

**Tax Alert – 18.05.2017**



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1. Notification on Controlled Transactions

**According to Article 105.16 of the Russian Tax Code, Russian taxpayers should notify the tax authorities about controlled transactions made in 2016 no later than on 20 May 2017**

1. Which kind of transactions is recognized as controlled?
2. Who should report?
3. What should be reported?
4. What problems and sanctions may face a taxpayer who fails to comply with such rules?

1. Which kind of transactions is recognized as controlled?

“Controlled transactions” are those operations which are concluded between the following related parties<sup>1</sup> according to the conditions specified in the table below (“Table 1”)

Table 1

#	Parties	Country of residence of the other party involved in the analyzed transaction	Threshold income amount per year/counterparty
1	Related parties	Russia	From 1 bln rubles
2		International territory	Not prescribed

<sup>1</sup> Article 105.1 of the Russian Tax Code lists a detailed set of parameters, according to which two parties of an agreement may be recognized as “related parties”: the main parameter consist in: a) direct or indirect participation of one company into the other for an amount exceeding 25% of the latter’s share capital and: b) actual control of one party on the other, by means of personal relations or delegation of decisional powers.

3	Related parties through third non-related parties if these parties do not perform any additional functions, do not take risks and do not use any assets	Russia	Not prescribed
4		International territory	Not prescribed
5	Parties in the field of foreign trade in mineral goods of world exchange trade <sup>2</sup>	Russia	N/a
6		International territory	From 60 mln rubles
7	A party with a place of registration / residence / tax residence in an “off-shore” state, as well as a permanent representative office of a Russian company in such states <sup>3</sup>	Russia	N/a
8		International territory	From 60 mln rubles
9	Related party who pays the extraction of minerals tax if the object of the transaction is a taxable extracted mineral and the tax rate is established as a percentage	Russia	From 60 mln rubles
10		International territory	N/a
11	Related party applying a special tax regime <sup>4</sup>	Russia	From 100 mln rubles
12		International territory	N/a
13	Related party exempted to pay the profit tax or applies a 0% tax rate, based on Clause 5.1 Article 284 of the Tax Code <sup>5</sup>	Russia	From 60 mln rubles
14		International territory	N/a
15	Related party - resident of a special economic zone	Russia	From 60 mln rubles
16		International territory	N/a
17	Related party who has licenses to use a new offshore hydrocarbon deposit or acts as an operator of such a deposit	Russia	From 60 mln rubles
18		International territory	N/a

<sup>2</sup> Clause 5 Article 105.14 of the Tax Code

<sup>3</sup> List of “off-shore” states is approved and published by the Russian Ministry of Finance

<sup>4</sup> The following special tax regimes are taken into consideration: the tax for producers of agricultural goods (the unified agricultural tax), or the unified tax on imputed income for certain types of activity

<sup>5</sup> According to 244-FZ "On the Innovation Center of Skolkovo"

19	Related party - participant in a regional investment project who applies a 0% income tax rate	Russia	From 60 mln rubles
20		International territory	N/a
21	Related party - a research corporate center <sup>6</sup> VAT-exempted	Russia	From 60 mln rubles
22		International territory	N/a

However, it should be noted that the Tax Code provides for several exclusions from the application of the above mentioned rules on “controlled transactions”.

## 2. Who should report?

Each company being a Russian taxpayer has to prepare and submit a notification to the Russian tax authorities on all “controlled transactions” conducted in 2016.

Regardless, whether the taxpayer received income within the controlled transaction or incurred expenses, each party of the controlled transaction must notify the tax authorities about such transaction.

## 3. What should be reported?

The notification should include certain information on controlled transactions, namely<sup>7</sup>:

- 1) Calendar year, for which information is provided on controlled transactions
- 2) Items of controlled transactions
- 3) Information on participants of controlled transactions:
  - Full name of the company, Russian identification number of the taxpayer (in case the company is registered in Russia)
  - Surname, name, patronymic of the individual entrepreneur and his taxpayer identification number
  - Surname, name, patronymic and citizenship of an individual who is not an individual entrepreneur
- 4) Income amount received and (or) amount of expenses incurred within controlled transactions with a separate indication of amounts related to prices subject to official regulation.

The information may be prepared in relation to a group of homogeneous transactions.

## 4. What problems and sanctions may face a taxpayer who fails to comply with such rules?

If a taxpayer does not provide a notification on controlled transactions within the required deadline or files incorrect data in the notification submitted, the tax authorities may apply sanctions to a taxpayer, including:

- Penalty of 5,000 rubles if the notification is not provided within the deadline and/or contains incorrect information<sup>8</sup>;
- Additional tax of 40%, but not less than 30,000 rubles, of tax underpaid caused by applying in controlled transactions for tax purposes commercial conditions which are not comparable with identical or similar commercial conditions of transactions between non-related parties<sup>9</sup>;

<sup>6</sup> According to 244-FZ "On the Innovation Center of Skolkovo"

<sup>7</sup> Clause 3 Article 105.16 of the Tax Code

<sup>8</sup> Article 129.4 *ibid.*

<sup>9</sup> Article 129.3 *ibid.*

- Penalty of 300–500 rubles to the responsible executive officer for non-compliance with the requirements of tax legislation<sup>10</sup>.

**In addition to these penalties, upon recognition of undeclared “controlled transactions”, either during the course of an ordinary tax review, or in connection with tax monitoring procedures, tax authorities may activate a special transfer pricing tax audit<sup>11</sup>.**

The aim of such specific tax audit would be to challenge the impact of such controlled transactions into the taxpayer’s tax declarations referred to the tax period, in which such transactions were executed, with special regard to:

- 1) Deductibility of costs;
- 2) Level of related revenues;
- 3) Calculation of related taxes (CIT, VAT, other applicable taxes, depending on the taxpayer’s tax regime).

## 2. Transfer Pricing Documentation

*Starting from 1 June 2017, the tax authorities may request the supporting transfer pricing documentation (hereinafter - "TP documentation"), in order to check the compliance of transfer prices used in controlled transactions conducted in 2016 with Russian TP rules.*

1. TP documentation – what is it?
2. Why TP documentation may be requested?
3. Why is it worth preparing TP documentation in advance?

### 1. TP documentation – what is it?

TP documentation is a set of documents or a single document prepared in free form and containing at least the following information:

*Table 2*

<b>Information on parties involved in the transaction</b>	A list of parties (indicating their country tax residency)
	Functions of the parties (if a taxpayer carried out a functional analysis)
	Assets used within the controlled transaction
	Economic (commercial) risks assumed by parties which a taxpayer took into consideration when concluding the transaction
<b>Information on controlled transaction</b>	Transaction description
	Transaction conditions
	Description of pricing methods applied (if any)
	Payment conditions and timing

<sup>10</sup> Article 15.6 of the Commercial Procedure Code

<sup>11</sup> Article 105.17 of the Tax Code

<b>Information on the methods<sup>12</sup> applied</b>	Explanation of the reasons for the choice of method applied and the manner it was used
	Indication of materials/information sources used
	Computation of the market price range (profit margin range) with a description of the approach used for the selection of comparable transactions
	Amount of income received and (or) the amount of expenses incurred as a result of the controlled transaction, and the profit margin obtained
	Information on the economic gain received from the controlled transaction
	Information on other factors which influenced the price (profit margin), including information on the market strategy of a taxpayer if such market strategy influenced the final price (profit margin)
	Adjustments made by a taxpayer to the tax base and to related amounts of taxes (or losses) <sup>13</sup>

A taxpayer may provide other information which demonstrates that the commercial and (or) financial conditions of controlled transactions are consistent with those applied in comparable transactions, which were concluded between independent parties “at arm’s length” condition<sup>14</sup>.

The level of documentation detail and its reasonableness should be consistent with the transaction complexity and the manner of price determination<sup>15</sup>.

## 2. Why TP documentation may be requested?

TP documentation can be requested only by the Federal Tax Service of Russia within the frame of a special tax audit of transactions between related parties, based either on the notification on controlled transactions submitted by a taxpayer, or as a consequence of an ordinary tax review or of tax monitoring process<sup>16</sup>. **Thus, the obligation to submit the requested documentation may arise due to an official tax request.**

However, a taxpayer is always welcome to provide TP documentation on a voluntary basis.

The Federal Tax Service cannot request documentation on transactions between related parties without appropriate tax audit. Meanwhile, a taxpayer must be notified by the inspection within three days from the date of the decision on audit, which should not, as a general rule, exceed six months.

In the following cases, TP documentation may not be claimed at all:

- 1) The transaction price is regulated by the state authorities
- 2) The transaction is conducted between non-related parties
- 3) The transaction relates to an organized securities or derivatives market

<sup>12</sup> A list of methods is provided in Chapter 14.3 of the Tax Code

<sup>13</sup> In accordance with clause 6 of Article 105.3 *ibid.*

<sup>14</sup> Clause 2 Article 105.15 *ibid.*

<sup>15</sup> Clause 6 Article 105.15 *ibid.*

<sup>16</sup> Article 105.17 *ibid.*

- 4) Parties have concluded a specific “Transfer Pricing Agreement” with Federal Tax Service with respect to a certain group of transactions<sup>17</sup>.

### 3. Why is it worth preparing TP documentation in advance?

Starting 2017, penalties and late payment interest have been doubled by Federal Law N 401-FZ, which increases the probability of initiating pricing audits by the tax authorities and the risk materiality of such audits.

In this regard, we recommend to prepare TP documentation, since the submission of documentation justifying the market level of applied prices within controlled transactions will exempt a taxpayer from liability for tax underpayment<sup>18</sup>.

*We will be happy to assist you in preparing the notification on controlled transaction and all related TP documentation!*

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<sup>17</sup> According to a specific provision available for major taxpayers contained in Chapter 14.6 of the Tax Code

<sup>18</sup> Clause 2 Article 129.3 *ibid*.