CLIENT NOTE

Transfer Pricing Has Made Its Way To Armenia During COVID-19

OVERVIEW

To start off with, let's take a look at where the idea of Transfer Pricing Regulations came from and its international regulation that countries are already operating under.

Today, transfer pricing has become one of the most actual and controversial topics in the global tax avoidance debates. From a tax perspective, the main idea behind transfer pricing as a method to reduce the group's tax burden is to manipulate the prices of these transactions, to minimize the tax base of one company and accumulate such profits in another company and to ultimately ensure that tax benefits are obtained by the group as a whole.

The first references to transfer pricing date back to the late 19th century in England. During this period, the need to generate domestic prices arose with the demand for the separation of structural units in enterprises, the division of labor and the emergence of workshops. In 1976, the first regulation of transfer pricing legislation was adopted at an international level. In particular, the main international documents adopted on this issue are the OECD of 1976 on International Investment and Multinational Enterprises and the first Guidelines on Transfer Pricing and Multinational Enterprises of 1979.

These regulations are of crucial importance for states to make their tax policies more transparent and ensure the fairness and accuracy of transfer pricing worldwide.

Transfer pricing regulations have been applied in the Republic of Armenia since January 1, 2020.

TRANSFER PRICES

The transfer price is a non-market price that is not formed by market value but by internal agreements. Transfer prices are used when individual entities of a larger multi-entity firm are treated and measured as separately run entities. It is common for multi-entity corporations to be consolidated on a financial reporting basis; however, they may report each entity separately for tax purposes.[1]

TRANSFER PRICING

Transfer pricing is the procedure for determining the financial performance of controlled transactions between affiliated taxpayers. It is one of the reasons why globalization has increased and why operating in more than one territory can be beneficial for firms looking to minimize their overall tax liability. The purpose of transfer pricing is to push profits into territories where either the tax rates are more favorable, or where more loopholes exist to be exploited.[2]

Transfer pricing is not, in itself, illegal or necessarily abusive. What is illegal or abusive is transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing. Transfer mispricing is a form of a more general phenomenon known as trade mispricing, which includes trade between unrelated or apparently unrelated parties.[3]

Transfer pricing is a company policy in determining the price of transfer of a transaction whether it is goods, services, intangible assets, or even financial transactions carried out by the company. The two transaction groups in transfer pricing include intra-company and inter-company. Intra-company transfer pricing is a transfer pricing between divisions within a company. While intercompany transfer pricing is a transfer pricing between two companies that have a special relationship. The transaction itself can be done in one country (domestic transfer pricing), as well as with different countries (international transfer pricing).[4]

"ARM'S-LENGTH PRINCIPLE"

If two unrelated companies trade with each other, a market price for the transaction will generally result. This is known as "arms-length" trading, because it is the product of genuine negotiation in a market. This arm's length price is usually considered to be acceptable for tax purposes.[5]

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[1] https://www.investopedia.com/terms/t/transferprice.asp
[2] https://www.economicsonline.co.uk/Business_economics/Transfer_pricing.html
[3] https://www.taxjustice.net/topics/corporate-tax/transfer-pricing/
[4] https://www.hilarispublisher.com/open-access/the-role-of-multinationality-and-transfer-pricing-on-the-effect-of-good-corporate-governance-gcg-and-companys-performance-in-tax-a-2375-4389-1000304.pdf
[5] https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en

In order to check the compliance of the transaction with the "arm's-length principle," it is necessary to make comparisons of controlled and uncontrolled transactions. This will determine whether there are no significant differences between them that could significantly affect the transfer criteria or financial conditions.

One of the five methods of transfer pricing, which is comparable to uncontrolled price method, resale price method, cost plus method, net profit method, profit distribution method, is used to check the conformity of the transaction distant hand. The specified distance range is determined by the Government of the Republic of Armenia. It is important to note that the "arm's-length principle" applies to controlled transactions only for taxation purposes and cannot be applied to commercial taxpayers' pricing. Thus, where the controlled transactions do not comply with "arm's-length principle":

1. The actual pricing of supervised transactions should be reviewed to ensure that it complies with the principle of arm's-length distance;
2. Without altering the actual pricing of the controlled transactions, they shall recalculate the relevant taxes independently, in accordance with the principle of arm's-length distance.

Currently, the Government of the Republic of Armenia has developed three draft decisions. These drafts regard the transfer pricing methods, the procedure to determine the span of “Arm’s Length,” and the procedure of mutual consent.

RELEVANT FRAMEWORK

In Armenia, the transfer pricing regulations entered into force beginning January 1, 2020. They constitute a part of the new Tax Code. The new rules significantly increase the burden of documentation for Armenian entities that have made controlled transactions during the financial year exceeding 200 million Armenian drams.

THE REGULATIONS ON TRANSFER PRICING IN ARMENIA

In Armenia, transfer pricing arrangements are applied to transactions and the taxpayer is required to submit a controlled transaction notice to the tax authority. The tax authority carries out tax control by checking the completeness of the calculation and of taxes and payments, as well as their compliance with the Arm's Length Principle. This means that the financial index in controlled transactions should not differ from the financial index used in comparable uncontrolled transactions. The tax authority is empowered to oversee these transactions, and taxpayers will be required to provide justification for the formation of prices in such transactions. In this case, a significant legal change has been made in the sense that transactions with offshore companies also fall under control.

From this point of view, the other concern of taxpayers is related to the use of tax secret information. Although the law prohibits the use of such information during tax audits, however, companies continue to be concerned that the tax authority may use this information that is not personally available to the taxpayer.

From the explanation mentioned above, it is necessary to understand which transactions are controlled and which are affiliated entities. A transaction is considered to be supervised if it is made between affiliated taxpayers who:

- Directly or indirectly participate in the management, control, or participation of the other taxpayer (shares, shares, shares) in the charter or share capital of the other;
- Directly or indirectly participate in the management, control, or participation of two or more taxpayers (shares, stocks, shares) in their charter or share capital;
- Directly or indirectly own or control 20% or more of the voting rights of the other taxpayer;
- Practically oversee the business decisions of the other taxpayer, etc.[6]

APPLYING TRANSFER PRICING REGULATIONS IN ARMENIA

Transfer pricing regulations apply for:

(a) Profit tax purposes
(b) Value added tax purposes
(c) Mineral royalty tax[7]

THE BENEFITS AND RISKS

Benefits

Transfer pricing helps reduce the fees by shipping goods into high tariff countries at minimal transfer prices so that fees associated with these transactions are low. Furthermore, it reduces income taxes in high tax countries by overpricing goods that are transferred to units in those countries where the tax rate is comparatively lower thereby giving them a higher profit margin.

Risks

There can be disagreements among the organizational division managers as to what the policies should be regarding transfers. Moreover, there are a lot of additional costs that are linked with the required time and manpower which is required to execute transfer pricing and help in designing the accounting system. Furthermore, it becomes difficult to estimate the right amount of pricing policy for intangibles such as services. Transfer pricing does not work well as these departments do not provide measurable benefits. Additionally, the issue of transfer pricing may give rise to dysfunctional behavior among managers of organizational units. Another matter of concern is the process of transfer pricing is highly complicated and time-consuming in large multinationals. Also, the buyer and the seller perform different functions from each other that undertake different types of risks. For instance, the seller may or may not provide the warranty for the product. But the price a buyer would pay would be affected by the difference. The risks that impact prices are as follows: financial & currency risk, collection risk, market and entrepreneurial risk, product obsolescence risk, and credit risk. Finally, as a result of transfer pricing, it becomes easier to disclose the tax secret of the business.

[6] RA Tax Code Article 37 Section, Code N ՀՕ-165-Ն, dated 01.01.2020, amended as of 01 January 2018
[7] RA Tax Code Article 360 (2), Code N ՀՕ-165-Ն, dated 01.01.2020, amended as of 01 January 2018

UNDERLYING ISSUES DURING TRANSFER PRICING IN CROSS-BORDER TRANSACTIONS

Transfer prices serve to determine the income of both parties involved in the cross-border transaction. Therefore, it tends to shape the tax base of the countries involved in cross-border transactions.

In any cross-border tax scenario, the three parties involved are the multinational group, taken as a whole, along with the tax authorities of the two countries involved in the transaction. When one country’s tax authority taxes a unit of the MNE group, it has an effect on the tax base of the other country. In other words, cross-border tax situations involve issues related to jurisdiction, allocation and valuation.[8]

MEASURES DURING COVID-19

Companies on a global level are faced with the effects of the globally spreading COVID-19. During this period, multinational groups should consider examining specific aspects of their business in order to minimize the negative effects of the crisis to the lowest extent possible.

Even though Multinational Enterprises will be in a more depressed position during COVID-19 affected times, Multinational Enterprises are likely to see increased scrutiny by tax authorities in post COVID-19 period. Tax authorities may focus on reviewing transfer pricing policies and outcomes for historical tax years affected by COVID-19. It is assumed that the tax authorities may try to distinguish between the economic effects of the pandemic versus normal market risk as a result of business success/failure. In order to develop a contemporaneous audit defense file, Multinational Enterprises must demonstrate to tax authorities that their transfer pricing arrangements were arm’s length during COVID-19 years with an in-depth analysis of the adverse factors beyond their control caused by it.

In this respect, critical transfer pricing assessments are necessary to determine whether losses and gains associated with COVID-19 should be allocated between the Multinational Enterprises’ value chain participants.

What should you consider?

- An evaluation of the management and allocation of risk within company’s specific transfer pricing model;
- Examination of each company's documents or agreements to see if the parties have certain risks or not, force majeure provisions, and etc;
- Adjust, exactly where the risk arises according to the company’s transfer pricing model (e.g., local entrepreneurs, principal company);
- Adjust, where key risk management decisions about COVID-19 responses are being made (e.g., level of supply chain diversification, changes in pricing of impacted goods/services, public communication, etc.);

[8] https://www.un.org/esa/ffd/wpcontent/uploads/2011/06/20110607_TP_Chapter1_Introduction.pdf

- Consider closed or temporarily halted operations or idle capacity and new allocation of workforce;
- Check the impact on inter-company financing and funding needs within the group;
- Verify the options for improving liquidity (e.g. deferring payments may be an option, if sufficiently evidenced by third party behavior). Where new funding is raised, you should, as always, consider both the perspective of the borrower and the lender and how the markets are evolving;
- In order to develop a contemporaneous audit defense file, demonstrate to tax authorities that your transfer pricing arrangements were arm's length during COVID-19 years with an in-depth analysis of the adverse factors beyond their control caused by COVID-19.
- Archive documents (including emails) that can serve as documentation of who have been the decision makers and the basis for making COVID-19 related decisions (That's all will be useful for potential transfer pricing audits a few years down the road).
- Evaluate whether adjustments should be made to existing inter-company contracts in order to account for the impact of a decrease in system profit and, in the long term, to include descriptions in the transfer pricing documentation supporting the allocation of lower or higher than expected profits.

NOTE: This material is for general information only and is not intended to provide legal advice

SHUSHANIK VARDANYAN
Junior Associate

svardanyan@tk.partners