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# Impact of new transfer pricing legislation on automotive industry

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#### Key changes in the Transfer Pricing legislation

On July 18, 2011 the RF President signed Law 227-FZ also known as the Transfer Pricing Law (hereinafter – the Law); the Law introduces significant changes to tax regulation of transfer pricing:

- The list of related Parties has been extended
- The list of controlled transactions has been revised
- Transfer pricing methods have been expanded
- The “admissible” 20% deviation from the market value is missing. Instead, a term of arm’s length range within the limits of which the price is deemed to be at the market level was introduced
- Additional obligation for the taxpayer was introduced:
  - Inform the tax authorities on controlled transactions
  - Prepare transfer pricing documentation; any failure to provide it will be penalized
- Protective measures: correlative adjustments, advance pricing agreements, consolidated taxpayers group
- Special tax audits

### List of controlled transactions

| Controlled transaction           |   | These transactions are controlled when their annual volume exceeds <sup>1</sup> : |
|----------------------------------|---|---|
| <b>Cross-border transactions</b> | 1. between related parties  | No threshold <sup>2</sup>   |
|                                  | 2. with commodities quoted on exchanges   | RUB 60mln (about EUR 1.4 mln) <sup>2</sup>  |
|                                  | 3. with a party-resident of a “black-listed” offshore   |   |
| <b>Domestic transactions</b>     | 1. between related parties  | RUB 2bln (about EUR 45.5 mln) <sup>3</sup>  |
|                                  | 2. between related parties if one party is subject to: <ul style="list-style-type: none"> <li>■ mineral extraction tax</li> <li>■ corporate profits tax at 0%-rate or CPT exemption</li> <li>■ residency in a special economic zone providing CPT exemption for its residents <sup>4</sup></li> </ul> | RUB 60mln (about EUR 1.4 mln)   |
|                                  | ■ special tax regime <sup>4</sup>   | RUB 100mln (about EUR 2.3 mln)  |

<sup>1</sup> Volume thresholds are calculated based on all transactions with one party within a year

<sup>2</sup> In 2013 cross-border transactions should be documented if their volume exceeds RUB 80mln (about EUR 1.8 mln)

<sup>3</sup> The threshold is applicable in 2013 only. Starting from 2014 the threshold will be RUB 1bln (about EUR 23 mln)

<sup>4</sup> Applicable from 2014

#### Uncontrolled transactions

1. Transactions between members of a consolidated taxpayer group
2. Transactions between parties that meet **all** of the following criteria **at a time**:
  - registered in the same region of the Russian Federation
  - have no separate units in other RF regions / outside the RF
  - do not pay any profit tax to budgets of other RF regions
  - have no losses
  - do not execute transactions controlled in the case either party to the transaction pays MET (%); either party to the transaction is profit tax exempt (or pays profit tax at the rate of 0%); either party to the transaction has been registered in special economic zone; either party to the transaction applies special tax regimes (UTII or SAT)

#### Transactions where the prices may not be documented

1. Transactions where the prices are in compliance with directions of anti-monopoly authorities
2. Controlled price transactions
3. Transactions with securities and transactions with publicly traded derivatives
4. Transactions with respect to which advanced pricing agreement has been made

| TP method  | Examples of controlled transactions   |
|--|---|
| 1. Comparable Uncontrolled Price (CUP) - priority method | <ul style="list-style-type: none"> <li>■ sales of commodities quoted on exchanges</li> <li>■ existence of sales to third parties as well as to related parties</li> </ul>   |
| 2. Resale price method                                   | <ul style="list-style-type: none"> <li>■ resale of goods</li> </ul>   |
| 3. Cost plus method                                      | <ul style="list-style-type: none"> <li>■ provision of management, engineering, processing and other services</li> </ul>   |
| 4. Transactional net margin method (TNMM)                | <ul style="list-style-type: none"> <li>■ transactions to which methods 2 and 3 cannot apply due to lack of the necessary information</li> </ul>   |
| 5. Profit split method                                   | <ul style="list-style-type: none"> <li>■ transactions to which methods 1 – 4 cannot apply,</li> <li>■ transactions the parties to which are holders of ownership rights to <u>intangible assets</u> that materially <u>affect the level of profitability</u></li> </ul> |

*Methods 2-5 may only be applied if CUP method is not applicable or if application of CUP method would not allow to make a reasonable conclusion on compliance/incompliance of actual prices with the arm's length prices*

*For each type of controlled transactions the most relevant TP method can be chosen. Alternatively, a combination of several TP methods can be applied to a specific controlled transaction*

### Transfer pricing documentation requirements

#### Taxpayers will be obliged to:

- Notify tax authorities about controlled transactions
  - For 2012 - till 20 November 2013
  - For 2013 and next years - till 20 May of the next year
- Document prices applied in controlled transactions
  - For 2012 - till 01 December 2013
  - For 2013 and next years – till 01 June of the next year
- Content of TP documentation is similar to OECD model, BUT
- Russian TP authorities require disclosing a number of additional details
- Penalty = 40% of underpaid tax, if no TP documentation is prepared and TP adjustment is made

### Transfer pricing audits

- The TP Law suggests a new type of tax audit, i.e. TP audits
- Federal Tax Service hired a dedicated team of TP experts to perform TP audits
- TP audits may last for 6 months (or 12 months in exceptional circumstances)

In 2013 a cross-border transaction must be documented if an amount thereof exceeds RUB80 million

Starting 2014 – no limit for cross-border transactions with related parties

In 2012 -2013 no penalties will be applied, in 2014 – 2016 penalties will account for 20% of the outstanding amount of taxes

### 1. Correlative adjustments

- If the tax base and amount of tax payable by either party to a transaction was adjusted as a result of a tax audit, the other party to the transaction shall have the right to make the respective correlative adjustment
- Applicable only to transactions in the domestic market
- The application procedure is unclear

### 2. Advance pricing agreement

- The subject matter of such agreement may be types and/or lists of controlled transactions, pricing procedures, and/or procedures for application of pricing methods
- This protective measure is available only for major taxpayers
- These agreements may be entered into starting from 2012 to be valid for 3 years (with the right of extension for 2 years)
- A fee for entering into an agreement equals to RUB1.5 million
- The TP Law provides for a possibility of making multilateral agreements

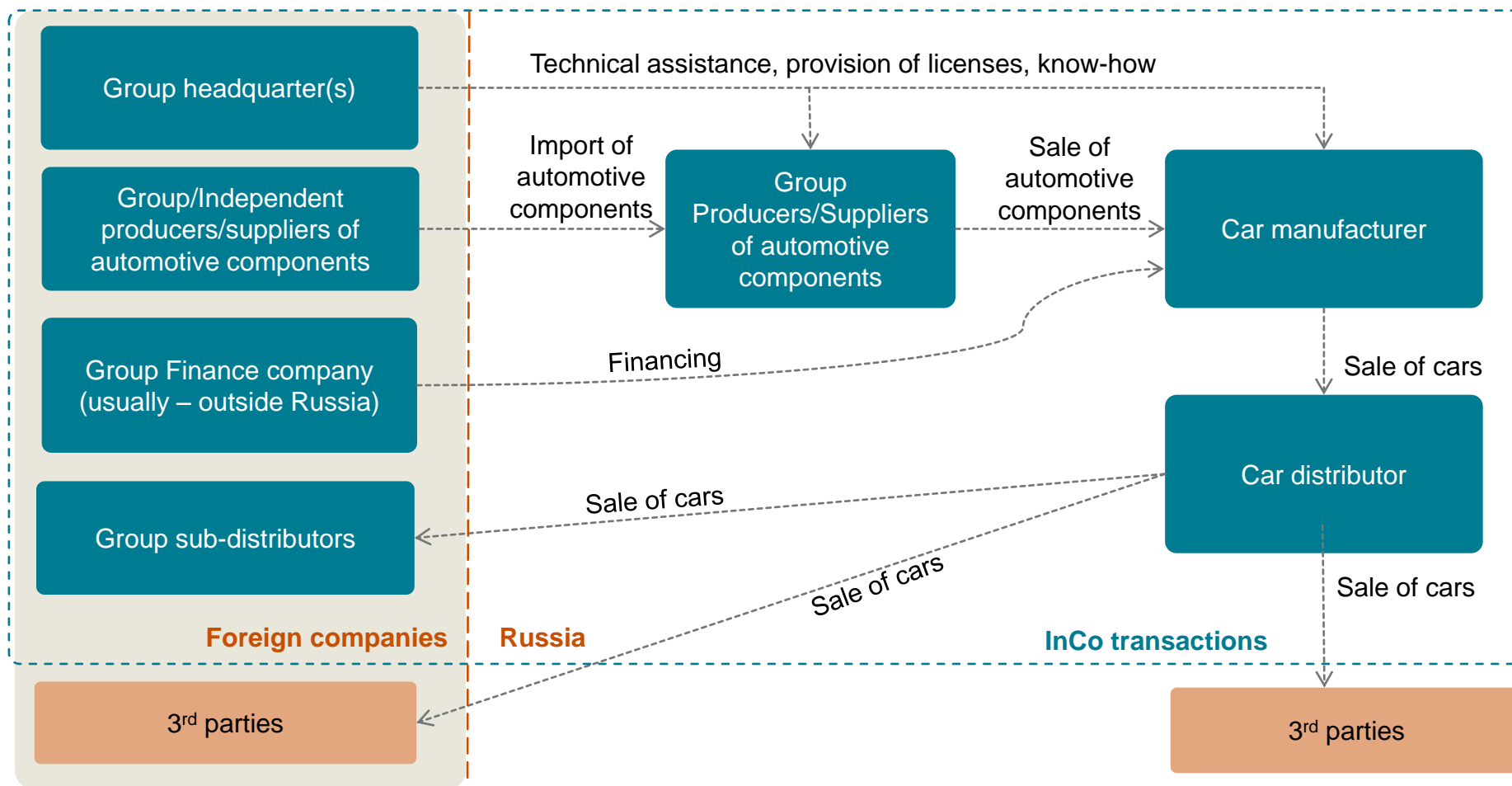
### 3. Consolidated taxpayer group

- Only major taxpayers structured via Russian holding may be recognized as consolidated taxpayer group
- Consolidation criteria (all criteria need to be complied with):
  - Share (interest) > 90%
  - Amount of taxes due from the group > RUB10 billion
  - Income of the group > RUB100 billion
  - Value of the group's assets > RUB300 billion



# Impact of new transfer pricing legislation on automotive industry (1/2)

## Scheme of business of large multinational car manufacturer



**Large number of significant ICO transactions >> more issues to consider for transfer pricing purposes >> increase of tax risks and reporting obligations**



- Recently, the tax authorities pay special attention to transfer pricing issues in automotive industry (Mazda Motor Rus case, case of Suzuki Motor Rus)



- Risk of TP audit
- Necessity of substantiation of prices/margin/mark-up applied in the controlled transactions >> TP documentation/policies

- Significant number of ICO transactions, including transactions with foreign related parties



- Careful TP planning
- Preparation of TP documentation >> is a time consuming process
- Development of TP internal policies, adjustments of accounting systems

- NO corresponding adjustments could be made in respect of transactions with foreign related parties



- Risk of cash outflow

- Losses of the group companies



- Significant risk of TP audit
- Necessity of careful substantiation of loss position for TP purposes

- Requirements for establishment of consolidated taxpayer group are not met
- Branches in various regions of Russia

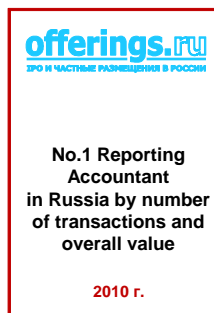


- In practice, protective measures to prevent adverse effects of TP legislation are not applicable to many companies operating in automotive sector

- Usually, no CUP is applicable to sale/purchase transactions of automotive components
- Close interconnections of ICO transactions
- Oligopoly market >> small number of comparable independent companies



- Choice of tested party
- Choice of relevant TP method. Application of Profit split method?
- Difficult to find comparable companies





### About us:

- KPMG has **the most extensive practice in transfer pricing in Russia** among audit and advisory companies.
- KPMG has a substantial experience in realization of transfer pricing projects (including preparation of transfer pricing documentation) **for companies from automotive industries** both in Russia and outside its borders, and has practical understanding of the companies business. More than 100 transfer pricing studies performed since 2007;
- Mikhail Orlov, tax partner, **chairman of the Tax Law Expert Council of the Budget and Tax Committee of the Russian State Duma**, may be involved in this project as an expert. Mikhail has participated in discussing and improving the legislation on transfer pricing control;
- KPMG team has access to and extensive experience in working with specialized databases that contain financial information on Russian (SPARK, RUSLANA) and foreign (Amadeus, ORIANA) companies;
- In 2012-2013 KPMG was recognized by International Tax review as **"Tax Team of the year in Russia"**.



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