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Determining Income in Related Party Transactions: Choice and Application

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On Jan. 1, 2012, Federal Law No. 227-FZ on amendments to certain legislative acts of the Russian Federation to improve the principles of price determination for tax purposes, dated July 18, 2011, ("Law") will enter force.

The Law establishes new regulatory rules on prices used in transactions between related parties and prescribes the use (by both taxpayers and tax authorities) of five methods for calculating transaction prices for tax purposes.

The Law means that all companies whose transactions qualify as controlled under the new rules will have to think about which of these five methods of calculating price for tax purposes should be applied to determine whether a market price was used.

The Law adds an important provision that, if the taxpayer used one or several methods to determine prices, the tax authority must use the same method(s) (unless the tax authority can prove that the method used by the taxpayer does not provide reliable results). Therefore, it would seem that the taxpayer has priority in choice of method, and in the near future those companies whose transactions fall under tax control should analyze the subject of the transactions, study the Law, and choose a method they believe will reliably confirm that the transaction prices match market levels.

Of the five methods, three are carried over from Tax Code Article 40, and two new ones are added. All five are entirely borrowed from international practice (the OECD Transfer Pricing Guidelines):

1. Comparable uncontrolled price method (priority method)
2. Resale price method
3. Cost plus method

4. Comparable margin method
5. Profit split method

What does the word "method" mean? How does a method enable us to determine whether a price is consistent with market levels? Let us take a look.

The process of choosing and using a method has several stages, but — most importantly — in all methods except the fifth, the company must compare the chosen financial indicators (price, profit, etc.) with similar indicators of other companies on the market.

Thus:

- Step 1: Determine the subject and any particulars of the transaction;
- Step 2: Check which method the Law recommends for the subject and particulars (if there are no specific recommendations, use the general recommendations);
- Step 3: Make a preliminary choice of method;
- Step 4: Find "comparable" companies on the market for a comparison (depending on the chosen method it will be clear what we are comparing — price of goods, cost margin, asset margin, or other factors);
- Step 5: Bring the "comparable" companies' indicators into conformity with our company — adjust the price, profit, etc. so as to enable an accurate comparison;
- Step 6: Find the price, margin or other indicator interval (depending on method), i.e., the "range" of indicators in several transactions — for example, for a certain kind of coffee, from 400 to 480 rubles per kilogram;
- Step 7: Determine the "market" price for tax purposes. This price must fall within the interval! The price can only be outside the interval for one reason — if adjusting it (to bring it within the interval) would result in a reduction in the company's tax obligations. For example: The company sells coffee at 490 rubles, and the upper boundary of the interval is 480 rubles. In this case, we do not adjust the price to the interval because it would reduce the taxable profit.

There is still time left until the tax authorities start auditing prices, and we recommend using this time to analyze the grounds for use of the methods, the existence of comparable transactions, and choosing a specific method for calculating prices for tax purposes that the company will be able to demonstrate is effective in the event of a dispute with the tax authorities.

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