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# Specifics of Legal Regulation of the Control over Transfer Pricing within the Relations of Large Taxpayers

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**This article explores specialties of the administrative and legal regulation of transfer pricing within the relations of large taxpayers. Efficient legislation in this area is analyzed; the positive effects of state regulation of transfer pricing are grounded. It is observed that the control over transfer pricing is the most effective method amongst all well-known ones striving to overcome the flight of capital out of the country. The simplification of the procedure to reimburse the non-accrual tax amounts while optimizing tax obligations is proposed.**

**Keywords:** large taxpayers, tax control, transfer pricing, controlled operations, price harmonization

The flight of capital out of the measures of economic jurisdiction of any country is a priori negative phenomenon. The problem of the continuous drain of funds by large segments of business elements (large taxpayers) to other states is a great danger for economic and political stability, and the social welfare of all the population. This financial drain is a major cause of the deficit of the state budget of Ukraine because by taking money out of the country the entrepreneur deprives the latter of the possibility of imposing taxes upon the profits received in the territory of our country, and the shares of money turnover to all Ukrainian subjects.

It is obvious that in this situation many foreign and transnational companies rely on international tax legislation. That is why all the world government officials are interested in the issues on transfer pricing. The international trade mechanisms are mainly used for taking the income out to companies registered in foreign countries which have lower tax rates or do not include some kinds of profits to the tax base.

In general, the phenomenon of transfer pricing emerged in the second half of the 20<sup>th</sup> century due to the foundation of large transnational corporations and the intensification of international trade. Some companies (units) existing within the same holding company (companies) provide each other with services, distribute

production, sell goods not at cost but at specific passing (transfer) prices. The transfer pricing instruments allow transnational corporations or industrial and financial groups to withdraw financial resources beyond the national economy and accumulate them within the economies of other countries in accordance with their strategies, as well as to minimize their tax obligations. As a result, it reduces the financial capacity of the national economy and negatively affects the amount of revenues arriving to the state budget of Ukraine. The return of this capital to Ukraine in the form of loans, direct or portfolio investment does not restore the country's financial potential in full because such processes are often accompanied with budget losses caused by the usage of so-called optimization tax schemes, as well as related to the constitution of additional external obligations in the form of costs on the maintenance of debt and dividends [Gryb, 2013: 29]. Thus, transfer pricing is to be defined as distortions of price contracts or distribution of profits or expenses in order to minimize the tax burden.

The unconditioned redistribution of taxable profits by corporations has induced some states to seek ways of settling this issue within national jurisdictions. Ukraine has also initiated the introduction of control over transfer pricing, and is ready to deepen cooperation and exchange of experiences in the fight against tax fraud and international minimization of taxes [10].

It should be noticed that transfer pricing regulation mechanisms are used to ensure that transfer prices are to be consistent with market prices established in the open market and used by independent parties. Under these circumstances, taxpayers have to pay taxes in the part where their profit is economically grounded but, at the same time, they should not change the prices or conditions of their business activities. Consequently, taking into account the transfer pricing rules, the state has the ability to protect its economic interests and make businesses pay an income tax in the territory where the entities receive it.

Amongst all the known methods, the control over transfer pricing is the most effective. Its optimal usage depends both on the development of domestic legislation and the establishment of international cooperation. This should be done in order that Ukrainian tax authorities may apply to a non-resident of the country involved in the taxpayer's household purchases (sales) of goods (works, services), for example, requesting the real value of proper transactions.

In particular, the Organization for Economic Cooperation and Development provides the governments of its Member States with guidelines for the study, development and improvement of social and economic policy. These concern the ways to solve common problems and contain positive experiences and advice on the coordination of domestic and international policies [Shpakovych, 2010: 30]. European countries having advanced legislation in the field of transfer pricing are united by the fact that all of them use the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations developed by the Organization for Economic Cooperation and Development as its basis. The legislation of various European countries contains most of the provisions of this document. However, the latter is not mandatory.

On 1 September 2013 the Law of Ukraine 'On Amendments to the Tax Code of Ukraine on Transfer Pricing', adopted on 7 July 2013, came into force. As of 7 August 2013 that regulatory act was published, legal scientists have warned that, unfortunately, the law of Ukraine is still far from the European standards of transfer pricing because the legislation development is considered in conjunction with the policy to combat profit outflow to offshore zones and the implementation of wealth taxes. So, the stress is mainly laid on internal law-enforcement practices with the introduction of some international developments [Iesyk, 2013: 30].

The main provisions of the adopted Law define the concept of 'transfer pricing'; establish the mechanisms of tax control over transfer pricing; determine the transactions to be monitored and methods of pricing therein; and, in particular, confer to large taxpayers the right to previous mutual arrangements of prices within the controlled transactions for a specified period with the central state tax authority. This Law contains such categories as 'related parties' and 'comparable transactions' that arouse much interest. Thus, enacting the amendments to the Tax Code the Government introduced in Ukraine the mechanism of transfer pricing in transactions between related parties including operations with contractors registered in offshore zones that, in its opinion, promotes the realization of the basic principles of tax law and prevents losses to Ukrainian state budget revenues.

According to the innovations, transfer pricing has been determined to be a system of defining the regular prices of goods and/or results of works (services) within those operations recognized as controlled under Article 39 of the Tax Code of Ukraine. The tax control over transfer pricing envisages the harmonization of taxpayers' obligations with the tax liabilities determined when the commercial and/or financial conditions of controlled transactions are compatible with the commercial and/or financial conditions applied during comparable transactions (specified in the above-mentioned Article) whose parties are not related ones. The Subsection 39.2.1.4. of Article 39 of the Tax Code defines the transactions, determined in subsections 39.2.1.1. and 39.2.1.2. of Article 39 of this Code as controlled ones, to be controlled only if the total amount of the taxpayer's transactions with each counter-party is equal to or exceeds UAH 50 million (excluding VAT) per a certain calendar year. The tax authority analyzes comparable transactions within the controlled operations in order to identify higher levels of taxpayer income for the purposes of taxation.

In order to control transfer pricing, the Law provides five methods of determining the prices within controlled operations:

1. Comparable uncontrolled price (analogues of sales) method. According to this method, transfer prices are based on the prices for identical/comparable goods under similar circumstances.

2. Resale price method. This envisages that transfer prices are determined due to the price of the resale of goods to non-related parties including deduction of taxpayers' expenses for such a resale.

3. 'Expenses plus' method. This method foresees that the price within the operation is to be determined as the whole sum of appropriate expenses (direct and indirect) and market extra charge. It is used for the services provided inside a group, and other operations between related parties.

4. Net profit (margin) method. Pursuant to the latter, the price is based on the comparison of the net profit of a controlled operation with the net profit of a non-controlled one. This method can be applied if the information on comparable transactions is insufficient.

5. Profit allocation method, which allows for the market distribution of income between counter-parties to the transaction. This method is used when there is a chain of closely related operations, as well as the significant impact of intangible assets on transfer pricing.

The taxpayer uses any method he/she reasonably believes to be the most appropriate one but in cases when it is possible to use both the comparable uncontrolled price (analogues of sales) method and any other method, the method of comparable uncontrolled price is to be used. For that end, the market prices range is calculated. The insurance rate price shall be determined in accordance with the Order of the National Commission for the state regulation of financial service markets № 4370 of 28 November 2013 'On Approval of the Methodology for Determination of the Insurance Rate Price' [2]. The methodology for pricing of banking services is approved by the National Bank of Ukraine and the executive authoritative body that implements the state tax policy.

It is clear that annual conduction of the operations which, according to Article 39 of the Tax Code of Ukraine, are recognized as controlled ones is possible only for medium and large businesses. The operations between medium enterprises and other contractors amounted to USD 50 million are responsible and rare for them. However, large taxpayers which play an important role for the state budget conduct such transactions within the framework of most relationships with the contractors. Therefore, it is worthwhile to consider the right of the large taxpayer to apply to the executive authoritative body ensuring development and implementation of state tax policy for the coordination of prices in the controlled operations. That procedure, involving a large taxpayer (or taxpayers) and tax authoritative body, determines the order of pricing in controlled operations for a limited period in accordance with the unilateral contract.

Transfer pricing is also put under tax control. Taxpayers that have conducted controlled operations during the reporting period (a calendar year) are required to submit a report on such operations to the tax authoritative body before 1 May every year. The order to consolidate the report on controlled operations and the form of such a report are prescribed by the Order of the Ministry of Revenue and Duties of Ukraine № 669 of 11 November 2013 'On Approval of the Form and Order of Consolidation of the Report on Controlled Operations' [1].

In the case of when the tax authoritative body, performing the functions of tax control, identifies the facts concerning the taxpayer's controlled operations which have not been reported, it informs the tax authorities thereof. A taxpayer which was under the tax control shall be informed by message concerning the identified controlled operations within a period of 10 days. Under the circumstances specified in Article 78 of the Tax Code of Ukraine, the central tax authoritative body has the right to request a submission of documentation on controlled operations from the taxpayers which conducted controlled operations during the reporting period. The request is sent to the taxpayer at the earliest on 1 May of the year following the calendar year when such an operation (operations) was conducted.

During two months from the day after the day on which the request is received, the large taxpayers are obliged to submit do-

documentation (a number of documents or a unified instrument drawn up in arbitrary form) on controlled operations specified in the request. This documentation should include the following: a) the information on related parties that allows their identification (including the names of states/territories where the relevant parties have their tax residence); b) the information about the group (a set of related economic entities) including its structure, description of activities, and transfer pricing policy; c) the description and conditions of the transaction (its price, time limits and other mandatory provisions of agreements/contracts determined by Ukrainian legislation); d) the description of goods (works, services) including their physical characteristics, quality and image in the market, country of origin and producer, the presence of trademark, and other data concern the qualitative characteristics of goods (works, services); e) terms and time limits for payments on the transaction; f) factors that influenced the formation and determination of the price.

Taking into account the scope and nature of the required reports, legal scientists point out that the implementation of the Law on transfer pricing in a company should involve tax, information and technical, judicial, commercial (financial) departments, an accounting department and the one to be responsible for budget planning and financial analysis, and foresee the need for scope and spheres of outsourcing in advance [Polianskyi, 2013: 29].

The tax authorities can also carry out a special audit on transfer pricing using it as one of the major control measures. The audit on transfer pricing may be performed in the event of submitting inaccurate reports and documentation, and identification of the controlled operation which was not carried out at usual prices. In particular, the failure to report controlled transactions causes the imposition of a fine equal to 5% of the controlled transactions' amount. The non-fulfillment of the requirements for filing documentation on transfer pricing by large taxpayers entails the imposition of a fine of 100 minimum wages (UAH 114 700 as of 1 September 2013). If the tax authorities identify that the prices of the controlled operation deviated from the normal (market) ones, the taxpayer should pay a fine of 25% of the tax amount subject to payment to the amount of adjustment (which equals to 50% in the case of repeated violations during 1 095 days) [Stetsenko]. We should note that till 1 September 2014 this fine shall be imposed in the amount of UAH 1 regardless of the amount of adjustment in accordance with Item 20 of Subsection 10 of Title XX of the Tax Code of Ukraine.

In contrast to Ukraine, some countries have decided to motivate business for providing documents and information on transfer pricing in other ways. Thus, in Russia the fine for failure to file such a report does not exceed USD 200, and the timely submission of accurate documentation is the grounds for releasing a subject from fines in the future [Steblevskiy, 2013: 9].

In addition to considerable fines, the legal regulation of transfer pricing procedure contains a number of inconsistent provisions. In particular, the Law of Ukraine 'On Amendments to the Tax Code of Ukraine on Transfer Pricing', enabling large taxpayers to agree prices in controlled operations with the tax authoritative body, does not strictly prescribe the order and procedure of such agreements (e.g., the term of reviewing the application of a large taxpayer on the procedure initiation and the utmost duration of this procedure). We believe that by adopting the provision on the unilateralism of such contracts, lawmakers stressed that the tax authoritative body, in having relationships with a payer, can provide them with service functions that confirm the taxation.

It should be emphasized that a significant amount of controlled operations results in a large volume of information received by controlled bodies. Therefore, it is possible that during a certain period of time the subdivisions of the tax authoritative body cannot efficiently process the obtained data. That may lead to a decrease in the efficiency of tax control over transfer pricing at the initial stages of its implementation.

In spite of a still imperfectly tested system of transfer pricing for certain spheres, in particular, for the banking sector, the usage of transfer prices for a fair financial evaluation of the banks' units is one of the most effective ways of using this type of pricing. Transfer pricing can also be a versatile tool for constructing an

effective system of internal financial management of banking institutions based on internal cost accounting [Savchenko].

Summarizing we should note that the peculiarities of the legal regulation of transfer pricing control over the relationships of large taxpayers are characterized with the actual establishment of the full accountability of large taxpayers before the tax authoritative body regarding the details of economic relations of the companies with all significant counter-parties and full information thereof. In order to achieve the purpose of transfer pricing in full, it is reasonable to elaborate a detailed procedural by-law basis to minimize the withdrawal of capital out of the country. The mechanism of reimbursement of the non-accrual tax amounts would also be extremely effective while destroying the schemes of income withdrawal. The condition for that is the harmonization of tax obligations with tax liabilities calculated due to the compliance of commercial and/or financial conditions of a controlled operation with the commercial and/or financial conditions observed during the fulfillment of comparable transactions whose parties are not related ones defined by the Tax Code of Ukraine (Article 39). Such compensation may be based on the adjusted tax obligations of a taxpayer, provided within the framework of tax control over transfer pricing, and made by way of the imposition of additional tax obligations. □

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