Regulation, this method is applied to the transactions of the seller (manufacturer) of goods (products) or provider of services if the goods are sold or services provided to a related party.

Using the method, the cost mark-up applied by the seller in the related-party transactions is compared:

- with the cost mark-up applied by the seller in a comparable uncontrolled transaction (internal comparable transactions); or
- with the cost mark-up applied by unrelated parties in comparable uncontrolled transactions (external comparable transactions).

An example of the application of the method is provided in Clause 3 of Annex 2 to the Regulation.

Transactional net margin method

Under Paragraph 16 of the Regulation, this method is used as the resale price method or the cost-plus method, if the comparison of the gross profit margin or the direct and indirect cost mark-up of the controlled transaction and the relevant financial indicators of unrelated parties has not yielded a sufficiently credible result, which can be justified with the factors affecting the price (value) of the transaction.

Using this method, the net margin indicator earned by the taxpayer in the controlled transaction is compared:

- with the net margin indicator earned by itself in a comparable uncontrolled transaction (internal comparable transactions); or
- with the net margin indicator earned by unrelated parties in controlled transactions (external comparable transactions).

An example of the application of the method is provided in Clause 4 of Annex 2 to the Regulation.

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Profit split method

Under Paragraph 17 of the Regulation, this method is applied to mutually dependent transactions, if comparable transactions between unrelated parties may not be identified as well as in transactions in which a number of related parties are involved.

Using this method, first of all, the overall (combined) profit earned by related parties in mutual transactions is allocated, using an economically justified, basis between the related parties involved in the transaction, according to the contribution of each party to the transaction in the creation of value.

An example of the application of the method is provided in Clause 5 of Annex 2 to the Regulation.

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