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The current state of tax control over transfer pricing in Ukraine

Abstract

The purpose of the article is to summarize and present the genesis of transfer pricing in Ukraine, to identify the problems and to assess the prospects of Ukraine in this direction. *Methodology.* The theoretical basis was the developments devoted to transfer pricing and the impact of globalization processes on the transfer pricing mechanism of transnational corporations and the system of international regulation. The methodology of the study consisted of general scientific and special scientific methods of research: analysis and synthesis, induction and deduction, methods of analogy, differentiation, generalization. The information base of the study consists of regulatory legal documents, materials of monographic studies of foreign and domestic scientists, textbooks and manuals, international and Ukrainian scientific conferences, articles in periodicals and information base of the Internet. The results of the study showed that transfer pricing as a tax institute appeared in Ukraine in September 2013 against the background of increased attention to transnational corporations and international trade. Unlike many other requirements of tax legislation, transfer pricing has no clear regulatory framework, which creates many problems for both taxpayers and controlling authorities. Ukraine's experience shows that transfer pricing rules focus on shifting the tax base between countries and redistributing profits between related companies, as well as transferring income to low-tax countries. *Practical implications.* The practical significance of the study lies in a comprehensive analysis and assessment of the current situation of transfer pricing processes taking place in Ukraine. The experience of European countries and judicial practice which formed a number of important and progressive legal positions and conclusions on improvement of transfer pricing control can be used in practice for Ukraine. The practical novelty of the results consists in a comprehensive analysis of the impact of transfer pricing on the current state of tax management as a whole. *Value/originality.* With proper control over transfer pricing instruments, it is possible to significantly prevent the erosion of the tax base and, consequently, to increase the volume of taxation and ensure the economic security of the state at the proper level.

Keywords

transfer pricing, transnational companies, controlled transaction, implementation of tax legislation, the Tax Code, martial law

JEL: H25, H61, F42, M21



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1 Introduction

The state of transfer pricing in Ukraine since 2013 (for the first time the task of introducing transfer pricing was set according to the Decree of the President of Ukraine "On the National Action Plan for 2013 to implement the Program of Economic Reforms for 2010–2014") has changed greatly: if in the beginning its introduction in Ukraine was a slow and imperfect process, by the end of 2021 there were already great prospects for development and improvement of tax legislation for regulation in this area. Due to the large-scale processes of globalization and the growing number of international corporations, interest in this issue has become quite significant, including in Ukraine, where transfer pricing has

become particularly relevant in recent years. This has also been influenced by the innovations in the Tax Code. Now, unfortunately, during martial law, the development of transfer pricing, as well as many other areas, has slowed down significantly, which is a very sad factor for the economy of Ukraine and for each of its residents. The objective of this study is to show how the process of transfer pricing was improved in peacetime and how the Tax Code of Ukraine is enforced, taking into account the changes introduced in connection with the introduction of martial law in Ukraine. The purpose of this article is to show the differences in transfer pricing control during peacetime and now.

Given the constant changes in transfer pricing rules and the complex domestic situation, taxpayers

should consider such changes when planning and structuring their business relationships for 2022 with non-resident related parties, or those whose jurisdictions are listed as "low tax", or non-residents whose organizational forms give them a tax preference of their home jurisdiction. Currently, control over transfer pricing in Ukraine has slowed down, old checks have been suspended and new ones have been banned. It is also worth noting that most of the companies that fall under the transfer pricing process belong to the group of large taxpayers. This group includes the largest strong manufacturers and mining companies, as well as the metallurgical, fuel, defense and food industries in Ukraine. Since the beginning of Russia's full-scale invasion of Ukraine, 25 major industrial enterprises have been seriously damaged or destroyed. Seven enterprises were destroyed and cannot be restored or reconstructed. Therefore, it is now difficult to talk about restoring the pre-war state of the economy, especially difficult to talk about transfer pricing control when, since the beginning of martial law, there have been changes in legislation aimed at weakening control measures to support entrepreneurs and their enterprises.

2 The development of transfer pricing before the outbreak of hostilities

Transnational companies (TNCs) often set their transfer prices different from market prices, that is, prices that would be applied by unrelated parties in similar transactions under similar open market conditions. International companies optimize taxation by shifting taxable income from high-tax countries to low-tax countries by changing transfer prices. Thus, transfer pricing is an important profit enhancing tool for both taxpayers and fiscal authorities because it largely determines the income and expenses, and thus the taxable income, of branches in different tax jurisdictions. The process of globalization separates and divides the country and the enterprise, resulting in unregulated markets and economies that disrupt social stability (Dzhoh, 2016). According to the UN, there are 35,000 transnational corporations with 150,000 subsidiaries in the world. The monetary turnover and revenues of some TNCs may exceed the GDP of underdeveloped and some developed countries. One of the consequences of these processes is increased tax competition, as investments and savings in such an environment are placed more efficiently for the TNCs themselves and less frequently for the countries.

Ukrainian transfer pricing legislation is based on international documents, the most important of which are the Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises and International Tax Administrations. According to this document, transfer pricing is the process of establishing the price at which a company

transfers goods, services or intangible assets. Ukraine's experience shows that transfer pricing rules are aimed at shifting the tax base between countries and redistributing profits between related companies (Mel'nichenko, 2016). The main resident countries with the largest volume of controlled transactions (excluding banking services) in 2019 were Switzerland – 32.6%, Cyprus – 9.8%, UAE – 6.9%. Controlled transactions in goods – 49.9% and banking services – 33.5% are the largest in terms of volume.

Transfer pricing norms were introduced in Ukraine on September 1, 2013. The first full tax reporting period for these norms was 2014, which actually started in 2015 with the monitoring of controlled transactions.

Ukraine has made comprehensive changes to its tax code affecting transfer pricing rules through Law 466-IX, effective May 2020, and Law 1117-IX, effective January 1, 2021. The main changes include a three-tiered approach to transfer pricing documentation, new requirements for reasonable economic purpose, amended provisions for deemed dividends and new rules for commodity transactions.

The changes adopt a three-tier approach to transfer pricing documentation in accordance with Action 13 of the OECD base erosion and anti-abuse project (BEPS) (Grinberg, 2015).

The OECD Transfer Pricing Guidelines are not included in the Ukrainian legislation, but the TPG is considered to be an internationally recognized guide that provides an explanation and clarification of the (application of) arm's length principle (OECD, 2022).

The main difference between the Ukrainian rules and the OECD Guidelines is that the scope of controlled transactions includes transactions with counterparties in low-tax jurisdictions, regardless of whether such companies are affiliated or not. Ukrainian regulations also include an atypical TP regime applicable to the export/import of certain goods, which differs from the OECD Guidelines. Overall, Ukrainian legislation remains unclear and has numerous gaps (TPA Global, 2022).

3 Choosing a transfer pricing method

The main problem is the correct choice of the method for comparing controlled transactions, so there are many court disputes, because the positions of the controlling body and the corporation usually differ and each independently forms the evidence base, which, in their opinion, is correct. Even after setting a fair price for the goods on the correct pricing date, there are many disputes over the valuation of transshipment services, transportation, freight forwarding costs, the appropriateness of marketing services, etc. (Grundel, 2015) As of the end of 2020, businesses had won 70% of their transfer pricing and fair pricing cases in controlled transactions.

Compliance of controlled transactions with the arm's length principle is confirmed by applying the most appropriate transfer pricing method within the above hierarchy of methods according to the facts and circumstances of the case, unless the Tax Code of Ukraine establishes requirements for the application of a specific transfer pricing method for a particular type of controlled transactions (for example, application of comparable non-controlled price (CUP) method for commodity transactions) (OECD, 2022).

Determining whether the conditions of the operation in question correspond to the "arm's length" principle is accomplished by one of the following methods:

- Comparable uncontrolled price (CUP) method;
- Resale price method;
- Cost plus method;
- Profit split method;
- Transactional net margin (TNMM) method.

The most appropriate transfer pricing method is selected based on the following criteria:

- The validity of the chosen method in accordance with the nature of the analyzed transaction, determined, in particular, on the basis of the results of the functional analysis of the transaction in question (taking into account the functions performed, the assets used and the risks incurred);
- Availability of complete and reliable information necessary for application of the chosen method and/or transfer pricing methods;
- The degree of comparability between analyzed and uncontrolled transactions, including the reliability of comparability adjustments, if any, that can be used to eliminate inconsistencies between such transactions.

The Ukrainian transfer pricing rules provide for a hierarchy of methods. In particular, the comparative uncontrolled price method is considered a priority, i.e., when it is possible to use both the comparative uncontrolled price method and any other method, the comparative uncontrolled price method is applied (Kalach, 2019).

When the use of the comparative uncontrolled price method is not possible or its application does not permit a reasonable conclusion that the terms of the transactions in question are consistent with the arm's length principle, and the resale price or cost-plus method and the net profit or profit sharing method can be applied with equal reliability, the resale price or cost plus method applies.

The transfer pricing rules permit the use of the following sources of information containing information that allows comparing commercial and financial terms of transactions, in particular:

- Information on comparable uncontrolled transactions of the taxpayer;
- Information on comparable uncontrolled transactions of the taxpayer's counterparty –

parties to the analyzed transaction with unrelated persons;

- Any information sources that contain open information and provide information on comparable transactions and individuals (Kurilov, 2018).

4 Features of control over transfer pricing in martial law

With the beginning of the full-scale invasion of the Russian Federation, the phrase "transfer pricing" was probably the last thing on the minds of business owners in Ukraine. The most important thing was to save their loved ones, develop an emergency action plan to save the company, and wait for news from the front. But the first shock has passed, the economy is back on "war footing," and the issue of transfer pricing has returned to the information space.

Regarding the submission of reports on controlled transactions and the responsibility of taxpayers for violations of tax laws: reports are submitted until 10/01/2022.

As for transfer pricing tax audits during martial law, the following can be highlighted:

- all started inspections are stopped;
- conducting new inspections is prohibited;
- upon completion of inspections, the terms of imposition of tax fines are suspended for the period of martial law in Ukraine.

Regarding the single tax at the rate of 2 percent and the criterion of controlled transactions: when reporting on TP, it is necessary to take into account that after the termination or cancellation of the military, emergency situation on the territory of Ukraine, taxpayers who used the special taxation features to pay a single tax at a percentage rate of 2 percent of income, from the first day of the month following the month of its termination or cancellation, lose the right to use the features of such taxation and are automatically considered to apply the system of taxation in which they were before the election of these features of taxation.

In this case, to determine whether the criterion of "cost" for classifying transactions as controlled, the amount of the taxpayer's annual income from any activity for the entire reporting year, including the specified features of taxation (payment of a single tax at a rate of 2 percent of income) is calculated.

In this case, the transactions carried out by the taxpayer in the payment of this single tax are not taken into account in determining the criterion of 10 million UAH, if they do not affect the object of taxation of corporate income tax.

5 Conclusions

Studying the issues of transfer pricing and finding ways to improve its development is becoming a

requirement of time. For Ukraine in practice, it is now possible to rely on the experience of European countries and judicial practice, which have formed a number of important and progressive legal positions and conclusions to improve control in the area of transfer pricing. At the same time, it can be emphasized that through proper control over transfer pricing instruments, it is possible to significantly prevent the blurring of the tax base and, consequently, to increase the amount of taxation and ensure the economic security of the state at the proper level.

The changes in transfer pricing rules are aimed at improving the efficiency of tax administration and supervision. However, some of these tools create serious new burdens for taxpayers. In addition, they provide tax authorities with discretionary powers, such as establishing the absence of a reasonable economic purpose. As a result, there is a high risk of misapplication of these tools without appropriate reform of the public tax service (Shynkarenko, 2021).

Ukraine is developing a system of fair taxation also through the Organization for Economic Co-operation and Development (OECD) project "Base erosion and Profit Shifting" (BEPS). It is important for Ukraine to get additional experience of European

countries in further implementation of BEPS plan, in the area of transfer pricing for companies and the choice of necessary methods of transfer pricing in accordance with OECD standards to improve and enhance the level of regulation and to maximize the use of European experience in this area.

The unfolding war crisis between Russia and Ukraine has large-scale tax implications for business. Unfortunately, as soon as Ukraine stabilized in its development in the area of transfer pricing, thanks to the implementation of control rules derived from the experience of European countries, everything came to a halt on February 24, 2022. Controls in the sphere of transfer pricing today are simply a matter of routine. The transfer pricing mechanism is at the heart of the latest approaches to price setting in the global economy. Thus, through the system of transfer pricing, the state protects its budget revenues and stimulates the inflow of foreign investment. The country's economic growth and, in particular, the creation of a favorable competitive environment, the development of national production, the level of transaction costs and the circulation of productive capital depend on the efficiency of transfer pricing and the establishment of an adequate level of prices.

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