The New Ukrainian Transfer Pricing Regulations: An Overview

The author examines the new Ukrainian transfer pricing regulations that define “related parties,” impose reporting and documentation requirements, set forth methods and the process for conducting a comparability analysis, and provide for an arm’s-length range of results. While Ukraine does not impose a hierarchy of methods, the comparable uncontrolled price method is preferred, he says.

By Vladimir Starkov, NERA Economic Consulting

The Ukrainian Parliament (Rada) July 4 passed Law No. 2515 introducing amendments to the country’s Tax Code that significantly alter the transfer pricing landscape in Ukraine. Beginning Sept. 1, the effective date of the bill, the safe harbor of 20 percent around the market price of comparable goods will no longer be sufficient for Ukrainian taxpayers to demonstrate compliance with the arm’s-length standard. Instead, new amendments to the Tax Code contained in Article 39, along with amendments to other articles, introduce full-scope transfer pricing regulations that constitute a significant step toward adapting the framework that parallels the Organization for Economic Cooperation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, although development of many important aspects related to the law’s implementation is left up to the Ukrainian government. Among the items to be further defined are:

- the method for calculating the arm’s-length range;
- content of the form for notifying tax authorities of controlled transactions;
- official sources of information for conducting comparability analyses;
- documents taxpayer must present to support the arm’s-length nature of prices in its controlled transactions, in addition to the documentation; and
- procedures for entering into bilateral or multilateral advance pricing agreements.

The law establishes penalties for failure to notify the tax authorities of controlled transactions and for the lack of proper transfer pricing documentation. After Sept. 1, 2014, these penalties will go from the nominal amount of one Ukrainian hryvnia, equivalent to $0.12, to their full scope. The transition period seems surprisingly short, given that many of the important implementation details are left for clarification in the future. In light of these developments, taxpayers with operations in Ukraine are well advised to familiarize themselves with the law to ensure compliance with its provisions, and monitor developments in the transfer pricing area coming from the executive branch of the Ukrainian government.

The following summary of the new transfer pricing regulations is an attempt to chart a “navigation map” through the new legislation and does not necessarily provide exhaustive coverage of every detail.

**Related Parties and Controlled Transactions**

The prior Ukrainian tax law contained definitions of terms such as “arm’s-length price” and “related parties.” The new legislation expands the definitions of those terms. On the definition of related parties, the new legislation stipulates that interdependence between parties (individuals or organizations) is formed via capital participation or contractual or other relationships that allow one party to influence decisions of the other party, either directly or through other dependent parties. The regulations list the following circumstances that give rise to such interdependent relationships:
The proportion of participation in the capital of a legal entity by another legal entity or an individual is 20 percent or more. The participation may be either direct or indirect—that is, through other related parties.

An individual or a legal entity can control appointment or election of a chief executive or at least 50 percent of the members of the board of directors or trustees in another company.

A company’s chief executives have been appointed by the same individual or by the same legal entity acting on behalf of an individual.

At least 50 percent of a company’s board of directors or trustees have been elected or appointed by the same individual or by the same legal entity acting on behalf of an individual.

Companies share more than 50 percent of the board of directors’ personnel or the same chief executive.

An individual is acting in a capacity of a chief executive of a legal entity.

Individuals are classified as related parties among themselves when the nature of their influence on the same legal entity forms a controlled relationship.

Individuals are immediate family members.

The types of transactions that can be considered controlled, subject to a materiality threshold, include transactions of the Ukrainian taxpayers with related parties registered in foreign countries, transactions with domestic related parties under certain conditions, and transactions with entities registered in “low-tax jurisdictions.” The materiality threshold above which these types of transactions are deemed to be controlled is 50 million hryvnia ($6.1 million). Low-tax jurisdictions are defined as countries or territories that impose corporate income tax rates lower than the corresponding Ukrainian tax rate by 5 or more percentage points.

As of 2013, the corporate income tax rate in Ukraine became 19 percent; it will be lowered to 16 percent in 2014. Notably, treatment as a low-tax jurisdiction also will apply to a foreign legal entity whose effective tax rate is lower than the corresponding Ukrainian tax rate by 5 or more percentage points. This clause seems to indicate that the universe of controlled transactions in Ukraine may include the transactions of Ukrainian tax residents with otherwise unrelated foreign entities that for one reason or another have tax benefits in their home countries.

Related domestic taxpayers whose transactions with other domestic taxpayers will be considered controlled, provided they exceed the annual volume threshold, fall into one of the following categories: a loss-making taxpayer, a taxpayer that is allowed to apply a tax rate that is different from the statutory tax rate, and a taxpayer that paid no income tax in the prior fiscal year.

Audits and Income Adjustments

The Ukrainian tax authorities pledge to monitor prices in certain markets and will initiate transfer pricing inquiries of taxpayers suspected of conducting controlled transactions at non-arm’s-length prices. Other grounds for having a transfer pricing audit initiated are engaging in controlled transactions per se, as well as failing to provide notification of controlled transactions or reporting erroneous information in the notification.

Unlike regular tax audits, which are conducted by the local tax authorities, transfer pricing audits will be carried out by the personnel of a specialized department at the Ukrainian central tax administration. However, should the local tax authorities identify controlled transactions undiscovered by the taxpayer during a routine tax audit, they are obligated to notify the central tax authorities about the controlled transactions. The central tax authorities are authorized to propose income adjustments.

If a transfer pricing audit has been initiated, the tax authorities must provide the taxpayer with a 10-day advance notice and an initial information and document request.

Taxpayers must provide documents other than transfer pricing documentation to the tax authorities within 10 days of a request. (The documentation requirements are discussed below.) Tax authorities may request documents from counterparties to the controlled transactions as well.

Transfer pricing audits generally must be concluded within six months. Where the audit involves requesting information from foreign tax authorities or requires additional expert analysis or document translation, the audit period may be extended by an additional six months. The time period open for a transfer pricing audit is the same as the time period open for a general tax audit. A tax audit for any given year can be initiated up to three years after the date on which the tax return for the year is question was filed. If the tax return for a given year is filed late or is amended after the statutory filing date by the taxpayer, the start of the three-year period shifts to this later date.

If the taxpayer applies one of the transfer pricing methods specified in the regulations (as described below), the tax authorities must apply the same method unless they determine that it is not reliable. The tax authorities cannot apply methods not listed in the regulations.

If the tax authorities conclude that a tax adjustment is necessary, they will notify the taxpayer using a notification whose form is to be developed. The taxpayer has a right to appeal the notice of tax adjustment up to 30 days after receiving the notice. The appeal may be accompanied by additional supporting evidence. The time frame for submission of the supporting documents may be extended beyond 30 days if the tax authorities agree. If the transfer pricing audit of a given taxpayer does not result in any income adjustments, counterparties of the same controlled transactions cannot be audited in the same year.

There is a presumption that the transfer prices used by the taxpayer are arm’s length unless proven otherwise by the tax authorities. Self-corrections of transfer prices by the taxpayers are permitted, but only if they increase the tax liability in Ukraine. The correction of the tax declaration must be made within the time limit set for paying the general income tax. Self-correction, if needed, must be performed on an annual, as opposed to a quarterly, basis.

When a taxpayer’s tax liability has been increased as a result of either tax authorities’ determination or a voluntary self-correction of taxable income, the counterparty of such a transaction has a right to make a corresponding income adjustment but only after the first taxpayer has paid the additional tax and the tax authorities have officially authorized the downward income adjustment by the second taxpayer. The law also specifies reverse income adjustments that can be applied when the initial income adjustment is successfully appealed. The
regulations explicitly allow for corresponding income adjustments between the Ukrainian and foreign taxpayers who are residents of the countries that signed bilateral double tax avoidance treaties with Ukraine.

**Documentation, Notifying Tax Authorities**

Ukrainian taxpayers will report to the central tax authorities all transactions defined as controlled using electronic forms designed for such reporting. The content of these forms is to be developed by the Ukrainian tax agency. The reporting period is defined as the calendar year. The controlled transactions must be reported no later than May 1 of the year following the calendar year of the transaction. The penalty for failure to file such notifications is set at 5 percent of the controlled transaction amount. Only the controlled transactions with the volume exceeding the threshold of 50 million hryvnia ($6.1 million) are subject to reporting.

If the central tax authorities have initiated an inquiry into the taxpayer’s controlled transactions, the taxpayer may be asked to provide transfer pricing documentation. The documentation can be requested on or after May 1 of the year following the year being audited. The country’s “largest taxpayers” are required to provide comprehensive documentation, as described below. The documentation must be presented within 60 days of the request. Taxpayers that do not meet the criteria for the “largest taxpayers” may, upon a request from the tax authorities, present either the records pertaining to the controlled transactions or an open-form documentation. However, “small” taxpayers have only 30 days to comply with such a request. A special documentation regime applies to Ukraine’s banking industry. The National Bank of Ukraine is exempt from the documentation requirement altogether, and disclosures made by the commercial banks are required to abide by the country’s laws on banking secrecy.

The country’s largest taxpayers must present, upon request, documentation that contains the following information:

- identification of the related parties, including their countries of residence;
- a description of the taxpayer’s business, including information on the other members of the controlled group, the group’s ownership structure, and its transfer pricing policy;
- a description of the controlled transaction, including the subject of the transaction, the contractual terms under which it took place, including payment terms, and factors that may have affected the price of the transaction;
- a functional analysis of controlled parties including risks taken and assets used by each of those parties;
- a description of the methods used to test the arm’s-length nature of transfer prices, including discussion of why each particular method was selected;
- the total volume of the controlled transaction and its profitability;
- a calculation of the arm’s-length range of prices or profitability, including the description of the selection of the comparable transactions, information sources used, and a discussion of comparability factors between the tested and comparable transactions; and
- adjustments to the reported tax liability made by the taxpayer, if any.

The taxpayer’s failure to submit the documentation within the deadline or its failure to present the mandatory content of the documentation in full provides a cause for the tax authorities to initiate a transfer pricing audit. Additionally, noncompliance with the documentation requirement will trigger a monetary penalty. This penalty is computed as 100 times the local minimum wage. Thus, given the significant risks that a taxpayer may face in the absence of documentation, it is likely that Ukraine’s largest taxpayers will have to treat preparation of the transfer pricing documentation as a necessary exercise.

**Advance Pricing Agreements**

In the Ukrainian law, APAs are deemed to be contracts between taxpayers and the tax authorities. APAs are permitted only for the Ukraine’s largest taxpayers, as defined above. Bilateral and even multilateral APAs are allowed with countries that have double tax avoidance treaties with Ukraine. The procedure for bilateral and multilateral APAs has yet to be developed by the government.

**Comparability Analysis and Data Sources**

The regulations present an extensive list of factors that should be used to consider comparability between controlled and uncontrolled transactions. These factors include:

- characteristics of goods or services;
- functions performed, risks assumed, assets used, and responsibilities of the controlled parties;
- contractual terms of the transaction and common business practices in the industry, including transaction volumes, terms of delivery and payments, foreign exchange rates, common discounts and surcharges, and distribution of functions and risks among the parties;
- economic conditions of the transaction, including the market characteristics, that may affect prices;
- business strategies of the parties that may affect pricing;
- for financial transactions such as loans and guarantees, the credit history of the recipient, the recipient’s solvency, the term of the loan or guarantee, the currency of the transaction, and formulas for interest rate adjustments.

The central tax authorities are authorized to use only the specified sources of information when conducting transfer pricing audits. The list of such authorized sources is to be prepared by the government. If sufficient information cannot be found in the officially recognized sources, other information sources also may be used. Their list includes the following:

- prices established at public auctions and bidding for procurement contracts, as well as prices recorded by mercantile and stock exchanges;

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1 These are legal entities with annual revenues exceeding 500 million hryvnia ($61 million) or with annual tax liabilities exceeding 12 million hryvnia ($1.5 million).

2 The amount of this penalty currently is equivalent to approximately $14,100. By the end of 2013, the minimum wage in Ukraine is set to rise by 6.2 percent from its current level, which means that this penalty may reach nearly $15,000 using the current exchange rates.
statistical data reported by the various offices of the Ukrainian government;  
- pricing databases, including those officially published by the Ukrainian and foreign governments and commercial organizations and databases developed for transfer pricing purposes;  
- financial and statistical reports of companies obtained from publicly available databases or companies’ Websites;  
- valuation reports prepared according to the Ukrainian valuation standards; and  
- prices applied in the taxpayer’s own transactions (when unreported comparable transactions with unrelated parties are discovered in the course of a tax audit, the central tax authorities are compelled to use prices of those transactions to determine the arm’s-length price of the taxpayer’s controlled transactions).

If a taxpayer has used the transfer pricing methods and the sources of information specified in the regulations to support the arm’s-length nature of prices for its controlled transactions, tax authorities conducting a transfer pricing audit cannot use any other information sources unless they are able to prove that the sources used by the taxpayer are unreliable. Also, the tax authorities cannot use any non-public information in the course of an audit.

Transfer Pricing Methods

The previous Ukrainian Tax Code named the five OECD-recognized transfer pricing methods as tools for transfer pricing analysis; however, the new law provides significantly more details on the application of these transfer pricing methods along with introduction of a new “combination” method.

The new regulations state that the following transfer pricing methods can be used to establish the arm’s-length prices: the comparable uncontrolled price (CUP), resale price, cost plus, and comparable profit method (CPM), as well as profit split. On profit split, both the comparable profit split and the residual profit split are allowed. The definitions of those methods in the Ukrainian regulations are broadly consistent with those used in the OECD guidelines and the U.S. transfer pricing regulations. A taxpayer can use a combination of two or more methods to establish the arm’s-length price. However, prices for banking services and insurance tariffs will be determined using special methods to be developed by the state agencies regulating those industries.

While there is no formal hierarchy of methods, the regulations state that when the CUP method can be applied, it takes priority over other potentially applicable methods. Also, CUP is mandatory in cases when the taxpayer conducted one or more transactions with unrelated parties that is comparable in every way to the transactions with related parties and the taxpayer in question does not have a monopoly in the market for the goods or services being transacted.

Notably, application of the profit split method is sanctioned for use not only when both parties to the transaction use intangibles on an ongoing basis, but also in conjunction with the discounted cash flow analysis, in situations such as a new product launch, a product life cycle analysis, and an analysis of capital investments.

Special Pricing Regime for Key Exports

Until January 1, 2018, import and export of certain goods to or from the entities registered in “low-tax jurisdictions,” as defined above, will be subject to special pricing rules. The “baseline” prices for such transactions will be set either using prices realized at commodity exchanges or the pricing intervals established by the Ukrainian government based on prices quoted in market-surveying publications. Exporters can set prices in such transactions up to 5 percent below the minimum of the baseline pricing interval, and importers can set prices up to 5 percent above the maximum of the baseline interval.

The goods subject to these special pricing rules include certain agricultural commodities (grains, oils, and fats of animal or vegetable origin), mineral commodities (coal, crude oil and its products, and mineral ores), organic chemical compounds, products of inorganic chemistry, including compounds of precious and rare-earth metals or radioactive elements, ferrous metals, and items made of ferrous metals. Thus, it appears that this special pricing regime will, during the next four years, effectively sanction trade with the key Ukrainian export commodities via related trading companies registered in low-tax jurisdictions, as long as the price discounts on those exports do not exceed the “safe harbor” of 5 percent.

Profit-Level Indicators

The following profit-level indicators can be used in all of the transfer pricing methods described above (except CUP): gross margin (ratio of gross profit to sales), ratio of gross profit to cost of goods sold, ratio of gross profit to operating expenses, operating margin (ratio of operating profit to sales), ratio of operating profit to total costs, return on assets (ratio of operating profit to operating assets), and return on capital (ratio of operating profit to operating assets less current liabilities).

Arm’s-Length Range

The procedure for computing an arm’s-length range of prices (or profitability) is not defined in the law, but is left to the Ukrainian government to develop. The legislation, however, specifies that in calculating the arm’s-length range, it is permissible to use pricing or profitability data not only for the current year but also data for an unspecified number of prior years. Reliability-enhancing adjustments of financial data of the tested party are allowed as well.

While the arm’s-length price under the CUP method can be established based on as few as one comparable transaction, calculation of an arm’s-length interval using profit-based methods requires a minimum of three comparable transactions.

If, as a result of application of one of the specified methods, the price or profitability of the controlled transaction is found to be outside of the arm’s-length interval, a taxpayer or tax authorities may perform an adjustment to bring the price or profitability of the controlled transaction to the closest edge of the interval (as opposed to a median). However, the only adjustments permitted are those that will not reduce the amount of taxes paid to the Ukrainian budget.
Notably, the law establishes that prices of certain types of transactions are considered arm’s-length by definition. These types of transactions include:

- transactions involving goods or services the prices of which are regulated by the state (except cases when only the minimum indicative prices are established by regulations);
- prices established using valuation analyses in cases when other transfer pricing methods cannot be applied;
- prices established as a result of publicly held auctions if such auctions are required by law;
- for a transaction involving a forward or future contract, a price equal to the market price at the time the contract was entered into; and
- a price manifested in a forced sale of goods or property pledged by a borrower to a lender as loan collateral.

**Conclusion**

Proper transfer pricing compliance in Ukraine will require a thorough understanding of the newly adopted regulations. In all likelihood, the new regulations will significantly increase compliance efforts by the country’s taxpayers. Given the broad criteria for recognition of related parties and a relatively low threshold for transaction volumes, many of the transactions (both cross border and domestic) will fall into the category of controlled transactions and will need to be reported to the tax authorities.

The country’s largest taxpayers will have to prepare formal transfer pricing documentation studies to avoid penalties. The short time frame before the full penalties for noncompliance will take effect, coupled with the lack of definition of the important implementation points (the method for calculating the arm’s-length range) should prompt taxpayers to develop rapidly their transfer pricing resources in Ukraine and closely monitor upcoming developments in the transfer pricing area.