

Russian President signs transfer pricing legislation into law

Russian President Dmitry Medvedev on 18 July signed Law #227-FZ, which introduces major changes to Russia's transfer pricing legislation. The legislation, which was officially published 22 July, follows the OECD Transfer Pricing Guidelines. The new law will enter into force on 1 January 2012, but some provisions will be deferred until 2013 and 2014. There is still a chance that the legislation may be amended, but most likely that would happen through a separate procedure of a new draft law adoption. The key provisions of the new law are summarized below.

Related parties

The new law defines "related parties" by listing 11 categories. One of the main criteria for recognizing the parties as related is the ownership threshold, which should be more than 25 percent. However, the law reserves the courts' right to recognize parties as being related based on factors not specified in the law. Taxpayers may claim themselves to be affiliated irrespective of the provisions of the Russian Tax Code.

Transfer pricing methods

The number of accepted transfer pricing methods has been increased to five: the comparable uncontrolled price (CUP) method, the resale minus method, the cost plus method, the comparable profits method, and the profit split method.

The law provides detailed guidelines on how to apply each of the methods. The CUP remains the primary method and may now be applied when information concerning at least one comparable transaction is available. In some cases, the resale minus method is the primary method (for example, in the case of the resale of goods). The application of two or more of the methods listed is permitted. If none of the methods is appropriate, the market price of a one-off transaction may be determined by performing an independent appraisal in accordance with the applicable Russian or foreign legislation.

Controlled transactions

The new law stipulates that the transfer pricing rules apply to a group of similar transactions, not just a single transaction, as under the now superseded rules. The list of controlled transactions subject to the transfer pricing rules has been reduced.

Cross-border transactions – The following cross-border transactions are subject to the transfer pricing regime:

- Cross-border related-party transactions, including supply arrangements with third-party intermediaries;
- Cross-border transactions involving goods traded on commodity markets, such as crude oil or precious metals, if the transaction amount exceeds RUB 60 million (USD 2.2 million);
- Cross-border transactions with offshore residents of jurisdictions on the Ministry of Finance's so-called "blacklist," if the transaction amount exceeds RUB 60 million (USD 2.2 million).

Domestic transactions – The following transactions between related parties are subject to the transfer pricing rules:

- If the aggregate annual amount of income resulting from transactions between related parties exceeds, in a calendar year, RUB 3 billion in 2012 (USD 109 million), RUB 2 billion in 2013 (USD 73 million), and RUB 1 billion (USD 36 million) starting in 2014. Possible exclusions may apply, for example, if both parties are registered in the same region, or do not generate losses.
- Related-party transactions, if the transaction volume exceeds RUB 60 million (USD 2.2 million) in a calendar year, and one of the following applies:
 - The transaction involves operations with mineral resources subject to ad valorem rate of mineral extraction tax (MET), and one of the parties is a MET taxpayer at ad valorem rate; or
 - One of the parties does not pay profits tax, or pays it at a 0 percent rate (that is, a participant in project "Skolkovo"); or
 - One of the parties is a resident of a special economic zone (this provision will come into force on January 1, 2014).
- Related-party transactions, if the transaction volume exceeds RUB 100 million (USD 3.6 million) in a calendar year, and one of the following applies:
 - One of the parties pays unified tax on imputed income; or

- o One of the parties pays unified agricultural tax.

Transactions between companies that are members of a consolidated taxpayer group will not be subject to the transfer pricing regime. The consolidated taxpayer provisions are included in another draft law that is currently under consideration, and is expected to apply only to the largest taxpayers. A draft law on consolidated taxpayers was adopted by the State Duma in a first reading on October 22, 2010. Unless the law comes into force, the above exception regarding consolidated taxpayers is not valid.

Sources of information

The information required to determine market price/profitability should be obtained only from available sources (both official and publicly available), in particular:

1. Prices and quotations from stock or commodity exchanges (both domestic and foreign);
2. Customs data relating to Russian overseas trade;
3. Official sources of information on prices (and price fluctuations) and exchange quotations held by the federal, regional, and local authorities, including statistical data; also, official sources held by foreign countries and international organizations or contained in other published and/or available publications and databases;
4. Information prepared by special pricing agencies;
5. Information on the taxpayer's own transactions (internal comparables).

If the information contained in the above sources is not available or is insufficient, the following information may be used:

1. Information on prices (and price fluctuations) and exchange quotations obtained from published and/or available publications and databases;
2. Information from company accounts and statistical reports, including that published in available Russian or foreign publications and databases;
3. Information from independent appraisals;
4. Other information.

The law specifically states that for purposes of determining the profitability range, accounting and statistical data of foreign organizations may be used only if Russian sources do not exist or are unavailable.

Transfer pricing documentation

Taxpayers will be obligated to keep specific transfer pricing documentation if the total amount of income received by the taxpayer from all controlled transactions with the same counterparty exceeds RUB 100 million (USD 3.6 million) in 2012 and RUB 80 million (USD 2.9 million) in 2013. These restrictions will not be applicable after 2014.

Transfer pricing documentation must include the following information:

- The structure and terms of the transaction, the parties involved and their functions, and the pricing methodology;
- A description of the transfer pricing methods, sources of information used, and rationale for the choice of transfer pricing method;
- Information on other factors that might influence the price (for example, marketing strategy); and
- Information on adjustments to the tax base.

The tax authorities will be allowed to request transfer pricing documentation from taxpayers no later than 1 June of the year following the calendar year in which the controlled transactions occurred. A taxpayer will be obligated to file the documentation with the tax authorities within 30 days after receiving their request.

Moreover, taxpayers will be obligated to submit information on controlled transactions (i.e., notifications) in a calendar year to the tax authorities no later than May 20 of the following year. These notifications should be made only if transactions are subject to the requirements for transfer pricing documentation described above.

Advance pricing agreements

"Major taxpayers" (those with annual tax payments exceeding RUB 1 billion (USD 36 million) or annual revenue/assets exceeding RUB 20 billion (USD 726 million)) may enter into an advance pricing agreement (APA) with the tax authorities (other criteria may also be used to determine eligibility for an APA).

The new law envisages the potential participation of foreign tax authorities in APAs, provided one of the companies involved is a tax resident of that foreign state.

The tax authorities have six months to review an APA application, extendable to a maximum of nine months. An approved APA would be valid for three years and may be prolonged for an additional two years at the taxpayer's request.

An APA would not be changed even if relevant provisions of tax legislation are amended.

Transfer pricing audit

Transfer pricing audits may cover the preceding three-year period, with the following exceptions:

- 2012 will be open for transfer pricing audit only until 31 December 2013; and
- 2013 will be open for transfer pricing audit only until 31 December 2015.

Adjustments

The new law allows taxpayers to make adjustments to the tax base in accordance with the chosen transfer pricing method (that is, voluntary adjustments), provided these do not lead to a reduction in tax liabilities. Hence, the law does not provide for the possibility to make downward adjustments. Thus, the application of profitability-based methods (the comparable profits and profit split methods) might be limited.

An exception to this rule will be allowed when the tax authorities impose an additional tax assessment on a taxpayer as a result of a transfer pricing audit, and the taxpayer's counterparty is allowed to use the determined market price for purposes of calculating its own profits tax and VAT liabilities (so-called "corresponding adjustments").

Penalties

Starting in 2014, transfer pricing penalties of 20 percent of the amount of additional tax payable will be introduced. A penalty of 40 percent of the underpaid tax (but no less than RUB 30,000 (USD 1,100)) will be imposed in 2017 and will be used if the price/profitability is outside the market range (resulting in an underpayment of tax) and if the required transfer pricing documentation has not been prepared.

Permanent establishment

The taxable income of a foreign legal entity's permanent establishment (PE) in Russia or a Russian legal entity's PE abroad would be determined taking into account the specific functions performed, risks borne, and assets used by the PE. The new law does not provide specific rules that should be applied in such cases, including the allocation of income and expenses between a head office and a PE.

— Alexander Krylov (New York City)
Senior Manager
Deloitte Tax LLP
alkrylov@deloitte.com

Dmitry Kulakov (Moscow)
Partner
Deloitte Russia
dkulakov@deloitte.ru

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