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MEMORANDUM FOR

Mr. Sergey Shatalov
First Deputy Minister of Finance

cc: Professor Michael Alexeev
Mr. Mark Degler
Dr. Yegor Gaidar
Dr. Sergey Sinelnikov
Mr. Illya Trounin

From: Bob Conrad

Subject: Valuation and Transfer Pricing: Memo #1

Two objectives are addressed in this memorandum. First, transfer prices as a subcategory of valuation methods are described in order to clarify definitions. Second, a list of valuation and transfer pricing issues is provided in order to understand the specific questions that are important to you and others in the Russian government. Once these two objectives are satisfied, we hope to jointly develop proposals that satisfy both Russian needs and international standards.

1. Valuation for Tax Purposes and Transfer Pricing

Most taxes, except per unit charges, depend on some type of monetary valuation. In market economies where voluntary compliance methods are employed, the taxpayer generally reports this valuation, with some exceptions.[1] Tax administrators in such situations may be expected to validate the taxpayers' claim. Methods of validating claims include, but are not limited to:

- Use of published prices for goods and services;
- Use of "check" prices for goods (where tax authorities determine a minimum (or maximum) value for a particular good or service);
- Use of observed market prices;
- Use of some methodology based on observed values (such as net back pricing for natural resources);

[1] Ad valorem property taxes are one exception. Property values are computed by the government, generally local governments in market economies, and reported to taxpayers. Taxpayers have the right to appeal valuations but some level of government (and organization of government) provides valuations based on some specified methodology.

- Use of inference based on observation (computing income based on net worth for instance); and

- Use of a methodology for determining values that are not observed in markets.

The use of these and other methods for verification will depend on the facts and circumstances, the taxpayer and the type of tax.

Article 40 of the Russian Tax Code, entitled "Principles of Determining the Price of Goods (Works, Services)," contains a definition of allowable valuation methods for taxation purposes. I understand that Article 40 applies to all taxes (income taxes, VAT, excises, tariffs and other taxes) unless Article 40 is explicitly overridden in the specific laws contained in Part 2 of the Tax Code.[2] The standard to which any valuation methodology is compared is "market prices."[3] (Art. 40.1). That is, I understand that any valuation offered by a taxpayer that is equivalent to, or equal to, an observed price in a relevant market would satisfy the Russian standard.[4]

It appears that prices reported by taxpayers will generally be accepted as market prices. However, potential exceptions include transactions between related parties (however defined), swaps, international transactions and prices that deviate from some standard (at least for homogeneous goods).

Furthermore, it might be inferred that the price used to determine the value for one tax (tariffs, for instance) is expected to be used for all other taxes and charges (income taxes, for instance). While such an outcome might be desirable relative to some criteria, this outcome should not be necessary. For instance, customs valuations are generally based on c.i.f border prices. In addition, customs authorities might employ "check prices" where the customs value is the greater of the declared value or the check price.[5] The value of the same commodity for income tax purposes might differ because the value is computed either at a different time or place (for example, computing c.i.f. value at

[2] The article is clear in that "for the purposes of taxation" is included. No modifier to the term "taxation" is present and thus the article appears to apply to all taxes.
[3] The term "market price" is used in the English translation.
[4]There is no definition of market price and no implication is drawn about the type of market or market structure from this definition. For instance, the authorities would use the observed price for a good or service if the price was controlled by the government [Art. 40. 13] at a level that is less than the market price. In addition, market pricing may reflect market power in the case of monopoly, monopsony or other type of restricted entry. Market prices may, or may not, be equivalent to "arm's-length" prices. It appears that the arm's-length standard is one, but only one, component of determining market prices (Art. 40. 8). For instance, the observed market price of steel might be $20.00 per unit but an unrelated purchaser might be able to purchase steel for $19.00 because of market power or other factors. Such a transaction will pass any arm's-length test, but I am not certain whether the transaction would satisfy the "market price" requirement.
[5] These check prices might be the effective definition of "market prices" for customs. This inference is not precluded by Art. 40. 11.

the factory instead of c.i.f value at the port, computing the value two weeks later than the date of import with interest included in the price, or by using a transfer price).[6]

2. Transfer Pricing (As Understood in Market Economies)

As noted, transactions between related parties are one component of Article 40. Transfer pricing as commonly understood in market economies is a valuation issue for related parties (however defined) with respect to income (and perhaps value added) taxation. That is, transfer pricing is an issue pertinent to the attribution of income for related parties. For instance, Article 9 of the OECD model tax treaty states:

> "[When] conditions are made or imposed between… two [associated] enterprises in their commercial and financial relations which differ from those which would be made between independent enterprises, then any profits which would, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."[7]

Also, Section 482 of the US Internal Revenue Code states:

> "In the case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States and whether or not affiliated) owned, or controlled directly or indirectly by the same interests, the Secretary (of the Treasury) may distribute, apportion, or allocate gross income, deductions and credits or allowances between or among such organizations in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or business."

Three implications can be gleaned from these two passages:

a. Transfer pricing is a method to attribute "income", and thus applies to income tax matters;[8]

[6] The burden of proof for changing the valuation method is understood to be on the tax administration under Russian law, with possible exceptions.
[7] As quoted in OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations".
[8] Transfer pricing in VAT transactions has become an area of increased interest. This is because source, resident and attribution rules similar to those for income tax are used in VAT legislation, at least since the development of the VAT in New Zealand. Eventually, it might be the case that VAT issues be included in international tax treaties.

b. Transfer pricing is generally restricted to transactions between related parties (however defined); and,

c. Transfer pricing is generally applied to business transactions.

Note that the term, “transfer price”, is not used in either cited passage. This is because transfer pricing is only a means to an end. The objective is the attribution of income and not to determine the value of any particular transaction or value.

A fourth inference may be that transfer pricing generally refers to cross border international transactions between related parties. This inference is not necessarily correct. Income attribution issues may arise between regions in a country (such as the states in the United States or the regions in Russia), particularly if tax rates differ. In addition, income allocation issues might arise between related parties within a single jurisdiction if one party is operating at a loss (or is a not-for-profit enterprise or otherwise not taxable) while the other party would otherwise have taxable profit.

Finally, transfer pricing, however defined, is not necessarily a tax concept. Business decision makers with more than one activity (within or across jurisdictions) must determine the price signals that will maximize profits and provide a reasonable summary of the operations of the divisions (even absent taxes). Transfer pricing is one method to provide such signals. For instance, a firm that produces both cloth and shirts might establish a price for cloth supplied to the shirt operation in order to provide incentives for both the cloth and shirt operation to maximize the profits of the overall enterprise and to determine whether the overall enterprise would be more profitable without one segment. That is, it might be more profitable for the overall operation to simply produce shirts and purchase cloth from other unrelated enterprises.

3. Implications for the Russian Situation

One implication of the distinction between valuation methods and transfer pricing is that transfer pricing is not a general valuation methodology. That is, methods to determine a transfer price, such as the transactional profits method, resale price method and cost-plus method, are generally restricted to income taxation (and perhaps VAT) questions. This does not imply that such methods are inappropriate for other taxes. For instance, net back pricing is commonly employed to determine transfer prices for income attribution of multinational related mineral enterprises. Such a method might also be employed to determine the export tax (or royalty) for a single domestic mineral producer who sells output on the spot market.

It is reasonable to ask the following questions before attempting to employ transfer pricing methods such as those advocated by the OECD:

1. Is the issue related to valuation?

    a. If yes, then go to Step 2.
    b. If no, then use another method.

2. Is the valuation issue pertinent to a legally related (or controlled) party (however defined)?

    a. If yes, then go to Step 3.
    b. If no, then use methods relevant to the particular tax and circumstances (such as fraud).

3. Is the transaction or valuation issue related to income tax (or VAT)?

    a. If yes, then a transfer pricing methodology might be applied.
    b. If no, then valuation methods other than international standard transfer pricing methods may be employed.

The distinction made in Step 1 is important. For instance, suppose a single entity purchases inputs from a fly-by-night firm at high prices, relative to some standard, and the fly-by-night firm steals the VAT revenue. The purchasing firm then exports the goods and claims a VAT refund. This is not a transfer pricing issue. Rather, the issue is whether the purchasing firm colluded with the fly-by-night to defraud the government of revenue. There is no issue about value in this case. Valuation only determines the amount of theft. In addition, control, in some legal sense, is not the issue. Two otherwise unrelated parties might collude to steal from the government.

The second distinction is relevant to the legal definition of a related party (or an enterprise controlled by another enterprise or person). Related parties have an incentive to maximize the after-tax profits of the entire group. Unrelated parties have an incentive to maximize their separate after-tax profits. This difference in incentives has been deemed sufficient to employ "transfer pricing rules". For instance, a person might sell output at a significant discount today to a completely independent party in the hope of generating significant future sales. The fact that the price is lower than any established market price today, any contract price, or any observed price is irrelevant. No income tax adjustment is necessary in this case because the person is acting in her/his self-interest to increase profits over a longer time period.

The third point implies that other valuation methods might be appropriate for other taxes. For instance, I have advocated that average observed retail prices (with some adjustment) be used to compute the per unit equivalent of an ad valorem excise tax on alcoholic beverages, among other items. This value should not be used for income tax purposes, however. The objectives of each valuation method are different. The estimation method for excise tax is intended to mimic an ad valorem retail sales tax; a sale that might be made by a completely independent party, while reducing overall administrative costs.[9] The purpose of the valuation method for the income tax is to determine the base of that tax with reasonable accuracy.

Finally, it should be noted that transfer pricing issues are pertinent for a variety of transactions between related parties and not simply pertinent to valuation of goods. The comparable uncontrolled price method might be appropriate for commodities that are relatively homogeneous and for which established markets exist. Other transactions for goods or services that are either unique or for which established markets do not exist might determine whether a related party will report significant income in a particular jurisdiction. For instance, overhead allocations from the head office, charges for trademarks and payments for proprietary technology are examples of transactions where neither a market exists nor a comparable transaction might occur. Such issues do not arise between unrelated parties. A price simply might not exist in such cases and determining a transfer price has been judged to be the international standard.

4. List of Issues

Given the discussion above, I believe it might be productive to develop a list of valuation issues pertinent to Russia. Such a list will provide a means for all our colleagues to understand the valuation issues relevant to the Russian situation. In addition, a discussion of each example will provide a basis for understanding the issues specific to each case (fraud, transfer pricing, undervaluation, overvaluation or other issues). The ultimate goal is to develop principles to be used in modifying Article 40 and other relevant Articles of the Russian Tax Code. Objectives for modifications include:

- Increasing the understanding of taxpayers and tax administrators of the issues involved,
- Increasing compliance,
- Developing rules that can be administered, and
- Applying the appropriate tool for different situations.

[9] It is cheaper to monitor a few producers relative to many retailers.

Mike Alexeev reviewed the list provided. This list is based on our understanding of situations where valuation issues might be important for Russian authorities. Thus, it would be beneficial if you, colleagues at IET and others review the list, making corrections and modifications where necessary. My plan is to discuss each type of valuation method based on the examples in a series of memoranda so that the issues are clarified. I hope that such a discussion will provide input into developing productive modifications to the law.

Thank you for your consideration of this matter.

Valuation Issues
First Round

1. An oil company exports crude oil for $24.00 per barrel to a third party (completely independent unrelated party) and reports $20.00 per barrel on its income tax return.

2. A new car is imported into Russia. The market price in Germany is 100,000 Euros but the customs value reported is 45,000 Euros.

3. A foreign related party loans money to a Russian domestic entity. The loan is in Euros. The interest rate charged is 1% and the market interest rate for Euros is 7%.

4. A new firm is created. The firm is below the VAT threshold and is a small business taxpayer. This firm buys from a supplier at 8 rubles per unit when the market price is 800 rubles. The supplier has no VAT liability and lower income taxes. The new firm sells the supplies without VAT and pays small business tax.

5. A branch in a region with a low profits tax rate sells to a Moscow office for a price of 150 when the market price is 110.

6. A branch (or domestic subsidiary) of a Russian corporation is making taxable losses and sells output to the profitable parent company for 150 when the market price is 100.

7. A foreign company (unrelated to any Russian business) ships components to Russia. The Russian business uses the components to produce a machine that is exported to the foreign company. The Russian business is paid a fixed fee of 75 per unit for producing the machine.

8. A foreign firm ships components to a Russian subsidiary. The Russian subsidiary uses the components to produce a machine that is exported to the foreign company. The Russian subsidiary is paid a fixed fee of 75 per unit for producing the machine.

9. A foreign firm ships 10 bottles of French wine to a Russian subsidiary. In payment, the Russian firm ships the foreign firm 30 cases of Russian beer.

10. A domestic subsidiary of a foreign firm is charged a management fee by the foreign parent for centralized management charges. This fee is equal to 2% of the domestic subsidiary's gross turnover from domestic sales.

11. A Russian company sells goods to a related party overseas for 50 rubles. In addition, the Russian company is charged 200 rubles by a second related party for insurance.

12. A foreign firm charges a Russian related party 15% of gross revenues as a license fee for the rights to use patented production technology.

13. A foreign drug company charges a Russian subsidiary 200 rubles for research and development expenses. These charges are based on the Russian share of worldwide gross revenues from sales of patented drugs.

14. A foreign petroleum company leases equipment to a Russian joint venture to which a permanent establishment of the foreign petroleum company is a partner.

15. A foreign firm sends a Russian smelter alumina and the Russian smelter sends the foreign firm aluminum ingots in exchange. The Russian smelter is paid a fee of 5 Euros per ton of aluminum shipped.

16. A person resident in Russia provides professional services to another person. Both persons are VAT taxpayers. The purchaser pays the seller 2,500,000 rubles plus VAT. The purchaser takes credit for the VAT. The seller disappears.

17. A legal entity in Russia sells goods to another legal entity. Both entities are VAT taxpayers. The purchaser pays the seller 2,500,000 rubles plus VAT. The seller disappears. The purchaser officially exports the goods and claims a refund.

18. A domestic subsidiary of a foreign firm imports goods from the foreign parent. The price charged by the parent is 50 rubles and the world price of the good is 50 rubles. The domestic subsidiary is charged 100 rubles for transportation. This transportation charge is paid to another subsidiary of the foreign firm that specializes in transportation.

19. An executive of a Russian company obtains a loan from the Russian company at 50% of the central bank rate.

20. Heirs to an estate list financial assets and property of 1,000,000 rubles for inheritance tax purposes when the basis of the assets is 10,000,000 rubles.

21. A foreign purchaser who exports from Russia has strong bargaining power and is able to negotiate a price for a commodity with an unrelated Russian supplier that is lower than the price the Russian supplier sells in the domestic market (adjusted for exchange rate effects).