

Peculiarities of the new transfer pricing rules in Ukraine

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INTRODUCTION

The new rules contained in Article 39 of the Tax Code of Ukraine regarding arm's length prices have been revised and completely rewritten, and came into force in September 2013. The new rules are far more comprehensive in comparison to the previous rules and are different in many respects, with an emphasis on administration and control of transfer pricing related matters.

CONTROLLED TRANSACTIONS

The transfer pricing rules are only applicable with respect to "controlled transactions", that is:

- Transactions with related non-resident entities.
- Transactions with related resident entities in specific cases, such as where the related resident entities either:
 - declared negative amounts for taxation for the previous tax year;
 - applied special tax regimes as of the beginning of the year;
 - pays profit tax and/or VAT at a rate different from the basic one;
 - was not a profit tax or VAT payer as of the beginning of the reporting year.
- Transactions with non-residents registered in a low tax state where the income tax rate is at least 5% lower than in Ukraine.

In order to be deemed "controlled" the annual aggregate value of the transactions in any of the above cases must be equal to or exceed UAH50 million with each of the parties.

It is worth noting that the Ukrainian tax authorities issue interpretations of the new rules and the content of these interpretations shows that the tax authorities are aiming to widen the scope of control.

An example of this approach can be seen in the amendments to the Generalised Tax Consultation on Transfer Pricing, adopted by Order No 699 of the Ministry of Revenues and Duties of Ukraine (Ministry) and introduced on 1 July 2014. In these amendments, the Ministry interpreted the rules regarding recognition as controlled if the transactions are between two related Ukrainian entities. In particular, the central fiscal authority gave a rather controversial interpretation of what will be deemed as payment of the profit tax and/or VAT at a rate different from the basic rate.

According to this interpretation, transactions with a related entity in Ukraine will be deemed controlled in the case where the entity is engaged in the exportation of goods taxable to VAT at the zero rate. This position is rather questionable, taking into account the fact that the VAT is not paid at all during exportation, while the Tax Code of Ukraine in defining which transactions are controlled literally refers to the payment of the tax. Moreover, a zero rate is the general rate applied to transactions involved in the exportation of goods from Ukraine, meaning that any exporting entity automatically falls under this definition and the transaction will be deemed a controlled transaction.

Another controversial aspect concerns the position when a Ukrainian related entity withholds and remits to the budget the tax on non-residents' incomes (withholding tax), the general rate of which is 15% in Ukraine. The Ministry considers these circumstances as sufficient to recognise transactions with that Ukrainian related entity as controlled transactions for transfer pricing purposes. This conclusion is also rather questionable, given that the Ukrainian entity acts as a tax agent with respect to this tax.

The above approach to interpreting the rules of the Tax Code of Ukraine regarding transfer pricing illustrates that the Ukrainian Ministry intends to broaden the scope of what can be classified as controlled transactions, even in cases where it has questionable legal reasoning for doing so. This may indicate that the Ministry perceives the transfer pricing rules as a new mechanism for collecting monetary funds to the budget.

TRANSFER PRICING METHODS

The transfer pricing methods, established by the Tax Code of Ukraine, are in line with the Organisation for Economic Co-operation and Development (OECD) Guidelines. In particular, the methods include:

- Comparable uncontrolled price (analogue sales).
- Resale price.
- Cost plus.
- Net margin.
- Profit split.

The comparable uncontrolled price method is set as the "basic" method. Under paragraph 39.4 of Article 39 of the Tax Code of Ukraine, this is the primary method that should be used to determine the price. At the same time, taxpayers can use a combination of transfer pricing methods for proving the price.

The new transfer pricing rules do not allow for a 20% deviation from the arm's length price, which was permitted under the preceding rules. However, the new transfer pricing rules introduce two new concepts of "market price range" and "market range of profitability", which are calculated according to specific rules contained in the new transfer pricing rules and which will ensure that the transfer pricing methods remain flexible.

PRICING INFORMATION

Article 39 of the Tax Code of Ukraine envisages two main groups of sources of pricing information, which are:

- Official sources.
- Other sources.

The Cabinet of Ministers adopts the list of official sources of information. They include information taken from various state institutions and enterprises and have priority over any other sources under the Tax Code of Ukraine.

Although the new transfer pricing rules have been in force since September 2013, there is still a lack of local sources of pricing information which contain both sufficient and reliable information as is needed to make the calculations required under the Tax Code of Ukraine. Even the official sources are incomplete, since they both:

- Contain the required information only for a limited range of goods.
- Lack sufficient details concerning the conditions of the transaction in question for conducting the comparability test.

Information about the prices of services is almost entirely absent.

It is also now questionable whether it is possible to use uncontrolled comparable transactions conducted by the taxpayer with third parties to substantiate the price in controlled transactions, because of the specific wording used in the Tax Code of Ukraine. The list of information sources is exhaustive (see *subparagraph 39.5.3.2 of Article 39, Tax Code of Ukraine*), and in the case of internal comparable transactions literally only mentions "information on other controlled transactions, conducted by the taxpayer". The reference to "other controlled transactions" creates ambiguity, since such other controlled transactions may hardly be comparable, and their price will require separate justification if used as a comparison.

TRANSFER PRICING REPORTING

One important change is the new requirement to file annual reports on controlled transactions before 1 May of the year following the reported one (for 2014 this deadline was extended to 1 October). Taxpayers submit their reports by electronic means, in accordance with the form established by the central fiscal authority.

As has been shown in practice, it is not an easy task to complete the report, since the form requires listing all of the separate transactions. For example, reports which were submitted before the original 1 May deadline during 2014 in many cases comprised over 1,000 pages, and it was not possible to automate the processing of these reports. In some cases taxpayers have tried to circumvent this time-consuming process by applying various grouping approaches for transactions of a similar type.

Although in practice the lion's share of taxpayers had filed their transfer pricing reports before the 1 May deadline, a number of practical issues with completing the reports still remain unresolved. For example, the form of the report does not allow for the price to be stated as a percentage. It is therefore unclear how the price should be indicated where either:

- There is an absence of a fixed price.
- The value of services is determined as a rate (for example, in the case of royalties or interest).

Finally, there is also an issue concerning measurement units, which have been indicated as being in accordance with the list units, though this has been based on an outdated state standard.

TRANSFER PRICING DOCUMENTATION

The central fiscal authority has the right to request to see the documentation that has been used to confirm the prices set in controlled transactions. For example, the central fiscal authority has the right to:

- Request submission of the documentation regarding controlled transactions once it has analysed the transfer pricing report.
- Receive information about the presence of non-reported transactions, as well as certain other matters.

Under the Tax Code of Ukraine, the central fiscal authority has the right to make such a request commencing from 1 May of the year following the reported one. As mentioned above, the first deadline for submission the transfer pricing report with respect to transactions which occurred in 2013 was extended from 1 May to 1 October 2014. However, the new rules have not introduced any transitional rules with respect to the right of the central fiscal authority to request to see the transfer pricing documentation. As a result, formally the central fiscal authority can make a request to see the transfer pricing documentation at any time from 1 May 2014.

Taxpayers (except for taxpayers that fall into the category of large taxpayers) have one month following the date of receipt of the request to file the transfer pricing documentation to comply with that request. That documentation includes:

- The primary documents on controlled transactions specified in the request.
- Other documents (whether a set of documents or a single document, drafted in any form) which prove the compliance of the contractual prices to the level of the arm's length prices.

The Tax Code of Ukraine attributes to the category of large taxpayers those legal entities that reported income exceeding UAH500 million in the results of their last four consecutive reporting quarters, or that paid to the budget more than UAH20 million during the same period.

Large taxpayers have two months to file the transfer pricing documentation, which can comprise a set of documents or a single document, drafted in any form. The Tax Code of Ukraine (*paragraph 39.4, Article 39*) establishes the specific content requirements of the transfer pricing documentation of large taxpayers which must be filed with the central fiscal authority upon its request to do so.

Large taxpayers must provide the following information in their transfer pricing documentation:

- Information on related parties.
- Information on the group (set of entities that are deemed to be related parties), including group structure, description of activities and transfer pricing policy of the group.
- Description of the transaction, the conditions of its completion (cost, terms, and other matters required to create a valid agreement/contract under Ukrainian legislation).
- Description of the goods (works, services), including physical characteristics, quality and reputation on the market, the country of origin and the manufacturer, the presence of a trade mark, and other information related to the characteristics and quality of the goods (works, services).
- Terms and conditions of settlements.
- Factors that influence the pricing.
- Information about:
 - the functions of related parties who are parties in the controlled transaction;
 - the assets used by them in connection with the controlled transaction;
 - the economic (commercial) risks which those parties took into consideration during the controlled transaction (functional analysis and risk analysis).

- Economic analysis, including:
 - the methods that are used to determine the price of a controlled transaction and an explanation of the reasons for selecting that particular method;
 - the amount of earned income (profits) and/or the amount of expenses (losses) incurred as a result of the controlled transaction;
 - the level of profitability;
 - the calculation of the market price range (profitability) in respect of a controlled transaction (including a description of the approach used to select comparable transactions);
 - the sources of information used to determine the price of controlled transactions.
- Results of a comparative analysis of the commercial and financial conditions of transactions.
- Information on the proportional adjustment of the tax base and tax amounts made by the taxpayer (if any).

As is evident from the above, large taxpayers are required to prepare rather extensive transfer pricing documentation. In the absence of clarity concerning the pricing information sources which can be used, practical issues often arise with the economic and comparative analysis, which is required to substantiate that the price in a transaction is in fact at arm's length.

TRANSFER PRICING CONTROL

The central fiscal authority of Ukraine created a monitoring department which is in charge of transfer pricing control. There are two ways in which the monitoring department can ensure that the new law on transfer pricing is implemented:

- Monitoring prices in controlled transactions through observation of the prices and by way of analysis of the transfer pricing documentation on controlled transactions.
- Conducting special tax audits of controlled transactions to see if they are compliant with the transfer pricing rules.

Under paragraph 39.5 of Article 39 of the Tax Code of Ukraine, the central fiscal authority will establish the procedure for the monitoring of prices in controlled transactions. However, as yet no such formal procedure for monitoring the prices has been established, and so currently the legal basis to conduct this monitoring is absent.

The central fiscal authority will conduct a special tax audit of controlled transactions in the following cases:

- Where a notification has been provided on unreported controlled transactions by the local fiscal authority to the central fiscal authority.
- Where monitoring has revealed that there has been a deviation of the controlled transactions from the level of arm's length prices.
- Where a transfer pricing report has not been provided at all, or where the report provided breaches the requirements established by the Tax Code of Ukraine.
- Where transfer pricing documentation has been requested but has not been provided, or where that documentation has been provided but it breaches the requirements established by the Tax Code of Ukraine.

The special tax audit is conducted by the tax officers of the local fiscal authority, but is headed by a representative of the central fiscal authority. The special tax audit of controlled transactions can last up to six months, though this period can be extended for up to another six months. This means that a transfer pricing special tax audit can take up to one year to complete.

ADVANCE AGREEMENTS

The new transfer pricing rules envisage the possibility of obtaining an advance agreement on prices in controlled transactions, which is available for large taxpayers.

For example, a large taxpayer and the central fiscal authority can agree on the following matters:

- The types and list of goods (works, services) that are the subject of the controlled transactions.
- Prices of the goods (works, services) in the controlled transactions and/or the list of methods of determining the prices in controlled transactions.
- The list of pricing information sources used for determining the prices in controlled transactions.
- The period for which the prices are agreed.
- Admitted deviations from the established economic conditions of controlled transactions.
- Procedure, terms of submission and the list of documents which will be required to confirm compliance with the agreed prices in the controlled transactions.

The Cabinet of Ministers of Ukraine establishes the procedure for advance agreement on prices. Under this procedure, a taxpayer intending to obtain an advance agreement is required to submit a letter to the central fiscal authority outlining the reasons for such agreement. The central fiscal authority preliminary considers the case and within 60 days is required to conclude whether the advance agreement is necessary.

In the case of a positive decision, the taxpayer files a formal application to the central fiscal authority and a working group (specially formed by the central fiscal authority) considers the application. At this point, the taxpayer and the central fiscal authority discuss the advance agreement in detail. In the case where the working group and the taxpayer make an agreement on the prices in the transaction, where a non-resident party participates, the central fiscal authority of Ukraine applies to the authorised body of the state of the non-resident's registration with a request to participate in the agreement.

The fiscal authority can refuse an advance agreement in the following cases:

- It discovers unreliable information in the documents submitted by the taxpayer.
- It concludes that the advance agreement would not comply with the arm's length principle.
- The authorised body of the registered state of a non-resident party to the controlled transactions refuses to participate in the agreement process or does not reply to the request to participate.

SELF-ADJUSTMENT AND PROPORTIONAL ADJUSTMENT

Article 39 of the Tax Code of Ukraine establishes a mechanism to enable taxpayers to apply a self-adjustment to the tax results of transactions up to the level of arm's length prices. Taxpayers can implement this self-adjustment using the standard mechanisms, which are established by the Tax Code of Ukraine for the adjustment of tax reporting.

The proportional adjustment mechanism can be used to bring the tax results of a transaction with a related party to the level of the arm's length price. For example, this mechanism applies where either:

- The related party applies the mechanism of self-adjustment.
- The fiscal authority establishes an arm's length price during the special tax audit of the related party.

Such proportional adjustment is allowed provided that the tax liabilities assessed to the related party as a result of the special tax audit, or the tax liabilities as determined by applying the mechanism of self-adjustment, are fully paid to the budget.

TRANSFER PRICING AND CUSTOMS VALUATION

In the absence of clear rules, reliable sources of pricing data and established practice, many taxpayers and tax advisors in Ukraine have sought alternative ways to evidence that the price in controlled transactions is at arm's length. One of the promising options that has been available and has been used is the customs valuation results with respect to goods imported to Ukraine from non-resident related parties.

However, in 2012 the Ukrainian Government united the tax and customs authorities by creating the Ministry of Customs and Duties, and recently transformed this Ministry into the State Fiscal Service of Ukraine. Starting from 2012, this single state authority therefore exercises both tax and customs control.

In the case of importation into Ukraine of goods purchased from related, non-resident parties, or from entities registered in a low-tax jurisdiction, the price in the transaction will be controlled both at the stage of customs clearance and again under the transfer pricing mechanisms. In other words, in this case the customs valuation and the transfer pricing controls will coincide.

The basic principles of both these types of control are similar. In both transfer pricing and customs valuation the purpose of the control is to ensure that the taxes are paid from the base, determined following the arm's length principle.

There are differences between the methods used to establish the customs valuation and transfer pricing control. However, a comparative analysis of the two shows that there are also many similarities between the methods used. For example, the transfer pricing method for establishing the comparative uncontrolled price is very similar to the customs valuation method of establishing the price of contracts for identical and similar goods.

Notwithstanding these similarities, in practice the conclusions for establishing the arm's length level of the price produced by following these two different methods can vary significantly. This means that there can be a "conflict of interest" between the arm's length level of the price established under the customs valuation, and the arm's length level of the price established under transfer pricing control.

To briefly explain, the principal concern for customs officers is in identifying cases where the price of the imported goods has been understated. Where the price has been understated, customs officers can increase the customs valuation, which increases the taxes and duties that can be collected on importation. In recent years, customs valuations have been an effective instrument in collecting additional funds to the budget. In fact, certain importers have faced revisions of their contractual prices in two or more instances as a result of customs valuations, often without proper legal substantiation for the reasons for those revisions.

On the other hand, the principal concern for tax officers that exercise transfer pricing control in the case of importation is in identifying cases where the price of the imported goods has been overstated. Where the price has been overstated, the tax officers then have the ability to adjust deductible expenses and assess any additional corporate profit tax liabilities.

However, this difference in the principal concerns of customs officers and tax officers exercising transfer pricing control may work to the taxpayer's advantage.

It is a basic rule of customs valuations that the customs clearance of imported goods is based on the contractual price of those goods, unless there is evidence that the contractual price is not at arm's length.

As a consequence, in the case of imported goods which obtain customs clearance under the contractual price, it is certainly possible to argue that customs officers have already scrutinised the contractual price of those imported goods and have concluded that the contractual price is in compliance with the arm's length principle, since they did not find any violations of that principle and gave customs clearance. This argument could be used as the basis for questioning the validity of any further revision of the customs officers' conclusions under transfer pricing control, which, after all, is conducted by the same state authority.

A taxpayer will have even stronger legal grounds to question any revision to the price of the goods under transfer pricing control in cases where customs officers have already determined that the customs valuation of those goods is actually higher than the contractual price. In practice in these instances, customs officers will often apply the contractual price of identical or similar goods in order to determine that the customs valuation should be higher than the contractual price.

However, in raising the customs valuation to a level that is higher than the contractual price, the central fiscal authority has determined that the contractual price is below the price determined following the arm's length principle. In this instance, any attempt to then adjust the contractual price in the opposite direction under transfer pricing control would be completely illogical, since that would mean that one of the divisions of the central fiscal authority (whether the customs officers or the tax officers exercising transfer pricing control) will have incorrectly determined the arm's length level of the contractual price.

TRANSFER PRICING AND STATE PRICING CONTROL OF SERVICES

Under the Ukrainian rules governing currency control, agreements on the provision of the services from non-resident entities must undergo the scrutiny of a specialised state enterprise, called the *Derzhzovnishinform* (DZI), where the value of those services is expected to be more than EUR100,000. The DZI scrutinises these agreements and determines whether or not the pricing of those services contained in the agreement is in line with market conditions.

The DZI publishes its conclusions and these are included on the list of official sources of information for transfer pricing control purposes, which means that the pricing information provided by DZI is reliable. As a result, taxpayers could argue that the confirmation of the contractual price, as issued by the DZI, is sufficient evidence that the contractual price complies with the arm's length principle for the purposes of transfer pricing control, and that no further computation of that contractual price is required.

SUMMARY

The comprehensive new transfer pricing rules are still a novelty in Ukraine and taxpayers are only beginning to become accustomed to the new control mechanisms. Compliance with the new reporting rules requires an extensive effort on the part of taxpayers, and the absence of developed local pricing information sources makes it difficult to ensure that the transfer pricing documentation is in line with the requirements of the Tax Code of Ukraine.

In practice, whilst the transfer pricing rules are still new and are unfamiliar to taxpayers and tax officers exercising transfer pricing control alike, it is possible that the transfer pricing mechanisms

may be used by tax officers as a way to collect additional funds to Ukraine's budget, particularly since this budget is currently struggling.

However, there are smart options available for taxpayers who wish to defend the prices quoted in controlled transactions, particularly once the Ukrainian central fiscal authority has full-scale control of the transfer pricing rules in the future.

Practical Law Contributor profile



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Publications

- *Tax on corporate transactions in Ukraine: overview (2012; 2013).*
- *Recent developments in transfer pricing regulation (2013).*
- *Hidden tax implications of secondment to Ukrainian subsidiaries (2013).*