RUSSIA: NEW TRANSFER PRICING RULES CAME INTO FORCE ON JANUARY 1, 2012

January 19, 2012

To Our Clients and Friends:

On January 1, 2012 Federal Law No. 227-FZ (the "Law"), which completely revamps the Tax Code provisions on transfer pricing, came into force. The changes fully replace the previous outdated transfer pricing regulation system with more sophisticated controls which are based mostly on OECD Transfer Pricing Guidelines. The new rules are expected to lead to greater enforcement by the tax authorities; a special division was recently established within the federal headquarters of Russian Tax Service in order to focus specifically on transfer pricing control and international cooperation (the "TP Tax Body").

The previous Russian transfer pricing rules had been in effect since 1999, when the Tax Code entered into force, and were widely criticized for their incompleteness and ineffectiveness. This was due, on the one hand, to their vagueness which created a threat of unpredictable tax assessments to taxpayers, and on the other hand, to imperfections in the criteria for "relatedness" and the lack of agreed sources of acceptable market information. The absence of clear guidance often led to differing and inconsistent interpretation of the transfer pricing rules by the Russian tax authorities and courts. Adoption of this Law came on the heels of protracted reworking by the Ministry of Finance, numerous public discussions, and rejections of several previous bills by the State Duma and has become one of the most noteworthy of recent tax developments.

TRANSACTIONS IN FOCUS

The Law generally confirms the arm's length principle: a transaction price may be reviewed and adjusted for tax purposes if (i) the parties to such a transaction are deemed related (with certain additional qualifications for parties that are all Russian related entities, described below); or (ii) a particular kind of transaction is specifically defined as controlled.

Related-Party Transactions: Definition of Related Parties Expanded. Parties may be deemed related either based on formal criteria (*i.e.*, the type of relation falls within the statutory list), or if the court at its own discretion finds that the parties are able to affect each other's business operations (so called "judicial criterion"). Under the previous formal criteria, parties could be deemed related if (i) one party directly or indirectly held more than 20% of the other party's share capital, (ii) the parties were both individuals and have an employer – employee

relationship; or (iii) the parties were spouses or relatives under Russian family law. In practice, these criteria excluded any relations between sister companies, or between a company and its management, and many other common situations where individuals and/or entities in fact have significant influence over each other.

Under the new Law the general approach of referring to both formal and judicial criteria remains the same except that the participation threshold is increased to 25%. The previous list of formal criteria, however, is significantly expanded. As a result, the following parties are be deemed related under the new rules:

- legal entities (or a legal entity and an individual) if one entity (or individual) holds, directly or indirectly, more than 25% of the other entity's share capital, as well as groups of legal entities, where more than 25% of each entity is directly or indirectly owned by the same person;

- legal entities (or a legal entity and an individual, including together with his or her spouse and certain relatives) [1] if one entity (or individual) has the right to appoint the CEO or more than 50% of the board of directors/management board of the other entity, as well as legal entities when their CEO or more than 50% of their board of directors/management board is appointed by the same person;

- legal entities where more than 50% of the board of directors/management board of both entities are comprised of the same individuals (attribution rules apply with respect to spouses and certain relatives);

- a legal entity and an individual acting as the entity's CEO, as well as legal entities managed by the same person acting as CEO; and

- individuals where one is subordinate to the other as an employee or where they may be deemed close relatives under Russian family law.

As this expanded list shows, the rules of relatedness have become much more comprehensive under the new Law.

[1] *Such relatives include parents, children, siblings and legal guardians.*

Additional Prerequisites for Russian Related Entities. In order for the new transfer pricing rules to apply to a transaction between related parties who are all registered or tax resident in Russia (*i.e.* in a non-cross-border context), at least one of the following prerequisites must be met:

- aggregate revenue from all transactions between these two parties in any respective calendar year exceeds RUB 3 billion (which is approximately USD 100 million) (in 2012);[2]
- one of the related parties is a payer of mineral extraction tax ("MET"), the transaction concerns extracted minerals subject to a MET percentage rate, and the revenue from transactions between these related parties exceeds RUB 60 million in the respective calendar year;[3]
- at least one of the parties enjoys a special tax regime in the form of Unified Agricultural Tax or Unified Tax on Imputed Income, while at least one of the parties does not apply either of these special regimes, provided that the aggregate revenue received from transactions between these related parties exceeds RUB 100 million in the respective calendar year;[4]
- at least one of the parties to this transaction is exempt from profits tax or applies a 0% profits tax rate as a resident of the Skolkovo Innovative Center area, while the other party (or parties) does not apply such exemption or such tax benefit, provided that the aggregate revenue received from the transactions between these related parties exceeds RUB 60 million in the respective calendar year; or
- at least one of the parties enjoys profits tax benefits as a resident of a special economic zone, while the other party/parties is not resident in any special economic zone with a beneficial

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[2] *According to the Law, a threshold of RUB 3 bln. is set forth for 2012; for 2013 it is set at RUB 2 bln., and starting from 2014 RUB 1 bln.*

[3] *In order to determine the aggregate annual revenue the TP Tax Body is entitled to examine all revenue received within the calendar year from the transfer pricing perspective.*

[4] *This additional prerequisite will become applicable starting from 2014.*

profits tax regime, provided that the aggregate revenue received from the transactions between these related parties exceeds RUB 60 million in the respective calendar year.[5]

These rules make the majority of domestic small- and medium-scale business transactions not subject to transfer pricing control.

Given that Russian tax laws do not provide for any other pricing control mechanisms, starting from 2012 Russian tax authorities should not have any supervision powers with regard to "domestic" related-party transactions that do not hit these thresholds.

Other Controlled Transactions. The Law specifically names the following transactions as being in any event subject to transfer pricing control (even when the parties are not deemed related as described above):

- any series of transactions effectively consummated by related entities with the involvement of intermediaries that are not related, but at the same time do not perform any additional functions apart from arrangement of resale from one related party to another;
- foreign trade in international exchange commodities: oil and oil products, ferrous and non-ferrous metals, mineral fertilizers, precious metals and stones, provided that the amount of aggregate revenue received from to the transactions with the same party exceeds RUB 60 million in the respective calendar year; and
- any transactions with persons registered or tax resident in jurisdictions on the so-called "black list" of the Russian Ministry of Finance (that list currently includes, for example, Cyprus, along with other popular jurisdictions for holdings in Russia, such as British Virgin Islands, Jersey and Guernsey), provided that the amount of aggregate revenue received from the transactions with the same party exceeds RUB 60 million in the respective calendar year.[6]

In addition, a court may, upon a claim filed by TP Tax Body, rule that a transaction must be subject to transfer pricing control if the court believes that such a transaction belongs to a series of similar transactions consummated to avoid transfer pricing control.

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[5] *This additional prerequisite will become applicable starting from 2014.*

[6] *The "black list" is ratified by the Order of the Ministry of Finance No. 108u, dated November 13, 2007, as amended, and includes 42 low-tax jurisdictions that do not require the disclosure and provision of information on financial operations.*

Transactions Exempt from Transfer Pricing Control. Interestingly and importantly certain transactions are outside of the scope of the new transfer pricing rules: some are specifically exempt and therefore relevant prices cannot be reviewed, some are subject to specific rules (*e.g.*, transactions with securities and derivatives), and some are not yet expressly covered by the Law, as described below.

First, the Law provides for two types of transactions that are expressly not subject to transfer pricing control; both exemptions relate to the specific status of the parties. Exempt from control are (i) transactions between parties that belong to the same consolidated group of taxpayers,[7] and (ii) transactions between profitable parties that are registered in the same region of Russia, act exclusively within this region and pay profits tax (in its regional portion) only to the relevant budget, provided that they do not apply any exemptions and special tax regimes or are not subject to MET as described above.

According to the Law, with regard to these transactions Russian tax authorities have no power to review or revise relevant prices.

Secondly, any transactions with securities or financial instruments (derivatives) are still regulated by specific transfer pricing rules enacted in 2010, which remain in force; the amendments provided for in the Law do not cover any specific issues associated with the sale of securities. At the same time, it is unclear but still possible that parties to securities and derivative transactions are now required to adhere to the new tax administration connected to the new transfer pricing rules (including reporting and audits, as described below).

Notably, under the common treatment (that was in the past supported by the Ministry of Finance, tax authorities and courts) the previous transfer pricing rules did not apply to transactions with proprietary rights, such as shares in Russian limited liability companies, and could not be applied to royalties and interest. However, under the Law these transactions are not expressly exempt from control. When commenting on the Law, representatives of the Russian Ministry of Finance expressed their view that the new rules should also make these types

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7 *The concept of consolidated group of taxpayers was enacted together with the new transfer pricing rules: at the end of November the President signed into law No. 321-FZ ("Law On Tax Consolidation") to amend the Tax Code with relevant special provisions. According to this Law, consolidation for tax purposes is available only for Russian companies with inter-company participation of 90% or more, consolidated group revenues of no less than RUB 100 bln., consolidated taxes of no less than RUB 15 bln. and consolidated asset value of no less than RUB 300 bln. Obviously, with these thresholds, tax consolidation is unavailable to the vast majority of taxpayers in Russia.*

of transactions subject to transfer pricing control, and it is expected that relevant amendments to the Law will be soon initiated.

ADJUSTMENT OF PRICE

Prices set in transactions between unrelated parties and other transactions not subject to transfer pricing control are presumed to be at a market level. For related-party and other controlled transactions prices can be compared to the market level and, if necessary, re-assessed by the TP Tax Body (but not by the local tax inspectorate) for the purposes of the following taxes:

- Russian profits tax;
- personal income tax payable by individual entrepreneurs, notaries, advocates and other individual practitioners;
- MET (if one of the parties is a MET payer and the transaction deals with minerals that are subject to a MET percentage rate);
- value added tax ("VAT") chargeable on transactions where one party is a person exempt from VAT.

It is now expressly stated in the Law that income received other than at an arm's length basis can be re-assessed only if this leads to an increase in tax liability (except for adjustments made as a result of a corresponding adjustment). This provision conflicts with Art. 9 of the OECD Model Tax Treaty and similar provisions in tax treaties entered into by Russia. As of yet, the Russian Tax Administration has not indicated how it wants to deal with this conflict.

Before the enaction of new transfer pricing rules the tax authorities were tasked with determining whether the actual price deviated from the market level by more than 20% (if the difference was less than 20% no pricing adjustment was permissible). From 2012, this rule is abolished, and the TP Tax Body is required to compare the reviewed transaction with one or more comparable non-related-party transactions. In making its determination the TP Tax Body can use a range of five different methods (separately or in any combination) of recalculating the price, three of which (using the comparable market prices, transactional net margin method and profits split method) are new and are available along with the previously used resale minus and cost plus methods. In any event, the comparable market prices method should be given priority.

Comparability of Transactions. The Law provides for numerous criteria that must be taken into account when determining the comparability of transactions. For example, it is necessary to consider the characteristics of the goods, the functions performed by the parties, as well as their possessions, commercial strategies and risks taken. The terms and conditions of the contracts in

question, as well as the nature and any peculiarities of the relevant markets should also be taken into account.

Information About Market Prices. In contrast with the previous transfer pricing rules, the Law introduces a list of public information sources that can be officially used by TP Tax Bodies to compare the price in question with the applicable market price. The list includes quotations of Russian and foreign stock exchanges, foreign trade customs statistics, information officially published by Russian and foreign state authorities and provided by information and price assessment agencies. The tax authorities can also use information on prices that was previously used by the audited taxpayer. This list of sources is non-exhaustive but the authorities are not allowed to use any confidential information, apart from information concerning the audited taxpayer itself and its transactions with related parties.

Under the Law, it is the TP Tax Body that is obliged to prove that a price is not at a market level; at the same time, taxpayers remain responsible for their transfer pricing reporting and calculations.

Prices Presumed to be at Arm's length. According to the new rules, certain prices are presumed to be at a market level:

- prices prescribed by antitrust authorities and other state regulated prices (if they fall within specifically established limits);
- prices set as a result of exchange auctions at Russian and foreign stock exchanges;
- the value of the property that is the subject of the transaction as determined in the course of the independent appraisal (when such appraisal is mandatory); and
- prices determined in accordance with an advance pricing agreement (see below).

TAX ADMINISTRATION

The TP Tax Body is the authority exclusively empowered to perform transfer pricing control by conducting specific transfer pricing audits ("TP Audits") which will take place along with regular field and desk tax audits conducted by local tax inspectorates.

Reporting Requirements.[8] No later than May 20 of each year, a taxpayer is required to notify its local tax inspectorate about any related-party or other controlled transactions (as described

[8] *Reporting requirements addressed in this section will be applicable in 2012 if the aggregate annual income from related-party or other controlled transactions with the same counterparty exceeds RUB 100 million; in order for these requirements to apply in 2013 such amount must exceed RUB 80 million; starting from 2014 they will apply without limitations.*

above) performed in the previous calendar year (the statutory form of such notification is yet to be approved). The local tax inspectorate must pass this information on to the TP Tax Body, together with any similar information revealed in the course of ordinary tax audits.

In addition to self-reporting duties, at the request of the TP Tax Body a taxpayer must provide information about particular transactions (or series of transactions), its counterparties (with indication of their tax residency, role in the transactions, used assets, risks taken, etc.), the terms and conditions, as well as pricing methods used by the taxpayer and adjustments of tax base made by him (if any). The TP Tax Body can request this information no earlier than June 1 of the year following the year when the transaction in question took place. The TP Tax Body is not entitled to request any documents concerning (i) transactions that are not related-party or not otherwise controlled, (ii) prices that are state regulated or prescribed by antitrust authorities, (iii) transactions with securities or financial instruments quoted on a stock exchange, (iv) transactions regulated by pricing agreements.

Failure to comply with the above reporting requirements can lead to a fine of RUB 5,000.

Transfer Pricing Audits.[9] A specific TP Audit will be performed at the location of the TP Tax Body following a notification of a taxpayer or a relevant local tax inspectorate as described above.

A decision to conduct a TP Audit must be issued no later than two years after the relevant notification is received; the review period for a TP Audit cannot exceed three years prior to the year of the audit (*i.e.*, the year when a decision to undertake the audit is made). Repetitive TP Audits (*i.e.*, second transfer pricing audits concerning same transaction (or series of transactions) and the same calendar year) are not allowed. Moreover, once a TP Audit is performed with regard to one party to a transaction (or series of similar transactions) and the prices are found to be at a market level, other parties to such transactions cannot be subject to a separate TP Audit. A standard TP Audit will last no more than six months (other than exceptional cases where it can possibly be extended to nine months). It is remarkable that the TP Tax Body has significantly less power than a local tax inspectorate performing a regular tax audit; for example, the TP Tax Body cannot examine a taxpayer's premises or seize any documents.

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[9] *For the year 2012 tax audits addressed in this section will be applicable to taxpayers whose aggregate annual income from related-party or other controlled transactions with the same counterparty exceed RUB 100 million; in 2013 such amount must exceed RUB 80 million; starting from 2014 they will apply without limitations.*

If as a result of a TP Audit the TP Tax Body discovers any deviations from market level that lead to underpayment of tax, it is supposed to issue an act to summarize the findings and justification thereof. The taxpayer may then file a letter of disagreement.

In order to collect taxes assessed as a result of a TP Audit as described above, the TP Tax Body must apply to a court.

Corresponding Adjustments. The Law introduces the right to corresponding adjustments: namely, if the TP Tax Body discovers any underpayment of tax and the audited party discharges the underpayment, other parties to the transaction in question that are Russian taxpayers can also adjust their tax liabilities accordingly. The TP Tax Body is obliged to notify other parties about such possibility. Adjustments can be made within the limits indicated in the relevant notification (provided that the figures set in the notification are the same as those in the decision to charge underpayment). If the decision to charge underpayment is revoked or changed, the other parties are also required to reverse the corresponding adjustments. The Law does not provide for the right to make corresponding adjustments if the principal adjustment is made as a result of the taxpayer itself proactively adjusting the transfer pricing as distinct from the TP Tax Body requiring and making such adjustments.

Advance Pricing Agreements. Advance pricing agreements ("APA") are a new concept for Russian taxpayers. Starting from 2012 Russian legal entities that are "major taxpayers" have an opportunity to enter into APAs with the TP Tax Body (represented by its head or deputy head) and thus to agree upon the pricing methods applicable to a related-party or other controlled transaction (or series of transactions) as well as on the sources of information on market prices. If the taxpayer plans to enter into a foreign trade transaction with a resident of any country that is a party to a double tax treaty with Russia, it can apply to the TP Tax Body with a request to enter into an APA with an authorized body of such a treaty country. A multilateral APA can also be concluded with a group of related entities that plan to enter into similar controlled transactions; in such cases the APA applies to all such related entities. An APA can be concluded for three years and possibly be extended for no more than two years. In order for the TP Tax Body to consider an application for conclusion of an APA, a taxpayer must pay a fixed state duty in the amount of RUB 1.5 million.

As mentioned before, prices agreed on in the APAs are presumed to be at arm's length. If a taxpayer complies with APA provisions, it cannot be charged with any underpayments, fines or late payment interest. In addition, the TP Tax Body is not entitled to request any documents relating to transactions entered into in accordance with the conditions set forth in an APA. Taxpayers that are parties to an APA are guaranteed that the agreed pricing methods will remain in effect regardless of any changes in Russian tax laws. Nonetheless, the APAs may not become

a very popular tool, as they are available only to a small range of Russian legal entities and cannot be quickly entered into. TP Tax Bodies have six months to consider every application for APA conclusion, and any APA can enter into force no earlier than January 1 of the year following the execution thereof. In addition, the TP Tax Body has the right to terminate any APA if it believes that the terms of the APA were breached and that led to underpayment of tax.

PENALTIES

Starting in 2017, any underpayment of taxes resulting from transfer pricing will be subject to a fine amounting to 40% of such underpayment (but in any event no less than RUB 30,000) and applicable late payment interest. Before that, the Law provides for a transition period: in 2012 – 2013 fines will not be applicable at all, and in 2014 – 2016 fines will amount to 20%. A taxpayer will be relieved of fines if it provides the TP Tax Body with documents justifying its transaction pricing and proving its compliance with the methods provided for in the Tax Code. Therefore, transfer pricing monitoring and compliance and transfer pricing documentation are expected to become more relevant in Russia like it has in many other countries to avoid the imposition of stiff penalties.

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We would be happy to answer any queries you may have on this or any other Russian tax issues.

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