

LT in Focus

Uralkali wins the dispute over TP audit assessment of additional tax liabilities

In 2012, Uralkali (the "Company") exported potash fertilisers through a related Swiss trader (the "Trader"). The Company prepared transfer pricing ("TP") documentation to substantiate the pricing in those controlled transactions using the **transactional net margin (TNM) method** with the Trader as a tested party.

However, when auditing the transaction pricing, the Russian Federal Tax Service (the "FTS") applied the **comparable uncontrolled price (CUP) method**, sourcing price information from the Argus Media agency and, having discovered a price underestimation, recalculated the Company's revenues and assessed an additional profit tax liability of RUB 980 million and imposed penalties.

The Company challenged the regulator's decision in court. The Moscow Commercial Court **sustained the Company's appeal** and ruled that the use of TNM method was appropriate from the TP regulation perspective. The court cited the tax authorities' failure to prove that the use of the TNM method was inappropriate and when applying the CUP method, the regulator had not taken into account the material factors affecting the method applicability.

Position of the Federal Tax Service

Court position

Conclusion

Position of the Federal Tax Service

- The Trader sold the products to a foreign related party which **prevents the use of the TNM method**. Furthermore, the relation between the Trader and the end customers can neither be established nor disproved, as the list of end buyers is unavailable.
- The use of the TNM method was inappropriate as the Trader's actual margin had to be determined **per each transaction** (shipment), not per group of transactions.
- **Neither company from the sample meets the criteria** of Item 5, Article 105.8 of the Russian Tax Code, in particular, the criteria of independence of comparable companies was unreasonably overestimated (to 50 percent).
- **Even in the absence of internal or external transactions**, the Company still may apply the CUP method using the data of price reporting agencies.



Dmitry Kulakov
Partner,
Transfer pricing

"We realise that this court ruling should be treated very seriously. However, let us not forget that this is a first instance court and we may expect an appeal. We will watch out for further developments."

Court's position

- **The CUP method** was applied by the tax authorities inappropriately for the following reasons:
 - The Company does not supply potash fertilisers to unrelated entities
 - The Company's internal supplies of this type of fertilisers are incomparable with the export transactions as:
 - ✓ The internal prices are regulated by the Russian Antimonopoly Service
 - ✓ The Company has to carry out marketing activities and build direct contacts with the buyers in the internal market (in export transactions, the function is performed by the Trader)
 - ✓ The demand-supply balance in the mineral fertilisers market varies country to country
 - ✓ The logistics of foreign supplies is very time-consuming.

- The CUP method applied by the tax authorities **does not ensure comparability of financial and commercial terms of the tested and compared transactions** for the following reasons:
 - Using Argus Media data, the tax authority inappropriately compared the prices of transactions between the Company and the Trader (**Tier One supplier**) with the prices of transactions between another trader and an end customer (**Tier Two supplier**)
 - The FTS failed to take into account the **difference in terms** between the controlled transactions and the transactions selected as comparables in accordance with Argus Media approach, namely, the difference in time, terms of delivery, volume, and the ports of dispatch
 - **Comparability of the seller's functions and risks** between the comparable transactions and those of the Company is not ensured: in transactions from the Argus Media database, the trader of potash fertilisers carried out its activities in a different state (Belarus), its functions and transaction terms being totally different as he had acted as a reseller and bore different risks
 - The principle of selecting the transactions with goods of **identic properties for comparability purposes** was not complied with, as different potash fertiliser brands have different technical properties which affects their pricing.
- The FTS **did not perform the required analysis of the transactions** using Argus Media price data and failed **to adjust their terms** for comparability purposes (in particular, the reseller's (trader's) margin, transaction and delivery terms).
- When carrying out its TP audit, the tax authorities should have applied **the same TP method that was**

described in the Company's TP documentation as it had not proved that the use of the TNM method prevented the Company from determining the comparability between the commercial and/financial terms of the controlled transactions and those of the comparables, which is enough to invalidate **the tax authorities' decision**.

- The sales to the buyer, related with the Trader, did not exceed 10 percent and had no material effect on the Trader's profitability. Even net of these sales, the Trader's profitability would remain within the arm's length range.
- The Company **reasonably grouped the tested potash fertiliser transactions** with the Trader for TP purposes in accordance with the clarifications of the Russian Ministry of Finance and the OECD's Guidelines and calculated its margin for the group of transactions; therefore, the tax authorities' citing the need to calculate the margin per each transaction (shipment) is unsubstantiated.
- The tax authorities **did not provide any proof that the transactions with the related Trader were aimed at achieving tax optimisation and moving capital abroad** which, in accordance with the legal approach described in the Court Digest of TP rulings, can be a crucial factor in TP cases.

Conclusion

The Company's arguments supported by the Moscow Commercial Court and underlying the positive judgement can be grouped based on the following criteria:

- ✓ The **availability** of the **TP documentation** providing the due substantiation of pricing the controlled transaction
- ✓ The tax authorities' **failure to prove the inappropriate use of the TNM method**
- ✓ **The inappropriate use of Argus Media price data:** the tax authorities failed to take into account the differences in **transaction terms, compared non-identical goods, did not consider the financial and commercial incomparability** of transactions, failed to make the **necessary adjustments** of prices from the database, which hampered the comparability of the tested and comparable transactions.
- ✓ **The tax authorities failed to comply with the established procedures and formalities:** the downloaded information was not dated and was not attached to the audit report; new evidence presented by the FTS had not been previously included in the audit materials.



Yulia Orlova
Partner
Chemicals

"The Russian Federal Tax Service has been challenging the pricing in controlled transactions between the Russian exporters of finished goods and foreign traders more and more often. However, the cases of Uralkali and Dulisma (see LT in Focus of 7 February 2017) show that commercial courts prioritise TP documentation, substantiating the choice of the TP method and the pricing in controlled transactions. If TP documentation is poorly prepared or not in place, the taxpayer's chances to appeal the FTS's decision are seriously affected. Still, the odds are in the taxpayer's favour in this type of disputes and we recommend taking this trend into account when preparing the TP documentation."

We hope that you will find this newsletter interesting and informative. Please feel welcome to contact us for more information on the topics covered.

Best regards,

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