Transfer pricing rules in Ukraine: back to the drawing board

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INTRODUCTION

In late 2014, the Parliament of Ukraine (Verkhovna Rada) adopted a set of laws that introduce a comprehensive tax reform. The Parliament adopted Law No. 72-VIII of 28 December 2014, which introduces major amendments to the transfer pricing rules that had been introduced by the previous government in 2013. The transfer pricing control rules were subsequently amended by Law No. 609-VIII of 13 August 2015.

Transfer pricing rules are still a novelty in Ukraine, as there were no comprehensive transfer pricing regime in Ukraine before 2013, and compliance with the new reporting rules requires an extensive effort on the part of taxpayers.

The new rules constitute a significant improvement of the previous system. They are more in line with the Organisation for Economic Co-operation and Development (OECD) Guidelines on Transfer Pricing and appear to be clearer. However, certain rules remain ambiguous, and their practical application is likely to be problematic.

This article provides an overview of the main features of the new transfer pricing rules, including those relating to:

• The arm’s length principle.
• Controlled transactions.
• Related parties.
• Transfer pricing methods.
• Special rules for commodities trading.
• Special corporate income tax (CIT) rules for transactions with "low-tax" states.
• Transfer pricing reporting and documentation.
• Transfer pricing audits.
• Advance agreements.

ARM’S LENGTH PRINCIPLE

The arm’s length principle is now explicitly recognised and defined in Article 39 of the Tax Code of Ukraine, which sets out the transfer pricing control regime. These rules follow the OECD standard approach. The focus of the transfer pricing rules is to ensure that, for tax purposes, business transactions are computed on an arm’s length basis.

There is a presumption that taxable profits comply with the arm’s length principle if the terms and conditions of the transaction are not different from those that would apply between independent parties in comparable uncontrolled transactions. Under the new rules, the price of a transaction is deemed to be in line with the arm’s length principle if it falls within the arm’s length range. If not, the taxable base must be adjusted.

The new rules provide that such adjustment must be done in accordance with the median of the arm’s length range, rather than its limits, as was the case previously. Consequently, transfer pricing adjustment will be more significant than under the previous regulations.

A taxpayer can use the following information to establish that the prices of transactions comply with the arm’s length principle (Article 39, subparagraph 39.5.3, Tax Code of Ukraine):

• Information on uncontrolled comparable transactions between the taxpayer and the entity that is party to the controlled transaction.
• Any information sources that are open to general use and provide information on comparable transactions and entities.

If a taxpayer proves compliance with the arm’s length principle through use of data from the sources above, the fiscal authority must use the same sources. The only exception is where the fiscal authority can prove that other information sources ensure a higher level of comparability.

For transfer pricing purposes, the fiscal authority cannot use non-public information, in particular information that is only available to state authorities (subparagraph 39.5.3.3, Tax Code).

The rules on information sources are probably the most significant improvement of the transfer pricing legislation. Under the previous system, state-controlled “official” sources of information had priority over any other sources.

CONTROLLED TRANSACTIONS

The new transfer pricing rules do not apply to “internal” transactions between Ukrainian legal entities and natural persons. The rules apply to the following controlled transactions:

• Transactions with related non-resident entities which may affect the taxpayer's corporate income tax (CIT).
• Sales of goods through non-residents acting as commission agents.
• Transactions with non-residents registered in states/territories included on the list of “low-tax” states/territories that require special control over transfer pricing, which has been recently adopted by the Cabinet of Ministers of Ukraine (CMU). The CMU’s list is based on the following criteria:
  - states with CIT rates that are lower than Ukrainian rates by 5 percentage points; and
  - states with which Ukraine does not have treaties containing information exchange provisions.

The last amended version of CMU’s list came into force in mid-September 2015 and covers 65 states/territories, which is 11 states less than the previous version of the list. The reduction of the list...
was most likely, caused by the fact that when adopting the previous version of the list, CMU had to consider a third criterion (that is, disclosing of ownership structure of companies).

The transactions above are deemed to be controlled even when, in the chain of business transactions between the taxpayer and its related non-resident entity, the title to the goods is first transferred to one or more non-related entities that act as intermediaries, and is then transferred to the related non-resident entity (or to the taxpayer in the case of import transactions), provided that such intermediaries:

- Do not perform any significant functions.
- Do not use significant assets.
- Do not bear significant risks in a transaction between related parties.

Under the previous rules, to be deemed “controlled”, the annual aggregate value of the transactions in any of the above cases had to be equal to or exceed UAH50 million. The new rules have significantly lowered this threshold, and transactions are deemed controlled if the following conditions are met:

- The annual income of the taxpayer from any sources which is reported in accordance with accounting requirements exceeds UAH50 million.
- The value of the transactions between the taxpayer with one entity defined in accordance with accounting requirements (excluding indirect taxes) exceeds UAH5 million.

Therefore, although local transactions are no longer subject to transfer pricing controls, the new transfer pricing rules significantly increase the number of controlled transactions involving non-resident parties.

**RELATED PARTIES**

The Tax Code of Ukraine defines when two entities are deemed "related parties" for transfer pricing purposes. In particular, two legal entities will be recognised as related if any of the following applies:

- A third legal entity appoints one-person executive boards in such entities.
- A third legal entity appoints more than 50% of their collective executive boards.
- The same persons hold more than 50% of positions in executive boards of such entities.

Another criterion is related to share ownership. Under Ukrainian legislation, two entities will be deemed “related” if either:

- One legal entity holds 20% or more of the shares in another legal entity.
- A third entity holds 20% or more of the shares in two other legal entities.

Indirect ownership must be taken into account.

A new indicator of control has been introduced. Namely, persons are recognised as "related" if the overall value of loans, credits and interest-free loans provided by one person to the other is more than three and half times the equity capital of the borrower (or is more than ten times for financial institutions and lease companies). This rule also applies when financing is provided by various institutions but under a personal guarantee.

In addition, Ukrainian fiscal authorities have the right to prove in court that an entity exerted practical control over the decisions of another entity, where such entities are formally independent.

**TRANSFER PRICING METHODS**

The transfer pricing methods, established by the Tax Code of Ukraine, are in line with the OECD Guidelines. In particular, the methods include:

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

The new rules set out the criteria for taxpayers to choose the method for establishing compliance of the price of a transaction with the arm’s length principle. The general rule is that a taxpayer can choose any transfer pricing method that it deems appropriate with due regard to the criteria (Article 39, subparagraph 39.3.2.1, Tax Code of Ukraine). However, the CUP method is set as the “basic” method (that is, the primary method to substantiate the price). Where it is possible to use the CUP and any other method, a taxpayer must apply the CUP method. In turn, the resale price and cost plus methods have priority over the net margin and profit split methods.

It is prohibited to apply transfer pricing methods (or their combination) that are not envisaged by the law (Article 39, subparagraph 39.5.2.12, Tax Code of Ukraine).

The fiscal authority can apply a transfer pricing method other than the method used by the taxpayer if it proves that the method of the taxpayer fails to establish compliance of the controlled transaction with the arm’s length principle.

**SPECIAL TRANSFER PRICING RULES FOR COMMODITIES TRADING**

The new rules include special rules for commodities trading with companies registered in “low-tax” jurisdictions listed by the CMU (see above, Controlled transactions). These rules are probably the most heavily criticised innovation in this field so far.

These special rules are applicable to both (Article 39, subparagraph 39.2.1.3, Tax Code of Ukraine):

- Transactions with non-residents registered in the states included in the “low-tax” states list adopted by the CMU.
- Transactions involving the exportation or importation of commodities with quoted prices.

The CUP method must be used to determine whether the conditions of such transactions comply with the arm’s length principle. When applying the CUP method, the taxpayer must calculate the arms’ length price range based on prices of the respective commodities on exchange quotations for 10 days prior to the controlled transaction. The CMU adopts the list of commodities exchanges that are used for each group of goods subject to these rules, as well as the list of goods listed on the exchange.

There is an alternative option available for taxpayers. In particular, the other transfer pricing methods can be applied. However, in such a case, the taxpayer must submit to the fiscal authority information on profits realised by each related party that participated in the supply chain of the respective commodities, up to the first non-affiliated entity. This information must be submitted to the fiscal authority before 1 May of the year following the reporting year, and disclose the profit indicators in line with the...
selected transfer pricing method. The Ukrainian fiscal authority has the right to determine the arm’s length price in accordance with the CUP method, if either:

- The taxpayer fails to submit such information.
- The information is not sufficient to confirm compliance with the arm’s length principle.

These new rules potentially cover the majority of Ukrainian commodity exports, and raise serious issues for taxpayers which business is concerned. Therefore, in mid-March 2015, the CMU has issued the draft Regulation on the List of Exchanges and Commodities that are covered by the rules. These rules are expected to cover exports of grain, vegetable fats and oils, chemicals, fuels, ferrous metals, and so on. The list mentions the Chicago Mercantile Exchange, New York Mercantile Exchange and London Commodity Exchange.

Taxpayers and experts strongly criticise these new transfer pricing rules. The main arguments against the rules are as follows:

- Ukrainian exports are rarely comparable with exchange quotations, especially at the commodities exchanges mentioned in the draft regulation of the CMU.
- The Tax Code provides for the adjustment of the exchange quotations taking into consideration the volume of the controlled transaction, terms of settlements and supply, transport and other costs established in the contract. However, there are no clear rules for making such adjustment. In practice, it will be difficult to ensure satisfactory adjustment.
- The alternative option suggested in the Tax Code is unpractical. It would be extremely difficult to collect the necessary information within the set deadline, considering the standard deadlines for financial reporting. In addition, the rule gives the tax authority broad discretion to determine whether the information submitted is sufficient.

The author considers that there are fair grounds for criticism. The suggested rules contain significant flaws that must be resolved before their practical implementation.

**SPECIAL CIT RULES ON TRANSACTIONS WITH "LOW-TAX" STATES**

The special CIT rules apply when a taxpayer conducts business transactions with non-residents registered in “low-tax” states listed by CMU (see above, Controlled transactions). The taxpayer’s financial result is increased by 30% of the cost of goods (capital assets, works and services) purchased from non-residents registered in the list (paragraph 140.5.4, Tax Code of Ukraine). In other words, the taxpayer can only deduct 70% of its expenses in the case of import of goods, works or services from listed countries.

A taxpayer will have the right to deduct 100% of its expenses in two cases:

- If the transaction is controlled and the amount of expenses is evidenced in the report on controlled transactions and transfer pricing documentation.
- If the transaction is not controlled, but the amount of expenses is confirmed in accordance with the arm’s length price rules, under the procedure established by Article 39 of the Tax Code, without filing a transfer pricing report.

In conclusion, a taxpayer will have to calculate the price by applying transfer pricing methods (that is, prepare transfer pricing documentation) to deduct 100% of its expenses on transactions with residents of the listed states.

**TRANSFER PRICING REPORTING AND DOCUMENTATION**

**Transfer pricing reporting**

Taxpayers with a volume of controlled transactions with one counterparty exceeding UAH5 million (excluding VAT) must submit a report on controlled transactions to the central fiscal authority. Taxpayers must submit such report by electronic means in accordance with the established form by 1 May of the year following the reported year.

**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.

The new rules establish an obligation for taxpayers to keep transfer pricing documentation. Taxpayers must submit transfer pricing documentation within a month from the day of receipt of a request from the central fiscal authority. The central fiscal authority can request such information after the 1 May of the year following the reported year, if controlled transactions were carried out.

The transfer pricing documentation must contain the following information:

- Information on related parties, in particular, on counterparties to the controlled transaction and any other related party that (directly or indirectly) holds 20% or more of the shares in the taxpayer.
- 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;
  - assets used by them in connection with the controlled transaction; and
  - economic (commercial) risks that those parties took into consideration during the controlled transaction (functional analysis and risk analysis).
- Economic analysis, including the:
  - methods used to determine the price of a controlled transaction and an explanation of the reasons for selecting that particular method;
  - amount of income (profits) earned and/or the amount of expenses (losses) incurred as a result of the controlled transaction;

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- level of profitability;
- calculation of the market price (profitability) range in respect of a controlled transaction (including a description of the approach used to select comparable transactions); and
- sources of information used to substantiate the price of controlled transactions.

- Results of the comparative analysis of commercial and financial conditions of transactions.

- Information on the proportional adjustment of the tax base and tax amounts made by the taxpayer (if any).

**TRANSFER PRICING AUDITS**

The central fiscal authority of Ukraine has created a monitoring department that is in charge of transfer pricing control. Transfer pricing control is carried out through both:

- Monitoring of prices in controlled transactions through observation of the prices and by way of analysis of the transfer pricing documentation.

- Conducting special tax audits of controlled transactions.

The central fiscal authority must establish the procedure for the monitoring of prices in controlled transactions (Article 39, paragraph 39.5, Tax Code of Ukraine). However, no such formal procedure for monitoring has been adopted yet. Despite the absence of a formal procedure, the fiscal authority conducts the audits of controlled transactions according to the standard procedure provided for other types of audits.

The new rules extend the duration of audits, which can now last for 18 months, with a possible extension of 12 months.

Based on the results of the audits, the fiscal authority can apply penalties for non-submission of transfer pricing report and/or mandatory transfer pricing documentation, as well as for failure to report controlled transactions. The penalties are as follows:

- An amount equivalent to a 300 times the minimum wage, as set out on 1 January of the reporting year, in the case of non-submission or late submission of the report on controlled transactions. Under the Law No. 80-VIII of 28 December 2014 on State Budget for 2015, the minimum wage is fixed at UAH1378 per month. Therefore, this penalty currently amounts to UAH413,400.

- 1% of the value of the controlled transactions that were not reported. The maximum amount of such penalty is limited to 300 times the minimum wage (that is, UAH413,400).

- 3% of the value of the controlled transactions regarding which a taxpayer failed to provide mandatory transfer pricing documentation. The maximum amount of such penalty is fixed as 200 times the minimum wage (that is, UAH275,600).

Apart from the penalties above, following the results of the transfer pricing audit, the taxable base can be adjusted and the penalties for understating tax liabilities applied (that is, 25% of the assessed amount of tax for the year).

Under the Tax Code of Ukraine, officials of the central fiscal authority are entitled to interview the taxpayers' authorised persons and employees for their analysis of the transfer pricing report or documentation. The purpose of these interviews is to obtain additional information on controlled transactions. The central fiscal authority must establish the procedure for such interviews, but there is no such procedure yet. The fiscal authority can request additional information and conduct interviews of employees (authorised persons) of all parties to controlled transactions, including non-residents of Ukraine. In addition, taxpayers are responsible for providing the fiscal authority with an opportunity to conduct such interviews. The fiscal authority is also entitled to carry out “counter-audits” (that is, transfer pricing inspection of counterparties in controlled transactions). However, this provision is unlikely to apply in practice, as the rules only apply to transactions with non-residents from January 2015.

**ADVANCE AGREEMENTS**

Improved rules on advance agreements on prices are set out in paragraph 39.6 of Article 39 of the Tax Code. Such advance agreements are only available to large taxpayers. Large taxpayers are legal entities that either (Tax Code):

- Reported income exceeding UAH500 million in the results of their last four consecutive reporting quarters.

- Paid to the budget more than UAH20 million during the same period.

An advance agreement is a procedure between large taxpayer(s) and the central fiscal authority during which the parties agree on the criteria to be used for establishing whether the conditions of future controlled transactions are at arm’s length.

A large taxpayer and the central fiscal authority can agree on the following matters:

- The types and list of goods (works, services) that are subjects of the controlled transactions.

- The methods of establishing compliance of the controlled transactions with the arm’s length principle.

- The list of pricing information sources to be used for establishing that the conditions of the controlled transactions are at arm’s length.

- 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 outcome of the procedure is fixed in the agreement.

The procedure for concluding an advance agreement can involve the authorities of a foreign state if there is a double tax treaty in force between Ukraine and the relevant state.

If the taxpayer complies with the advance agreement, the fiscal authority will not have the right to assess additional tax liabilities and apply sanctions with respect to the controlled transactions that are covered by the agreement.

The new detailed procedure for advance agreements is to be adopted by the CMU.

**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 tax results of transactions up to the level of arm’s length prices. Taxpayers can implement this self-adjustment using 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 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 for the related party as a result of a special tax audit, or the tax liabilities as determined by applying the mechanism of self-adjustment, are fully paid to the budget. However, when there is a non-resident related party, proportional adjustment must be carried out in accordance with the procedure established under double tax treaties in force (Article 39, subparagraph 39.5.5.1, Tax Code of Ukraine).

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