Second transfer pricing court dispute shows unexpected approaches

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An appellate court has ruled on a second court case of transfer pricing[1]. The conclusions of this high-profile case will affect all taxpayers who have entered into cross-border transactions with related parties. This case confirms that it is necessary to thoroughly justify why a transfer pricing method has been selected over another and clearly specify the reasons for rejecting the other methods. This case also shows that approaches traditionally used to justify the selection of a certain transfer pricing method may miss the mark.

Background

In 2012, PAO Uralkaliy (further "Uralkaliy") supplied potassium chloride to a related Swiss company, Uralkali Trading SA (further "UKT"), for resale to independent buyers in foreign markets. The transactions entered into between Uralkaliy and UKT for such supply were deemed controlled transactions for Russian transfer pricing purposes so Uralkaliy prepared the required transfer pricing documentation justifying that the prices applied in the transactions with UKT were at arms' length level. Uralkaliy used one of the most popular methods among taxpayers to confirm that prices were at arm's length level, i.e. Transactional Net Margin Method (TNMM), and compared UKT's net profit margin with the net profit margin of comparable companies.

The Federal Tax Service (FTS) verified the transfer prices applied by Uralkaliy in the transactions with UKT and rejected the TNMM selected by Uralkaliy, stating that it had been used erroneously. Having compared the prices applied by Uralkaliy with data from the price information agency Argus Media, the FTS concluded that the comparable uncontrolled price method (CUP) should have been used and that Uralkaliy's tax base was understated because Uralkaliy applied non-market prices. The FTS requested Uralkaliy to pay additional profit tax and imposed penalties on the company, but Uralkaliy did not agree with the position held by the FTS so the case was referred to court.

Although this case was the second in the history of the application of the new transfer pricing rules, this was in fact the first case during which courts examined in detail the approaches commonly used by taxpayers to prepare transfer pricing documentation. This case is therefore of interest to all taxpayers who have entered into controlled transactions.

Court decision of first instance

The court of first instance upheld Uralkaliy's position and invalidated the FTS decision on the following grounds:

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[1] Ninth Commercial Appellate Court Ruling No. 09AP-37762/2017 Case No. A40-29025/17

- Taxpayers are not bound by the priority of transfer pricing methods established by the Tax Code (Article 105.7) and are entitled to select any (or some in combination) of the available methods which is most suitable based on the terms of the transactions;
- Tax authorities are bound by the method selected by taxpayers and are not entitled to select another method until they prove that the method used by a particular taxpayer cannot be applied;
- The data from the price information agency Argus Media, on the basis of which the FTS concluded that the prices applied by Uralkaliy in its transaction with UKT were not at arm's length level, do not provide the necessary level of comparability of transactions with Uralkaliy's controlled transactions;
- The tax base for transactions with related parties may be adjusted only if prices under such transactions are not at arm's length level and result in unjustified tax benefits for taxpayers.

Decision of appellate court

The FTS did not agree with the position held by the court of first instance and appealed to the Appellate Court which upheld the position of the FTS and reversed the decision of the first instance court on the following grounds:

- Under transfer pricing rules, the FTS is entitled to adjust a taxpayer's tax base if it establishes that the taxpayer has used non-arm's length prices in controlled transactions regardless of the taxpayer's intention to receive/actual receipt of tax benefits;
- To confirm that prices applied in transactions with related parties are at arm's length level, taxpayers must first use the comparable uncontrolled price method (CUP method) as a priority. Taxpayers are entitled to use other methods only if they prove that the CUP method is not applicable as the priority method;
- The transactions underpinning Argus Media data are comparable with Uralkaliy's controlled transactions. The fact that such data is used by other state authorities confers additional weight and priority to Argus Media data[2].

Below we have reviewed in more detail two key points:

(1) Transfer pricing rules require establishing tax benefit for tax base adjustment;
(2) Transfer pricing method selection.

Tax benefit and transfer pricing

Upholding the position held by the Supreme Court[3], the first instance court points out that the Tax Code rules on transfer pricing are intended to prevent tax base withdrawal from Russia. Following this logic, the first instance court argues that to adjust the tax base for controlled transactions, tax authorities must establish the following:

- Non-arm's length prices in transactions with related parties, *and*
- The taxpayer's intention to derive tax benefits and withdraw capital through price manipulation.

This conclusion is, in our opinion, disputable because the Tax Code does not tie tax authorities' right to adjust the tax base when taxpayers apply non-arm's length prices in controlled transactions with

[2] The appellate court justifying the application of data from Argus agency indicates that "Argus Media quotations are used by the Federal Antimonopoly Service and the Russian Government"
[3] Review of court practice on application of individual provisions of Section V.1 and Article 269 of the Russian Tax Code approved by the Supreme Court on February 16, 2017

the fact that taxpayers receive tax benefits[4]. The concept of unjustified tax benefit should not, in our opinion, be applied to areas under special regulation such as, for example, transfer pricing.

We also consider that this conclusion drawn by the court of first instance is very deleterious and risky as it blurs the boundaries between the concepts of unjustified tax benefit and transfer pricing. Further blurring of this boundary could end up in tax authorities, having failed to challenge prices in controlled transactions under transfer pricing rules, challenging such prices through the concept of unjustified tax benefit, which is vaguer and does not provide taxpayers with guarantees similar to those provided by transfer pricing rules. This approach would impose on businesses an excessive burden of evidence to justify certain models of doing business. For example, doing business in so-called "low-tax jurisdictions" – aside from the extreme subjectivity and vagueness of this concept – would give rise to additional burden of evidence for taxpayers to prove that it is economically justified for them to conduct business in such territories.

The appellate court did not support the position held by the first instance court and did not consider that tax benefit issues were relevant. And, in our opinion, the appellate court's approach is more sensible.

Transfer pricing methods

The court of first instance actually granted to the taxpayer the right to choose any of the most appropriate transfer pricing methods from those provided by the Tax Code, or a combination of these methods. It also forbade tax authorities to use other methods to assess whether prices are at arm's length level until they prove that it is not possible to use the method selected by the taxpayer.

The appellate court did not support the position held by the first instance court, indicating that the taxpayer must apply the CUP method first and is entitled to apply another method only if the taxpayer proves that the priority method cannot be applied. The question of the consequences that could arise for non-application by the taxpayer of the priority method with no sufficient grounds for such omission remains unresolved. According to the logic of the court, apparently in this case, tax authorities are not bound by the method chosen by the taxpayer and are entitled to use the priority method.

It is important to note that, when choosing the priority method, both the court and the FTS lost their way in two articles of the Tax Code and erroneously considered the CUP method as the priority method whereas the Tax Code expressly states that the resale price method is the priority method to determine market prices for sale-purchase of goods if goods are subsequently resold without processing to independent entities[5]. Moreover, we are of the opinion that, if the resale price method, being the priority method, turns out to be inapplicable, the taxpayer should be entitled to select any other appropriate method so, in this case, the CUP method should not have priority. On the contrary, we think that it would be more appropriate to apply the transactional net margin method (with net profit margin as a weighted indicator) as it is the closest to the resale price method, which is the priority method in this case.[6]

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[4] Article 105.3 Russian Tax Code

[5] Article 105.10(2) and Article 105.7(3) Russian Tax Code

[6] This approach would be consistent with OECD approaches to the application of transfer pricing rules (Items 2.2-2.4 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017). We would also like to note that the Tax Code does not give a clear answer as to whether taxpayers are entitled to apply any suitable method if the resale price method, being a priority, turns out to be inapplicable. So, on the one hand, the Tax Code expressly states that the resale price method "supplants" the comparable uncontrolled price method from its priority position for certain transactions (Article 105.7(3) and Article 105.10(2) Russian Tax Code). Moreover, the Tax Code does not provide for a "second priority" method. It therefore can be assumed that, if it is not possible to apply a priority method, taxpayers will be entitled to select any most appropriate method as set out in Article 105.7(4) of the Tax Code. On the other hand, Article 105.7(4) of the Russian Tax Code also provides that it is possible to apply the most appropriate method only if it is not possible to apply the comparable

The fact that Uralkaliy justified the inapplicability of other methods in the documentation it submitted is particularly troubling. Uralkaliy used standard commonly used wording, briefly and sufficiently clearly describing the reason for not using this or that method. But the court of appellate instance found this justification insufficient and rejected it. We therefore recommend taxpayers to reconsider the approaches they use to prepare transfer pricing documentation and to thoroughly justify transfer pricing method applicability, especially as far as the comparable uncontrolled price method is concerned if several information sources are used at the same time).

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The practice on application of the rules of Section V.1 of the Russian Tax Code is only just beginning to form so it is not uniform and consistent yet. This case is no exception, and Uralkaliy has, in our opinion, a fairly high chance of challenging the decision rendered by the appellate court.

If you have any questions regarding the above or require assistance in preparing transfer pricing documentation, please feel free to contact us.

Yours truly,
Forte Tax & Law Team

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uncontrolled price method. We, however, are of the opinion that, in the spirit of the Tax Code, this provision should not be applied if the comparable uncontrolled price method is not a priority method (supplanted by the resale price method).