

## Tax Control Methods for Transactions Between Mutually Dependent Persons: Advantages and Disadvantages

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### Abstract

The paper examines the methods defined by the Tax Code of the Russian Federation with regard to the tax control of transactions between interdependent persons. The authors of the paper reveal the basic principles of choosing a particular method of pricing in transactions between interdependent persons: the choice by the taxpayer of the optimal pricing method, which, with regard to all sides of the analyzed transaction, will give the most accurate and well-reasoned conclusion about the conformity of the price applied in the analyzed transaction to the market level; comprehensive analysis of the parties to the transaction taking into account the available data; general availability of information sources that allow information about comparable transactions to search for; the tax authority must justify and prove the impossibility of applying the previous transfer pricing method before proceeding to an analysis of the current transfer pricing method used in the transaction. The algorithms of application of each method, its advantages and disadvantages, as well as optimal economic situations for application of specific methods of pricing in transactions between interdependent persons are revealed. Based on the analysis carried out by the authors of the paper, a conclusion is made about the riskiness of applying methods of tax control of transactions between interdependent persons, since each method has inherent risks that can lead to a dispute between taxpayers and tax authorities.

**Keywords:** Comparable uncontrolled price method; Resale price method; Cost plus method; Transactional net margin method; Profit distribution method; Analysis.

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### 1. Introduction

In the process of tax control of transactions between interdependent persons, the tax authorities use methods that justify and confirm the fact that the prices applied in transactions between interdependent persons are market-based. The tax control methods for transactions between interdependent persons regulated by the Tax Code of the Russian Federation are based on international rules for the regulation of transfer pricing laid down according to the recommendations of the Organization for Economic Cooperation and Development (OECD). When determining the pricing method in the course of transactions between interdependent persons, the following principles should be adhered to: [Mastepanov \(2015\)](#).

- The choice by the taxpayer of an optimal pricing method which, taking into account all aspects of the analyzed transaction, will give the most accurate and well-reasoned conclusion about the conformity of the price applied in the analyzed transaction to the market level;
- A comprehensive analysis of the parties to the transaction, taking into account the available data, including the rationale for choosing the pricing method, the criteria for comparability and interdependence, etc.;
- The general availability of information sources that allow information about comparable transactions to search for as a result of analysis of stock quotes, data of price information agencies;
- The tax authority must justify and prove the impossibility of applying the previous transfer pricing method before proceeding to the analysis of the current transfer pricing method used in the transaction ([Baburyan, 2014](#)).

### 2. Methods

In the course of performing tax control transactions between interdependent persons in the Russian Federation, the priority is the comparable uncontrolled price method. This method can be used if there are at least four transactions with identical goods on the market performed in comparable economic conditions

between non-interdependent persons. With their help, the interval between market prices for comparable transactions is determined, when the price of the analyzed transaction is included in the market price. Otherwise, the transaction price should be reduced to the minimum interval boundary with the corresponding additional taxation (if the seller sold the goods at a price below the market price).

The comparable uncontrolled price method is used by organizations for transactions in commodities, when information on their prices and information on exchange quotations is available, and also when market transactions with non-interdependent persons are carried out by this organization (Valkovskaya, 2014).

Comparable transactions are those that are performed in similar commercial and financial terms having: homogeneous (identical) characteristics of the goods being the subject of the transaction; similar functions of the parties to the transaction and risks; similar terms and conditions of the contract; similar economic conditions of the parties to the transaction (Plus, 2015).

The algorithm for applying this method includes the following steps:

- Determination of the transaction price between interdependent persons;
- Selection of comparable transactions and pricing in these transactions;
- Determination of the interval between market prices;
- Comparison of the price value of the analyzed transaction and the interval between market prices;
- Conclusion about the need for additional taxation.

In the opinion of the authors of the paper, the advantages of the comparable uncontrolled price method consist in the objective nature of calculations of a comparable market price that does not require special qualification of specialists in the formation of the transfer price, and the relative accuracy of calculating comparable market price for tax control of transactions between interdependent persons. Also among the advantages of this method is a relatively simple mechanism for calculating the interval between market prices (Lazareva, 2015).

The disadvantages of the comparable uncontrolled price method are as follows:

- Lack of a single source of information to obtain data on comparable prices, comparable transaction conditions, identity criteria or uniformity of goods, work, and services being analyzed;
- Increasing time costs for the collection and analysis of comparable information;
- In the presence of adjustments in order to achieve comparability of the analyzed transaction with market transactions, the mechanism of their calculation is not clear, and a large number of adjustments call into question the correctness of the chosen method for verifying that the transaction price corresponds to market prices;
- Due to the availability of two options for the date of determining the interval between market prices (either a certain period from which comparable transactions are selected or the nearest date of a comparable transaction is taken by the date of the transaction being analyzed), the tax authorities may manipulate the dates of transactions for profit in calculating the market price interval;
- It is absolutely mismatch to works and services of an individual character, which makes it difficult to find identical or homogeneous works and services (Makhovikova, 2014).

The resale price method can be used as the tax control tool for transactions between the interdependent persons in situations when goods are acquired from an interdependent person and subsequently resold to an independent buyer without processing (Грундел, 2014).

This method is based on the comparison of the gross profitability of a buyer with the interval between its market values, and is based on the assumption that in carrying out similar activities, organizations bear similar costs and assume similar risks. Consequently, the values of gross profitability should also be similar. The condition for the applicability of the method is the absence of

intangible assets that could significantly affect the gross profitability of the taxable person who resells.

Advantages of the resale price method are that it can be used :

- In the absence of information on the market about transactions on identical or similar goods, works, services;
- In the absence of sources of information for the calculation of market prices of comparable transactions;
- If it is impossible to determine the differences in financial, commercial, etc. conditions of conducted and comparable transactions.

Disadvantages of the resale price method are the following:

- The burden on the tax authorities such that absence of comparable transactions should be proved and determining the market price should be impossible;
- The burden on taxpayers in the form of counter checks of the parties to the transaction at its price;
- The absence of a mechanism for determining the objective market price for the transaction;
- Lack of information on the rate of profit, costs and, accordingly, the profitability of the transaction, and the lack of order of their determination;
- Inaccuracy in calculating the profitability interval, which can cause a dispute with the tax authority;
- The uncertainty of tax control in respect of the reselling person, that is, either the person who made the controlled transaction, or the person who made the transaction with a non-interdependent person.

The cost plus method is used for tax regulation purposes mainly in relation to transactions for the provision of services, except transactions involving the use of intangible assets that have a significant impact on the level of profitability.

The condition for the applicability of the method is the absence of intangible assets from the taxpayer that sells, what can have a significant impact on the magnitude of gross profitability of costs.

The algorithm of application of the cost plus method in the context of tax control over transactions between interdependent persons includes the following consecutive stages:

- Calculation of gross profitability of costs in the analyzed person;
- Selection of comparable transactions and determination of gross profitability of costs in comparable organizations;
- Determination of the profitability interval;

- Comparison of the gross profitability of the costs for the analyzed person and the profitability interval;
- Making the conclusion that it is necessary to add taxes and adjust the size of the tax base.

Advantages of the cost plus method :

- The objectivity and simplicity of calculations;
- It is used for the sale of goods, works, and services in the form of calculating the costs of a person under a controlled transaction.

Disadvantages of the cost plus method:

- When equating the transfer price to the level of costs, it is possible to discourage the work of managers of the organization, and this could be a reason for manipulating the data on costs for obtaining additional benefits;
- The legislation does not define the gross profitability of costs, which is used to calculate the market interval for the gross profitability of costs;
- Profitability index is calculated in the analyzed transaction as a whole based on the results of the organization's activity, and the market interval of gross profitability of expenses is calculated only on the basis of comparable transactions with the analyzed transaction.

The resale price method and the cost plus method are effective in the cases when comparable intra-group transactions are available, and when the determination of profitability indicators for these transactions is carried out. In this case, the use of these transactions is possible when compared with non-interdependent external transactions (Bakhyt *et al.*, 2018).

If it is not possible to ensure the comparability of the analyzed transaction with the commercial and financial terms of transactions between non-interdependent persons, and if the cost plus method and the resale price method cannot be used, the comparative profitability method should be used; it consists in comparing the operating profitability of the analyzed transaction with the market interval between the operating profitability.

The transactional net margin method is used when dealing with an off-exchange product or in the absence of information on market prices for goods sold/purchased in the transaction by comparing the operating profitability of the analyzed transaction with the market interval of operating profitability. The transactional net margin method is based on an estimate of the margin received by the company as a result of the transaction (series of transactions) in relation to turnover, costs, capital.

The algorithm for applying the comparative profitability method for the purpose of tax control of transactions between interdependent persons is generally analogous to the algorithm of the cost plus method, the difference between the two methods of tax control of transactions between interdependent persons consists in comparing various indicators of operating profitability in the comparable and the analyzed transactions using the comparable profitability method.

Difficulties in the implementation of this method arise in the grouping of controlled transactions, as there are no clear criteria for grouping in the Tax Code of the Russian Federation. Also, the legislation does not provide clear recommendations on the assignment of the rules in the accounting policy for the distribution of managerial and commercial expenses by transaction groups. The process of confirming the calculation of the operating profitability index from a foreign counterparty also raises the question.

The information base for the application of this tax control method for transactions between interdependent persons is the accounting statements of the analyzed person and comparable organizations.

Therefore, the disadvantages of using this method are the same as in the previous three methods, and also, according to L.P. Grundel, there takes place the complexity of selecting comparable companies from the available sources of information, since various types of activities are simultaneously included in the same section of the All-Russian Classifier of Economic Activities (Грундел, 2015).

It should be noted that a serious problem is the procedure for calculating the profitability interval in the cost plus method, the resale price method and the transactional net margin method. It is advisable to propose the following stages of calculating the profitability interval:

- Functional analysis of the enterprise for the selection of comparable organizations, which includes the selection of Russian (foreign if they are unavailable) enterprises that carry out similar transactions on the market; ranking of selected enterprises by types of activities and ensure comparability with the transaction between interdependent persons;
- Selection of information base for analysis of commercial and financial terms of transactions;
- Quantitative analysis of net assets (there should not be enterprises with negative net assets for the last three years), ranking of enterprises by revenue value, direct and indirect participation of selected enterprises and subsidiaries (excluding interdependent companies), profits from selected comparable enterprises (there should not be enterprises with a loss for the last three years);
- More thorough qualitative analysis of the information received for its inconsistency, incompatibility with the transaction between interdependent persons;
- Calculation of the profitability interval based on Art. 105.8 of the Tax Code of the Russian Federation with the justification of its application in the transaction between interdependent persons;
- Preparation of documentation for each stage of calculating the market interval of profitability and the results for it.

The profit distribution method can be used for tax control over transactions carried out within large holdings and transnational corporations. Tax control in this case is subject to the correspondence of the distribution of the aggregate profit received from the analyzed transaction between the organizations belonging to the holding or the

transnational corporation, to the distribution of the aggregate profit in transactions between persons who are not interdependent.

The algorithm of application of the profit distribution method differs radically from the previous four methods used for purposes of tax control of transactions between interdependent persons, mainly because when applying this method, significant skills and specialization of the person performing the verification are required.

Advantages of the profit distribution method:

- It is used upon close interrelation between the types of activities of the parties to the transaction;
- It is used when the parties have transactions with intangible assets that can have a significant impact on the level of profitability.

Disadvantages of the profit distribution method are the following:

- Instructions are available not for all criteria concerning profit distribution, what makes it difficult to implement the mechanism for distributing profits;
- Complexity of the profit distribution method for its implementation in the process of tax control over transactions between interdependent persons (this method implies availability of high qualifications and expertise from tax authorities employees engaged in transaction analysis), as well as the difficulty of selecting comparable companies for transaction analysis;
- Incorrect accounting of the conditions and circumstances of the transaction when using regulatory methods of profit distribution;
- A variant of profit distribution is possible in favor of interdependent persons located in low-tax jurisdictions.

### 3. Results and Discussions

Comparative characteristics of pricing methods used in the implementation of transactions between interdependent persons with the advantages and disadvantages of each method revealed by the results of the study, are given in Table 1.

**Table-1.** Comparative characteristics of pricing methods for tax control of transactions between interdependent persons

Method name	Mechanism of application	Advantages	Disadvantages
The comparable uncontrolled price method	Comparison of the price in the transaction to the market price interval, which is determined by the prices in common transactions	<ul style="list-style-type: none"> <li>- the objective nature of calculations of a comparable market price, which does not require special qualification of specialists in the formation of the transfer price;</li> <li>- relative accuracy of the calculation of a comparable market for tax control of transactions between related parties;</li> <li>- a relatively simple mechanism for calculating the interval between market prices.</li> </ul>	<ul style="list-style-type: none"> <li>- lack of a single source of information to obtain information on comparable prices, comparable transaction conditions, identity criteria or uniformity of goods, work, services being analyzed;</li> <li>- increasing time costs for the collection and analysis of comparable information;</li> <li>- in the presence of adjustments in order to achieve the comparability of the transactions in the transaction to market prices;</li> <li>- due to the availability of two options (for a certain period of time, from the date of the transaction) tax authorities may manipulate the dates of transactions for profit in calculating the market price interval;</li> <li>- not suitable for work and services that are of an individual nature, which makes it difficult to find identical or homogeneous works and services</li> </ul>
The method of the next sale price	Comparison of the gross profitability of the organization on the observed transaction with the market	<p>Can be used:</p> <ul style="list-style-type: none"> <li>- in the absence of information on the market about transactions on identical or similar goods, works, services;</li> <li>- in the absence of sources of information for the calculation of market prices of comparable transactions;</li> </ul> <p>If it is impossible to determine the differences in financial, commercial, etc. Conditions of conducting and even transactions</p>	<ul style="list-style-type: none"> <li>- the burden on the tax authorities in the form of evidence of the absence of sensible transactions and the impossibility of determining the market price;</li> <li>- the burden of taxpayers in the form of counter checks of the parties to the transaction at its price;</li> <li>- the absence of a mechanism for determining the effective market price for the transaction;</li> <li>- lack of information on the rate of profit, costs and, appropriately, the profitability of the transaction, the lack of order of their determination;</li> <li>- inaccuracy in calculating the profitability interval, which can cause a dispute with the tax authority;</li> <li>- the uncertainty of tax control with respect to the resale person, that is, either the person who</li> </ul>

			made the transaction or the person who made the transaction with the non-reciprocally dependent person
Cost method plus	Comparison of the gross profitability of the organization's costs	<ul style="list-style-type: none"> <li>- the objectivity and simplicity of calculations;</li> <li>- is used for the sale of goods, works, services in the form of calculating the costs of a person under a controlled transaction.</li> </ul>	<ul style="list-style-type: none"> <li>- at equating the transfer price to the level of costs, it is possible to discourage the work of managers of the organization, the reason for manipulating the data on costs for obtaining additional benefits;</li> <li>- the legislation does not define the gross profitability of costs, which is used to calculate the market of gross profitability of costs;</li> <li>- profitability index is calculated on the basis of the transaction of the transaction</li> </ul>
The transactional net margin method	Comparison of the company's operating profitability for the analyzed transaction, with the market interval of operating profitability for relatively transactions	- used when applying the three previous methods is not possible	<ul style="list-style-type: none"> <li>- difficulties in grouping controlled transactions, as there are no clear criteria for grouping in the tax code of the Russian Federation;</li> <li>- there are no clear recommendations in the legislation on fixing in the accounting policies for distribution of managerial and commercial expenses by groups of transactions;</li> <li>- the complexity of the process of confirming the calculation of the operating profitability indicator for a foreign counterparty;</li> <li>- the difficulty of the company</li> </ul>
Method of distribution of profit	Comparison of the actual distribution between the parties to the transaction of total profit received by all parties to this transaction	<ul style="list-style-type: none"> <li>- is used in close interrelation of the types of activities of the parties to the transaction;</li> <li>- is used when the parties have an interest in the level of profitability</li> </ul>	<ul style="list-style-type: none"> <li>- the complexity of the method of distribution of profits in the process of taxation, as well as the complexity of selecting equal companies for transaction analysis;</li> <li>- not all of the criteria for profit distribution have instructions, which makes it difficult to implement the mechanism for distributing profits;</li> <li>- incorrect accounting of the conditions and circumstances of the transaction when using regulatory methods of profit distribution;</li> <li>- a variant of profit distribution is possible in favor of interdependent persons located in low-tax lawsuits</li> </ul>

#### 4. Summary

Based on the results of the analysis in Table 9, it should be noted that each of the pricing methods has drawbacks associated with both the uncertainty of some formulations in the legislation and the ability of tax authorities to influence the indicators in the process of confirming the compliance of the applied prices in the transaction with market prices, of each single method of pricing for both taxpayers and tax authorities.

#### 5. Conclusions

Based on the study conducted by the authors of the paper, the research should be further continued in the analysis, classification and development of approaches to risk management arising from the application of tax control methods of transactions between interdependent persons in the Russian Federation.

#### Acknowledgements

The work is carried out according to the Russian Government Program of Competitive Growth of Kazan Federal University.

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