Advanced Pricing Agreement Guidelines published in Russia

Introduction

Russian Federal Tax Service published a letter No.OA-4-13/85@ “On Conclusion of Advanced Pricing Agreements for the tax purposes” dated 12 January 2012 (hereinafter, the Letter) on its official website (http://www.nalog.ru/mnsrus/transfer/3883192/).

The letter is a recommendation, and although it is not binding for taxpayers, it provides guidance on the practical realization of an Advanced Pricing Agreement (APA) tool provided by Chapter 14.6 of the Tax Code.

Below we provide an overview of the key provisions of the Letter as well as our comments on issues that represent the most practical points of interest.

Executive summary of the Letter

The Letter covers various questions related to the conclusion of APAs, including the following:

▶ When is it reasonable to consider an APA?
▶ Who can conclude an APA?
▶ How to determine the subject of an APA?
▶ How would the APA negotiation process be structured?
▶ Which documents are required to conclude an APA?
▶ What is the term of an APA? When it can become effective?
▶ How would the execution of an APA be controlled?

The Letter generally follows the common international practice for concluding APAs. In particular, the tax authorities directly refer to the fact that they will follow the principles for concluding APAs provided by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.
When it is reasonable to consider an APA?
The Letter points out that the existence of controlled transactions by a taxpayer is not by itself reason for an APA. In particular, the Letter provides that in many cases it is reasonable and sufficient to maintain documentation justifying the prices applied in the controlled transactions instead of concluding an APA. Documentation will be the better approach when time and effort spent on reaching an APA exceeds the expenses for the preparation of documentation, the choice of pricing methodology for tax purposes is obvious and information used is accurate and reliable.

Who can conclude an APA?
The letter clearly states that only a Russian legal entity included in the largest taxpayer category may apply for an APA.

How to determine the subject of an APA?
The Letter refers to Article 105.21 of the Tax Code saying that an APA can be concluded for one particular controlled transaction, or for several controlled transactions (groups of homogeneous transactions). Therefore, most likely a separate APA would be necessary for each group of homogeneous transactions.

An APA may be concluded with respect to the transactions between the Russian interdependent entities (within the framework of “unilateral” agreements), and cross-border transactions (within the framework of unilateral agreements, as well as the agreements with the participation of the tax authorities of foreign countries - “bilateral” and “multilateral” agreements).

How would the APA negotiation process be structured?
The Letter provides an overview of the interaction between the taxpayer and the tax authorities in the course of an APA negotiation. It is notable that, as the first step of this process, preliminary discussion of the main APA provisions is recommended before the formal application is submitted by a taxpayer. Such preliminary discussion is in line with international practice and is aimed at improvement of the quality of APA preparation and reduction of the time for its consideration.

After preliminary discussion, the Federal Tax Service of the Russian Federation forms a work group that would consider the taxpayer’s APA application. If after consideration of the application amendments are required in the draft APA, the taxpayer has the right to apply to the Federal Tax Service with a second application. After considering an application (or the second application) the Federal Tax Service makes a decision to conclude an APA or to reject the application.

Which documents are required to conclude an APA?
The letter provides the list of documents that may be required in the course of an APA negotiation. Generally, all documents may be divided into three groups:

1. The documents that should be attached to the APA application in accordance with Article 105.22 of the Tax Code, including a draft APA and other supporting documentation stipulated in the Tax Code. The Letter also recommends an approximate structure of an APA.

2. In addition to the documents indicated in Article 105.22 of the Tax Code, the Federal Tax Service also recommends the following additional information be provided in free format in order to avoid excessive document turnover:
   - Description of the main characteristics of the taxpayer’s sphere (type) of activity (industry analysis)
   - Description of the main characteristics of the Group of companies to which the taxpayer belongs
   - Functional analysis
   - Choice of pricing method for tax purposes and sources of information, including analysis of potential influence of the APA terms and conditions on tax liabilities of the parties to the transaction

In substance, the information mentioned above represents the similar price justification a taxpayer is obliged to provide in the transfer pricing documentation required by the Tax Code in the absence of an APA. However, it is notable that the Letter refers to the necessity of disclosing the pros and cons of each method in relation to the controlled
transaction, to justify the choice of method of the arm's length price determination for tax purposes. We note that such requirement is absent in the Law.

3. Finally, in the course of consideration of an APA application, the Federal Tax Service may additionally request a wide range of documents, including:

- Accounting (financial) statements of the parties to the controlled transaction and audit reports confirming reliability of the financial statements
- Internal documents of the taxpayer regulating its pricing policy
- Contracts for the controlled transactions, way bills, acts of completed works, provided services, other documents confirming the results of sales of goods, works, services (reports, memorandums, etc.)
- Tax accounting policy
- Tax accounting ledgers for sales income, non-sale (extraordinary) income, expenses and non-sale (extraordinary) expenses with a breakdown by types of income/expense, counterparties and transactions (controlled transactions)
- Staff schedule, organizational structure, job descriptions of employees performing certain functions
- Transaction passport (a special document required for Russian currency control purposes), for foreign trade operations between a Russian and a foreign legal entity
- Bank statements, bank control statements to confirm actual payment for goods (works, services) under the controlled transaction
- Cargo customs declarations
- Transport, shipping and (or) other documents confirming import/export of goods

It is obvious the preparation and collection of the documents, especially those from the third group mentioned above, may be very time consuming for taxpayers. Therefore the question of efficiency of concluding an APA becomes vital in every case.

**What is the term of an APA? When can it become effective?**

The Letter draws attention to the fact that the duration of an APA is determined by the agreement of the parties within the limits defined by Article 105.21 of the Tax Code, i.e., three years. If all the conditions are observed, the duration of an APA may be prolonged for up to two years.

It is important to note that an APA may be made effective from the first day of the calendar year in which a taxpayer applied to the Federal Tax Service for conclusion of the APA.

**How would the execution of an APA be controlled?**

The Letter emphasizes that in order to avoid an excessive flow of documents and to minimize time and labor inputs, the mechanism of monitoring the execution of an APA by a taxpayer may be provided in the APA. The Federal Tax Service may control the execution of an APA within the framework of the tax control of transactions between interdependent parties. However, in cases where a taxpayer observes the APA conditions, the Federal Tax Service does not have the right to assess additional tax, fines and penalty interest associated with a transfer pricing review.

Existence of a valid APA does not exempt a taxpayer from tax audits on other grounds (i.e., not related to pricing), as well as from additional tax, fines and penalty interest charges resulting from such audits.

Also, existence of a valid APA does not exempt a taxpayer from an obligation to provide notification of the controlled transactions.

**How can we help?**

If you are considering a possible APA for your company, we would be glad to help with estimation of the efficiency of such APA, organizing and carrying out preliminary discussions with the Federal Tax Service, preparing the APA draft as well as other supporting documentation, and providing support in negotiations with the tax authorities in the process of the APA conclusion. Ernst & Young already has experience working with APAs in Russia, including the stage of preliminary discussions with the Federal Tax Service, and preparation of draft APAs for our clients.
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