

**SECTION 2 – YOUNG RESEARCHERS' PAGE**

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**THE TRANSFER PRICING CONTROL MECHANISM AND  
REPORTING SYSTEM IMPLEMENTATION CHALLENGES:  
UKRAINIAN EXPERIENCE**

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***Abstract***

*This paper was presented at the 10th annual WCO PICARD conference (in the frameworks of the “Youth Forum”), 8-10 September 2015 in Baku, the Republic of Azerbaijan.*

*In most countries of the world in order to avoid speculation with prices between related parties and prevention of evasion by businesses from payment of taxes have been developed and approved at the legislative level transfer pricing rules. In 2013, Ukraine made the first steps towards introducing a system of state regulation in the field of transfer pricing. This issue is one of the key in the management of tax risks for international companies, as the volume of intra-group transactions and their diversity is constantly increasing.*

*Actuality of the paper is connected with the fact that the process of transfer pricing control implementation caused by the common use of the transfer pricing mechanism in export-import operations is accompanied by the presence of a number of problematic issues that require investigation and correction.*

*The aim of this work is to study the features of the transfer pricing control process and specific statements of reporting on controlled operations of subjects of foreign economic activity, identify problematic issues and develop proposals.*

*The paper considers the essence of the transfer pricing control mechanism over transfer pricing operations. The authors' views on peculiarities of this mechanism introduction into the Ukrainian system are expressed; the problems existing in this area are analyzed as well as the recommendations for improving the control mechanism are provided. The current system of reporting on controlled transactions is studied; the disadvantages of the proposed report are described and ways of improving this system are developed.*

*To highlight the chosen subject definite scientific methods of investigation, namely analysis, synthesis, comparison, generalization were used. Such specific methods of economic study as economic-statistical and economic-analytical methods for the preparation of tables and diagrams were applied.*

*We express our gratitude to the organizers and participants of the conference PICARD 2015 for the discussion and expressed views on this subject, which became the basis for writing this paper.*

*Keywords: transfer pricing, controlled operations, taxation, reporting, economic operators.*

## **Introduction**

In most countries of the world in order to avoid speculation with prices between related parties and prevent evasion from payment of taxes transfer pricing rules have been developed and approved at the legislative level.

Transfer pricing control mechanisms are focused primarily on the correlation between a transmission (transfer) price and a market price prevailing at the open market between independent parties. In this case, taxpayers must pay taxes where income is economically justified, but they do not have to change the price or the terms of their business.

In 2013 Ukraine made the first steps towards introducing a system of state regulation in the field of transfer pricing. Transfer pricing is a key issue in the management of tax risks for international companies, as the volume of intra-group transactions and their diversity is constantly increasing.

Actuality of the paper is connected with the fact that the process of transfer pricing control implementation caused by the common use of the transfer pricing mechanism in export-import operations requires the complete, appropriate and accurate information about the details of these operations to be submitted to regulatory agencies, which can be done through the economic operators' reporting.

The aim of this paper is to study the features of the process of transfer pricing control, its information support and specific of businesses reporting on the controlled operations.

In order to establish the principles of state control over transfer pricing a number of regulations have been adopted in Ukraine. However, a number of problems having been systematized during the research exist in the present control system.

## **1. The nature and peculiarities of transfer pricing**

Improving the forms of capital consolidation, the development of corporate law and telecommunication technologies in the US and Western Europe in 20-30s led to the creation of transnational corporations and, as a consequence, the development of an internal pricing for products, which move between a company's units. This phenomenon is called transfer pricing.

The basis for the use of the transfer pricing mechanism by firms is the following principles, namely:

- maximization of profits for the corporation as a whole;
- minimization of taxes paid by the corporation as a whole;
- minimization of Customs payments;
- improvement of a parent company's control system over the financial flows of its branches;
- provision of management at all levels (both national and international) with equal conditions for establishing and maintaining such prices that would ensure the profitability of branches and a favorable attitude of consumers .

Transfer pricing has become a subject of governments' research and impact since taxpayers invented ways to minimize their tax liabilities through transfer pricing.

Today, the issue of transfer pricing is resolved at the legislative level in many countries, particularly countries in America (the United States and Canada), developed countries in Europe (Britain, France, Germany) as well as in CIS countries (Russia, Kazakhstan and others). In addition, within the framework of the Organization for Economic Cooperation and Development a number of documents in this area have been developed, which are guidelines for a majority of states. Ukraine's orientation to the international experience and the need to cover the budget deficit requires significant state regulation over transfer pricing, which should be one of the effective ways to replenish the state treasury.

According to the Ukrainian legislation the transfer pricing system is defined as the normal price of goods and / or services within the transactions recognized as controlled.

Now the issue of an artificial creation of the financial flows between companies being the parts of the same transnational corporation or industrial and financial group, which allows participants of these transactions to accumulate substantial financial resources and minimize tax liabilities, is rather acute.

So, there are three most common types of operations based on transfer prices that lead to an underestimation of tax liabilities :

1. Ukrainian enterprises, which are members of the trade and industrial groups, export manufactured goods to related parties located in jurisdictions with low taxation (in particular, Cyprus, Luxembourg, Switzerland), at prices close to the cost of production , and they, in turn, sell them to customers at market prices. Thus, as most of the profit from the sale remains abroad, Ukraine does not receive full amount of taxes and revenues in foreign currency do not flow into the national banking system. This type of operation is the most common and schematically shown in Figure 1 .

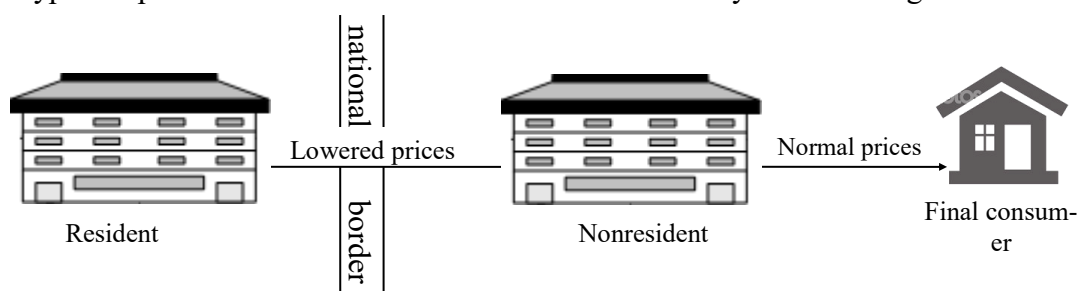


Figure 1. The scheme of operations with the use of transfer pricing

2. Distributors of international companies import products of foreign manufacturers into the territory of Ukraine at inflated prices, which reduces the Ukrainian company profits from the resale of such goods to domestic buyers as well as the amount of taxes payable to the budget. The margin created settles in the country from which such a supply came. The most risky in terms of carrying out such operations are importers of vehicles, industrial equipment, household chemicals, medicines, clothes and other similar goods .

3. The use of transfer pricing in transactions at the domestic market. At first glance, they do not require regulation, because an understatement of tax liability by one party will lead to its overestimation by the other, that is, the amount of unpaid taxes is offset by the sum overpaid. But it is not so. Firstly, many Ukrainian enterprises use preferential tax treatment (e.g., agriculture) and secondly, during the crisis companies have accumulated significant tax losses, which allow them not to pay taxes now. Such companies can carry out operations, result of which is avoidance of taxation [1].

According to the State Fiscal Service of Ukraine the usage of transfer pricing within all types of operations results in 100 billion hryvnia tax evasion annually (at the same time with the help of such schemes around \$ 21 trillion was derived in the offshore throughout the world during a year). This leads to almost 20-25 billion hryvnia loss of the national state budget, including 6.4 billion hryvnia shortfalls in funds from exports annually. The volume of ferrous metals, grains and oilseeds to be exported through related parties in the offshore areas is about 60% [4].

The subject of transfer pricing is actively studied in the works of modern Ukrainian scientists. All the scientific researches on the subject can be divided into two periods in terms of the time of their occurrence, in particular: until the introduction of the transfer pricing regulation mechanism in Ukraine and after its introduction. The majority of researches are related to the first period.

At present there are no researches, which would provide a systematic list of problematic issues arising during the transfer pricing monitoring mechanism implementation in Ukraine as well as give an appropriate response to these problems and improve the control system as a whole .

## **2. The mechanisms of state control over the operations using transfer pricing: problematic issues**

In order to establish the principles of state control of transfer pricing a number of regulations, in particular the Law of Ukraine "About the Amendments to the Tax Code of Ukraine concerning transfer pricing" (The Law of Ukraine from July 4, 2013 No 408-VII) have been adopted as well as the procedure for registration of reports on controlled transactions (Order of the Ministry of income and fees from November 11, 2013 No 669), a list of information resources on market prices (Resolution of the Cabinet of Ministers of Ukraine from October 23, 2013 No 866-r), a list of operations with agents which will be subject to verification (Resolution of the Cabinet of Ministers of Ukraine from December 25, 2013, No 1042-r) and other acts aimed at preventing the understatement of tax liability for the transactions with related parties have been approved.

However, there are a number of problematic issues in the transfer pricing control system introduced in Ukraine due to the novelty and the lack of study of this topic.

The new rules provide the evaluation and comparison of the profitability of foreign trading firms acting as intermediaries in the sale of Ukrainian goods, with a profitability of comparable unrelated persons. Though, the revenue authorities can make the exporter pay an additional tax after having discovered that his foreign counterpart gets too high profit from such transactions. The imperfection of the proposal is that data on the profitability will be provided to regulatory authorities directly by exporters, which is accompanied by the risk of concealing information about the ownership structure and related persons. On the other hand, exporters are unprotected from the breaches of confidentiality of information provided to control authorities, because there is no legal responsibility of the officials for the disclosure of their data in the legislation.

Another disadvantage of the new system is a limited approach to the selection of areas, the export into which is automatically subject to control, since the presence of a flexible system of tax coordination in some countries allows their residents not to be got caught in the control zone and continue to purchase products at transfer prices.

At present, there are several factors to be decisive for entrepreneurs in choosing the areas for operations using transfer prices (Figure 2).

In the current legislation only operations that are affected by the first group of factors become a subject of automatic checking. However, it should be taken into consideration that the gradual liberalization of the tax legislation in Ukraine reduces the ability to monitor transactions with agents located in the areas that will go out of control while income tax rates in Ukraine are reduced by 16-17%. Thus, the Republic of Cyprus with a rate of tax at 12.5% can be eliminated from the list of controlled states and territories, but for entrepreneurs, in connection with the existence of factors of group II, transactions with residents of this country will continue to be profitable, which is likely to maintain the further functioning of established circuits using transfer prices.

In addition, due to the inclusion in this list of typical consumer-countries of Ukrainian goods (Georgia, Moldova, etc.), conscientious exporters supplying goods to these countries will face the challenge of the procedure of proving disconnectedness and the risk of being subjected to unreasonable taxation. Therefore, according to a global study on transfer pricing conducted in Europe by Ernst & Young, 47% of respondents reported that checking operations on transfer pricing by public authorities led to unreasonable taxation (Chufarov 2013). That is, while conducting the monitoring of operations regulative authorities recognized as transfer those prices that participants of the transactions considered to be in relevance to the conditions of a particular delivery, namely market prices. This resulted in an adjustment of tax obligations and imposing additional tax on those revenues that did not actually exist. Projecting foreign experience in the Ukrainian realities, we can assume the presence of a greater number of such cases in the operations of local entrepreneurs.

Along with other know-how in the area of state control it has become necessary to provide a

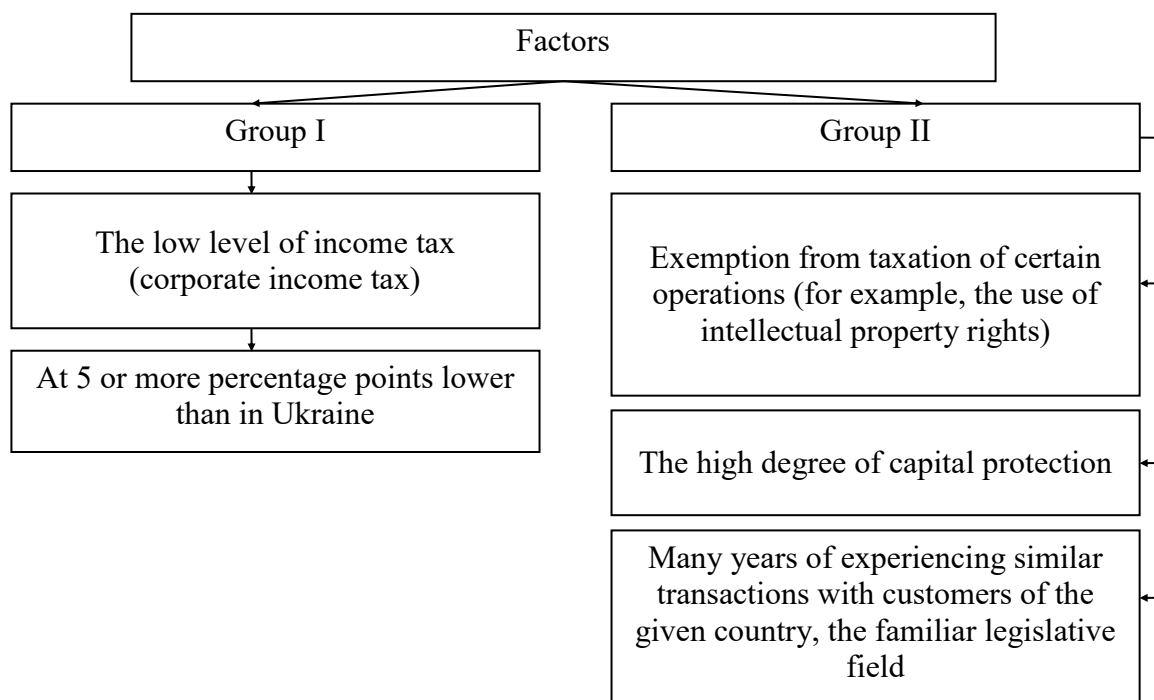


Figure 2. Factors of selection by entrepreneurs' of areas for operations using transfer prices

taxpayers' report on controlled operations and at the request of the regulatory authorities – primary and other documents in order to prove compliance of the contractual prices of such supplies with the level of the regular rates. Therefore, one of the key factors in the predicted effectiveness of the new legislation in this area should be the willingness of taxpayers to accept a contractor as a related party and uncover the details of its financial statements. Furthermore, additional documentation subject to submission, depending on the complexity of a controlled transaction, may involve significant amounts of documents, some of which, particularly containing information about the cost of production, constitutes a commercial secret and are not subject to public eye. Considering the great number of documents and often imperfect system of electronic document management throughout enterprises, an introduced provision will be an additional burden for Ukrainian exporters.

The issue of taxpayers' provision with necessary information, which would allow proving the authenticity of the contract price, is rather acute at the present stage of international transfer pricing rules implementation into the Ukrainian economy.

The list of publications (sources of information) for the purposes of transfer pricing in Ukraine, approved by the Cabinet of Ministers of Ukraine, is limited. What is more, all the sources of initial information are under the full control of government agencies and only some of them can be called commercial or specialized.

In its turn, the market information in these sources is often of low quality. In the vast majority of these sources there are no data on the range of goods, producers and product quality, delivery and payment terms, volume of delivery, conditions of obligations fulfillment as well as other necessary information. This makes it impossible to objectively compare the prices in comparable transactions.

The abovementioned list of officially approved information sources doesn't include international publications and databases (for example, pricing information of such agencies as Platts, Argus, 3000Xtra, Cotlook Cotton Quotes, CRU, Bloomberg, Reuters, FMB, FERTECON, international and national databases Amadeus, Isis, Orbis, Aida, Aurelia, Dafne, Dash, Diane, Icarus,

Markus, MintGlobal, Odin, Reach, Ruslana, Sabi, Sabina, Saffron etc.).

Such an approach of government officials contradicts to the modern world trends, because it violates the key elements of the substantive law on transfer pricing, namely :

- absence of any information sources' preference;
- accessibility and reliability of sources;
- possibility to use the information of previous periods (without any restrictions);
- using in practice by tax authorities the same volume of information as used by taxpayers;
- using by tax authorities the same sources as used by taxpayers, if the former do not prove the existence of more reliable information in other (alternative) sources (Association Newsletter 2014).

Implementation of the new standards of recordkeeping and rules for determining prices will require taxpayers' time to prepare qualified personnel, monitor transfer pricing, create suitable software to optimize procedures and make changes in the enterprises' administrative processes and workflow.

The obligation to provide a detailed report to tax authorities leads to an excessive burden on businesses, namely their employees are bound to keep an additional documentation. Furthermore, a business entity is forced to attract additional workers and bears additional costs.

Such provisions make it necessary to increase the staff of regulatory authorities as well. Handling large amounts of data requires more time to learn and adapt to the additional reporting rules. For this purpose the time for checking transfer pricing regulation is set as a period of 6 months.

As these checks provide for the provision of all primary documentation, it appropriately may lead to businesses' halt or significant complications in the long term .

### **3. The analysis of disadvantages of “Controlled Operations Report” of foreign economic activity participants**

The first experience of Ukrainian companies on the preparation and submission of a Controlled Operations Report has revealed weaknesses and inconsistencies of existing treatments (Figure 3).

One of the challenges is a detailed description by every object of controlled operations and a possibility of their grouping. Based on the report form, an operation should be described separately by each item. However, only within an operation of delivery (for example, in a single Customs declaration) hundreds and thousands of products with different names and prices may be sold. An identification of each item as a separate operation is a very complex process and the existing software does not allow it to automate. Therefore it would be appropriate in case of the delivery of goods with many headings to allow a generalization of their names, using a group name of items. This, on the one hand, will make it possible to save efforts of foreign trade participants, and, on the other hand, will not affect the credibility, because the amount of controlled operations and the total value of transactions according to a Controlled Operations Report will match (<http://www.km-partners.com/ua/eksklyuziv/992-pershiy-zvit-komom>).

Another problem is an obsolescence of the proposed classifier for defining the measurement units and its incompliance with a diversity of modern business operations objects. The order of filling a Controlled Operations Report implies that the measurement unit code of an item is indicated in accordance with Classifier 1997 [5], which is obviously a bit old. Therefore, during a service provision operation a foreign trade participant does not understand which Classifier code he has to apply. Thus, it is necessary to improve the existing classifiers by including certain measurements units not only for goods but also for services.

One more issue of a technical side of reporting is a necessity to specify all monetary figures in hryvnias without kopecks with the corresponding rounding according to generally established rules. Each unit price and the exchange rate used in the calculations are also the subject of rounding.

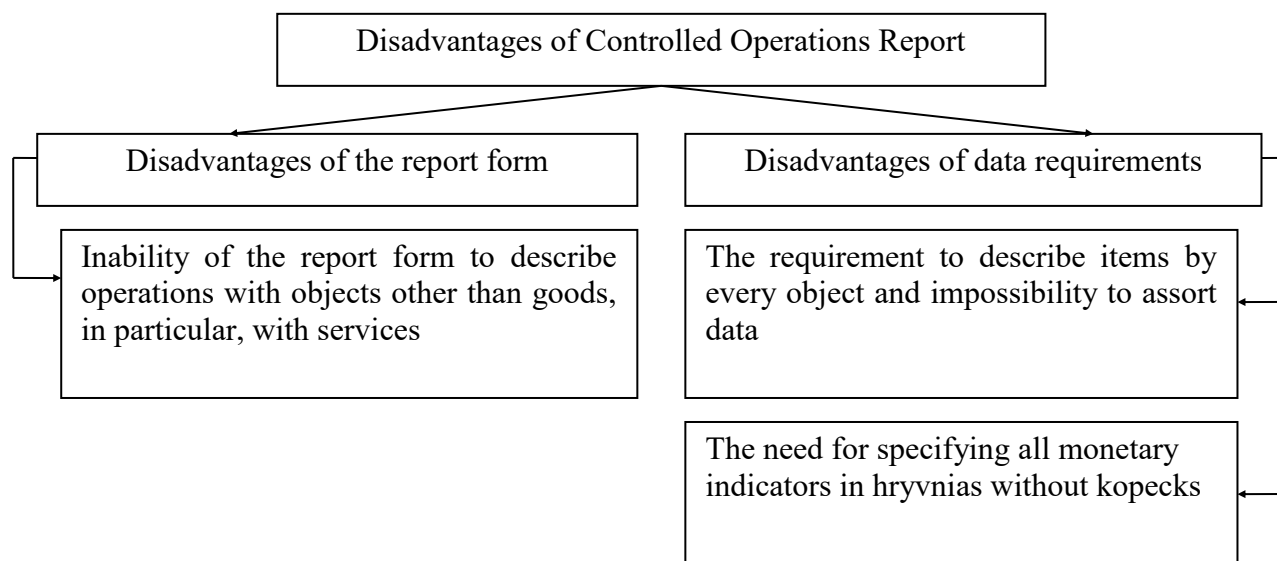


Figure 3. Disadvantages of Controlled Operations Report

Specifying each monetary figure with a corresponding rounding in the formula for determining the total value of a transaction can lead to incompliance of the transaction total amount calculated according to this formula with the actual amount of the transaction according to the primary documents. In case of fulfilling the rounding requirements a taxpayer may need to give additional explanations to regulatory authorities about existing inconsistencies. When filling out the reports using accurate data, that is, the required number of decimal places, the report details will be more in line with the primary documents data. This way of presenting digital information is more efficient.

In addition, many enterprises have a problem with using the sources of information on market prices determined by the Cabinet of Ministers of Ukraine in their Controlled Operations Report. The list of these sources is presented in a table containing data on titles of the information sources, publishers (holders of Internet resources) and a group of goods, which these sources relate to. The names of the sources show that they only provide information about products. That is why, when a controlled operation provides services, a taxpayer submitting a Controlled Operations Report can not use the official sources of information, because neither of them included in the list does not imply cost of services. Under the legislation a regulatory authority takes into account the information sources used by a taxpayer in determining the price of a controlled operation, only when they are official. Since the official sources of information on services (and most goods) are missing, in fact, taxpayers have to use other available sources to justify the level of prices in their transactions (<http://www.km-partners.com/ua/ekslyuziv/992-pershiy-zvit-komom>).

Experts Horn and Elbert emphasize that in Germany, unlike in Ukraine, there are no market price lists, which could be used to check transfer pricing. In some cases, prices being publicly available can be compared, e.g. of raw materials, or interest rates that can be obtained from the economic columns of daily newspapers or the Internet.

Of course, now in Ukraine a list of sources is non-exclusive and allows using other information resources. Thus, the transition to the other methods of determining the normal price, which differs from the method of comparative uncontrolled price, should incur a search of public information on the indicators of financial statements of similar enterprises. Especially taking into account that in Ukraine the market of some products is much monopolized, any production is a unique one and eliminates the possibility to compare prices and terms of business. Information on similar

production can be obtained only from commercial databases (world and European), which are payable and beyond the estimates of domestic enterprises. The reduction of many industries and workforce makes it inappropriate and untimely to lay on such businesses an additional financial burden in the form of the implementing transfer pricing rules costs (Ghutovska 2014).

The best solution for enterprises could be paid services from the entities having the corresponding licenses for the use of commercial databases, preparation of analytical information on the taxpayer's request about prices of goods, manufacturers of such goods, related parties etc.

Thus, when completing a Controlled Operations Report, agents of controlled operations face a large number of challenges that make it impossible to correctly present the information required .

### **Summary and concluding remarks**

To sum it up, Ukraine's commitment to the international experience, a need to cover a large budget deficit as well as a great number of operations using transfer pricing require state regulation of this process, which should be one of the effective ways to replenish the national treasury.

In order to improve the transfer pricing control system, it is necessary to modernize the existing legislation in the area, namely :

- to expand the number of criteria for the selection of countries to be monitored by deepening the analysis of the taxation systems characteristics and preferential treatments in each of these countries;
- to reduce and fix the amount of additional documentation to be sent to regulatory authorities, applying an expanded list only in case of audits;
- taking the experience of developed countries, to introduce a system of incentives for the correctness and completeness of reporting;
- to make regulatory authorities responsible for the disclosure of commercial secrets and develop effective measures to ensure information safety.
- In order to improve the reporting system of controlled transactions it is necessary:
- to allow a generalization of items names in a Controlled Operations Report by using their group name in case of the delivery of goods with many headings;
- to adapt the report form to the possibility of providing clear and accurate information not only on products, but also on services, including the provision of certain measurement units and sources of information about common prices;
- to complement the list of information sources on common prices with conventional international publications and databases, which would be more independent;
- to cancel rounding prices and exchange rate when determining the numerical values of the Controlled Operations Report, which will lead to a greater compliance between the calculated amounts and primary documents data.
- To maximize the effectiveness of legislation requirements implementation taxpayers should:
- within a management accounting system enter the accounting of transactions qualified as controlled together with employing a transfer pricing expert;
- gather preliminary information and prepare documents that would justify a compliance between contract prices of controlled transactions and common market prices;
- keep an analytical account of controlled operations in terms of their types and for each contractor with the indication in the accounting registers both the price of the contract and the common price determined in accordance with the Tax Code requirements;
- create a registry of related parties to include detailed information on the conditions of connectivity and specific information about each person to be used in the preparation of applications to the Controlled Operations Report.



## Endnotes

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