Tax Rules Close Loopholes With More Red Tape

By Irina Filatova

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The State Duma passed a bill on Thursday enabling the Federal Tax Service to control transfer prices for goods and services traded between parent companies and their affiliates starting Jan. 1, in a measure expected to prevent tax evasion.

The bill, which was first drafted by the Finance Ministry in 2001 and passed in the key second reading, is aimed at eliminating flaws in tax legislation frequently used by local companies to reduce income taxes.

"The bill is complicated but important for the Russian economy because lawmakers have been working on it for more than 10 years," said Yury Vasilyev, head of the State Duma budget and taxation committee.

The new rules are expected to prevent capital outflow to offshore companies, he said in e-mailed comments.

Transfer pricing is widely considered to be used by some Russia-based companies in tax evasion schemes. One possible method is to export goods through affiliated firms registered in offshore zones.

A company sells the exported goods to its offshore affiliates at a price lower than the market price. Firms registered in the offshore zone subsequently sell those goods to end customers at the market price and receive income from the deals. Thus parent companies are able to pay lower income taxes in Russia, and the federal budget loses out.

Former Yukos head Mikhail Khodorkovsky, who is serving a prison term till 2016, was accused of tax evasion using a transfer pricing scheme.

According to the bill, the Federal Tax Service will control deals between parent companies trading goods and services with their affiliates if the income from such deals amounts to 3 billion rubles ($107 million) per year in 2012, with that threshold being lowered to 2 billion rubles in 2013 and 1 billion rubles in 2014.

Companies will have to prepare a package of documents and provide them on request of the Federal Tax Service as proof that their transfer prices are in line with market prices.

Companies that pay lower income taxes but fail to prove that their transfer prices are in line with market prices will have to pay the remaining sum in taxes and a fine of 40 percent of that

unpaid sum.

The bill also defines interdependent companies and clarifies the methods of setting transfer prices.

Prime Minister Vladimir Putin said earlier this year that these amendments to the Tax Code must be "absolutely transparent, equally understood and equally applied to all participants in the economic activity."

The new bill introduces more effective rules to control transfer prices, which to a great extent are in line with the guidelines of the Organization for Economic Cooperation and Development, said Yevgenia Veter, a partner at Ernst & Young.

There are currently no effective mechanisms to control transfer prices because tax legislation has no clear definition of market price or guidance for applying methods to determine market prices, Veter said.

Companies are not now required to document that their transfer prices are in line with market prices, she said by telephone.

The bill, if approved by the Federation Council next week and signed by President Dmitry Medvedev, will go into effect on Jan. 1.

The bill primarily targets local vertically integrated companies operating in the oil and gas, and metals and mining industries.

The new rules, however, might result in additional problems for foreign firms that have subsidiaries in Russia, analysts said.

Mikhail Orlov, a tax and legal services partner at KPMG in Russia and the CIS, said big transnational companies headquartered abroad with subsidiaries in Russia will face "significant tax risks" because they'll have to justify the costs of Russian subsidiaries transferring money to the head office to compensate the management.

The local companies, which will see almost all their deals controlled by the tax authorities, will also face the additional burden of increased document flow and additional costs to pay for financial consultants, Orlov said.

Russian firms have more work than their foreign peers ahead of them as the bill goes into effect because they aren't acquainted with the procedure for justifying their prices, whereas foreign multinationals already face transfer pricing documentation requirements in many other countries.

"It's a great challenge for large Russian groups. Preparing the documents to justify transfer prices is a major burden for them because they've never done it before. They'll have to align their transfer pricing methodologies with the new rules and to document those," said Veter of Ernst & Young.

The largest metals and mining holdings, including Evraz Group, Mechel, RusAl, MMK Group and Metalloinvest, declined to comment on the new bill Thursday.

Meanwhile, foreign companies said they are concerned about additional costs due to the introduction of the new rules.

"Any additional administrative and financial load for a company automatically results in increasing costs of doing business in Russia," said Alexandra Tretyakova, chief executive of the International Medical Device Manufacturers Association.

The new rules have been passed too fast, without a proper transition period, which could result in companies losing money set aside for business development, Tretyakova said.

"As a result, the amendments to the Tax Code lead to additional costs for business and bring in money for financial consultants," she said in e-mailed comments.

"Life becomes more and more complicated," complained a chief financial officer of one of the Fortune 500 companies.

The executive, who spoke on condition of anonymity, said the company would face difficulties preparing the huge volumes of documents for the Federal Tax Service.

"We'll need to employ a whole accounting department for the work because it will be permanent, and life moves on, and prices change due to changing quality and an increasing range of services. Inflation plays a role as well," the executive said.

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