

www.pwc.ru

New Rules of Transfer Pricing and their Impact on Pharmaceutical Companies

8 November 2011

Overview of new Russian transfer pricing rules

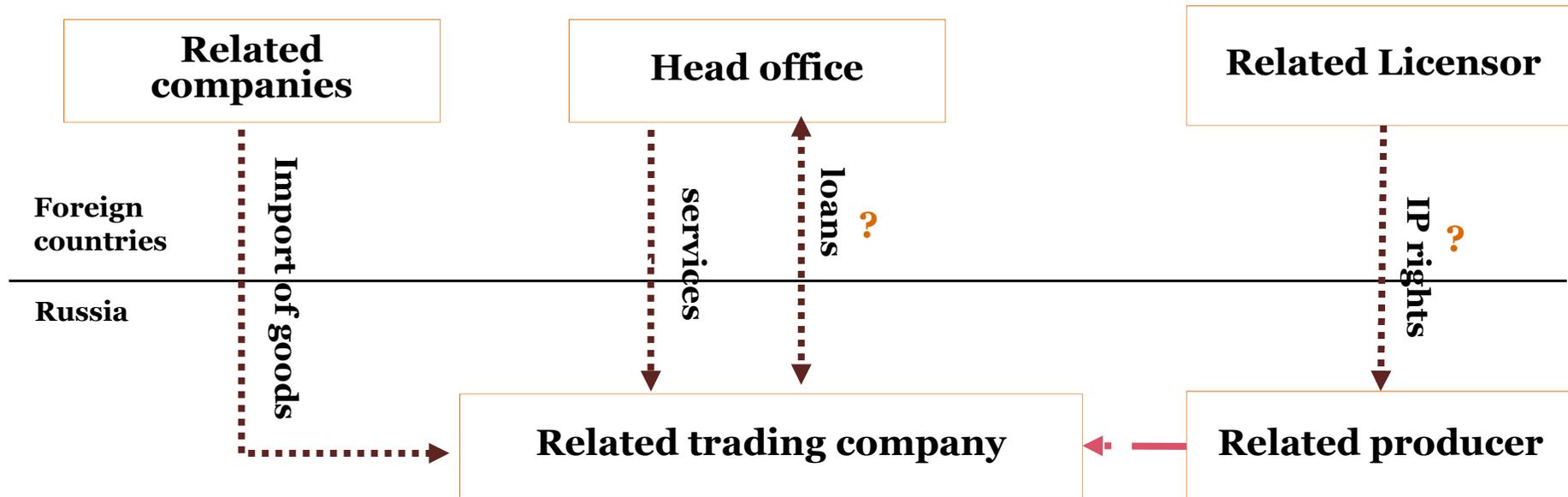
General overview of changes to Russian TP rules

The following main changes are expected **from 2012**:

- Reduction of the list of “controlled” transactions
- Expansion of the list of related parties
- Abolishment of 20% “safe harbour” and introduction of the concept of an arm’s length range
- New methods of determining arm’s length prices, and elaborating the current methods to harmonise them with OECD transfer pricing principles
- Feasibility of correlative TP adjustments for transactions within Russia
- Formal reporting and TP documentation requirements
- Introduction of unilateral and multilateral APAs for companies registered as “large” taxpayers

Below we outline the respective changes in more detail

Controlled Transactions





 - All types of transactions



 All types of transactions, if the sum of transaction exceeds **1 bln rub.**
 (in 2012 threshold will be 3 bln rub., in 2013– 2 bln rub.)

Exemption for domestic transactions between Russian entities
 (i) registered within the same region, (ii) having no subdivisions
 in other regions, (iii) without tax losses and (iv) meeting certain
 other conditions

Controlled transactions (continued)

- New rules applies to transactions with goods, works and services



Do not fall under control:

- Provision of loans (credits)?
 - Provision of guarantees?
 - Transactions with intangible assets, for example, provision of rights to use trademark?
- Fluctuation of prices within transactions is not the ground for tax control

Information Sources

Open list, including:

- Commodity exchange quotations
- Russian customs authorities' statistical data
- Pricing information of authorised state government bodies (e.g. National register of prices for EDL pharmaceuticals)
- Publicly available information systems
- Appraisal reports (for one-time transactions)
- Accounting and statistics data of foreign companies (in case the Russian data is absent)

Two-level hierarchy on use of information sources

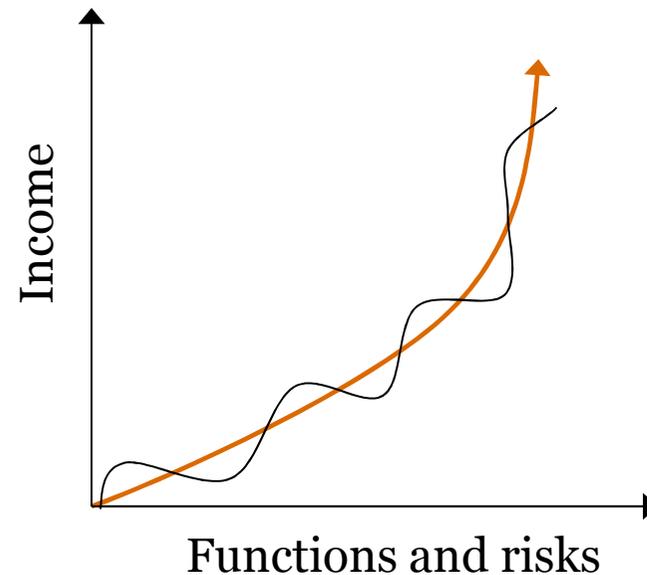
More flexibility in choice of the sources as compared to current rules (“official sources” only)



Functional analysis

When analysing comparability a functional analysis should be performed:

- What **functions** does company perform
- Which **commercial** risks to be born and who bears these risks
- What **assets** are used and who is the owner



- The more functions, risks and assets the company apply, the more expected income is

Transfer pricing methods

Current rules

1. Comparable Uncontrolled Price method (CUP)
2. Resale Minus method
3. Cost Plus method

Hierarchy:

- Strictly as above
- Functional analysis is not relevant for the choice of the method

New rules

1. Comparable Uncontrolled Price method (CUP)
2. Resale Minus method
3. Cost Plus method
4. **Transactional Net Margin method (TNMM)**
5. **Profit Split method**

Some hierarchy:

- CUP method must be applied first
- One comparable transaction between non-related parties may be enough for the application of CUP method, provided a seller does not have a dominant market share
- If not possible to apply CUP, then apply the RM, Cost+ or TNMM
- Profit split – last resort method

Methods of market price determination

- ***Resale minus method*** can be applied in case of:
 - ✓ Resale of goods without processing (in the absence of intangible assets)
 - ✓ Mixing of products, if characteristics of the final product (intermediate product) does not significantly differ from characteristics of mixed products

- ***Cost plus method*** can be applied in case of:
 - ✓ Provision of services (except cases when intangible assets are used in provision of services)

- ***Transactional Net Margin Method (TNMM)*** can be applied in case of:
 - ✓ Resale of goods
 - ✓ Rendering work and services (marketing, clinical trials)
 - ✓ Production of goods

Reporting and documentation on controlled transactions

Requirements	Terms
(1) Reporting on controlled transactions	till 20 May of the year of the following year
(2) Documentation, supporting market level of prices	Within 30 days upon request of the tax authorities, but not earlier than 1 June of the following year

Criteria: amount of all controlled transactions, concluded with one counterparty (a number of counterparties) exceeds ***RUR 100 mln in 2012 (RUR 80 mln in 2013)***

- ! Preparation of documentation gives protection from penalties:
- in 2014-2016 –20% penalties of amount of unpaid tax
 - from 2017 –40% penalties of amount of unpaid tax

Documentation requirements

Period of audit	Start date of TP audit	Penalty*	Requirements on preparation of TP documentation	
			Cross-border transactions	Transactions within Russia
2012	June - Dec 2013**	N/A	if > RUB 100 mln (appr. USD 3,5 mln)	if > RUB 3 bln (appr. USD 107 mln)
2013	June 2014** – Dec 2015	N/A	if > RUB 80 mln (appr. USD 2,8 mln)	if > RUB 2 bln (appr. USD 71,4 mln)
2014 - 2016	June 2015** – Dec 2017***	20%	all transactions	if > RUB 1 bln (appr. USD 35,7 mln)
2017	June 2018** – Dec 2020***	40%	all transactions	if > RUB 1 bln (appr. USD 35,7mln)

(*) If no proper TP documentation is provided by a taxpayer.

(**) Although the tax authorities may initiate a TP audit earlier, TP documentation cannot be requested earlier than 1 June of the year following the year under review.

(***) Decision on the initiation of a tax audit may be taken within 2 years after the date of receipt of notification from taxpayer/tax authorities, but the statute of limitation for a TP audit is 3 preceding years.

Documentation requirements

Content of documentation:

1. *Controlled transaction:*

- Counter-parties of the transaction
- Description of the transaction
- Functions, risks and assets, applied by taxpayer in the controlled transaction (formally optional, but strongly recommended)

2. *Data supporting correspondence of applied prices with market prices:*

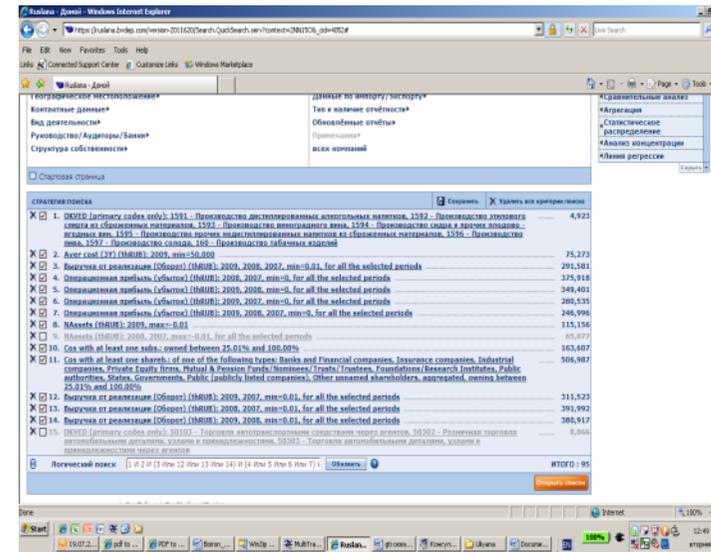
- TP methodology, sources of information and other information used for determination of market level of prices;
- Calculation of income (profit) earned within a transaction;
- Valuation of economic benefit from acquisition of rights to use information, intellectual property and other exclusive rights.

3. *Data about other factors which has impact on prices applied*

! Documentation for transactions with regulated prices is not necessary
(article 105.15 p.4 pp.1)

Russian benchmarking studies

- Use Russian comparables
 - => data can be obtained from commercial databases such as Spark, Ruslana
- Follow methodology provided in the law
- Perform additional steps:
 - Working capital adjustments
 - Confirmation of data with Statistics



$$\text{Inventory Adjustment} = \left[\left(\frac{\text{Avg. Inv.}}{\text{total costs}} \right)_{\text{tested}} - \left(\frac{\text{Avg. Inv.}}{\text{total costs}} \right)_{\text{comp}} \right] * \text{total costs}_{\text{comparable}} * \text{rate of return}$$

$$\text{RA} = \left[\left(\frac{\text{Avg. rec.}}{\text{total costs}} \right)_{\text{tested}} - \left(\frac{\text{Avg. rec.}}{\text{total costs}} \right)_{\text{comp}} \right] * \text{total costs}_{\text{comparable}} * \frac{\text{rate of return}}{1 + \text{rate of return} * \text{holding period}}$$

$$\text{PA} = \left[\left(\frac{\text{Avg. pay.}}{\text{total costs}} \right)_{\text{tested}} - \left(\frac{\text{Avg. pay.}}{\text{total costs}} \right)_{\text{comp}} \right] * \text{total costs}_{\text{comparable}} * \frac{\text{rate of return}}{1 + \text{rate of return} * \text{holding period}}$$

$$\text{PP\&E Adjustment} = \left[\left(\frac{\text{Avg. PP\&E}}{\text{total costs}} \right)_{\text{tested}} - \left(\frac{\text{Avg. PP\&E}}{\text{total costs}} \right)_{\text{comp}} \right] * \text{total costs}_{\text{comparable}} * \text{rate of return}$$

Совладельцы (источник: Росстат)

Наименование	Местонахождение / Компания	Доля в УК, руб.	Доля в УК, %
Граждане России		24 300	100

Дочерние компании (источник: ЕТРОП)

Наименование	Местонахождение	Доля в УК, руб.	Доля в УК, %
ТД Натели Алма, ООО	Челябинская область, Грозненский, проезд, Троицкий, д.13	8 000	80

Дочерние компании (источник: Росстат)

Наименование	Местонахождение	Доля в УК, руб.	Доля в УК, %
ТД Натели Алма, ООО	Челябинская область, Грозненский, проезд, Троицкий, д.13	8 000	80

История изменений

Наименование	Местонахождение	Доля в УК, руб.	Доля в УК, %	Дата обновления в СЭПАР
ТД Натели Алма, ООО	Челябинская область, Грозненский, проезд, Троицкий, д.13	8 000	80	28.03.2011

The impact of new Russian transfer pricing rules on operations of pharmaceutical companies (analysis of practical examples)

Do TP rules apply to ELD pharmaceuticals?

- TP provisions DO NOT address the specifics of regulated pharmaceutical market (e.g. article 105⁴)
- Do companies have to choose between compliance with TP vs Russian price regulations?

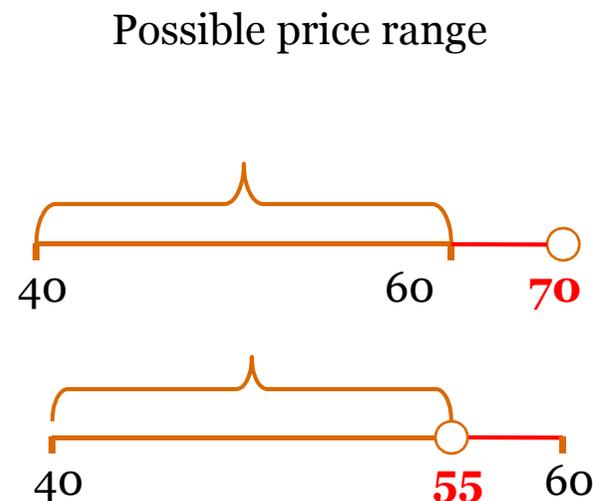


Practical applications of the Article 105⁴

«Prices applied by a taxpayer in transactions, which imply regulation of prices via e.g. establishing maximum prices, are considered as set on the market level for tax purposes, taking into account the *specifics outlined in this Article*»

What is the specifics about?

- Calculated market range [40;60]
- (1) Maximum registered price = 70
- > Range to be compliant with [40; **60**]
- (2) Maximum registered price = 55
- > Range to be compliant with [40; **55**]

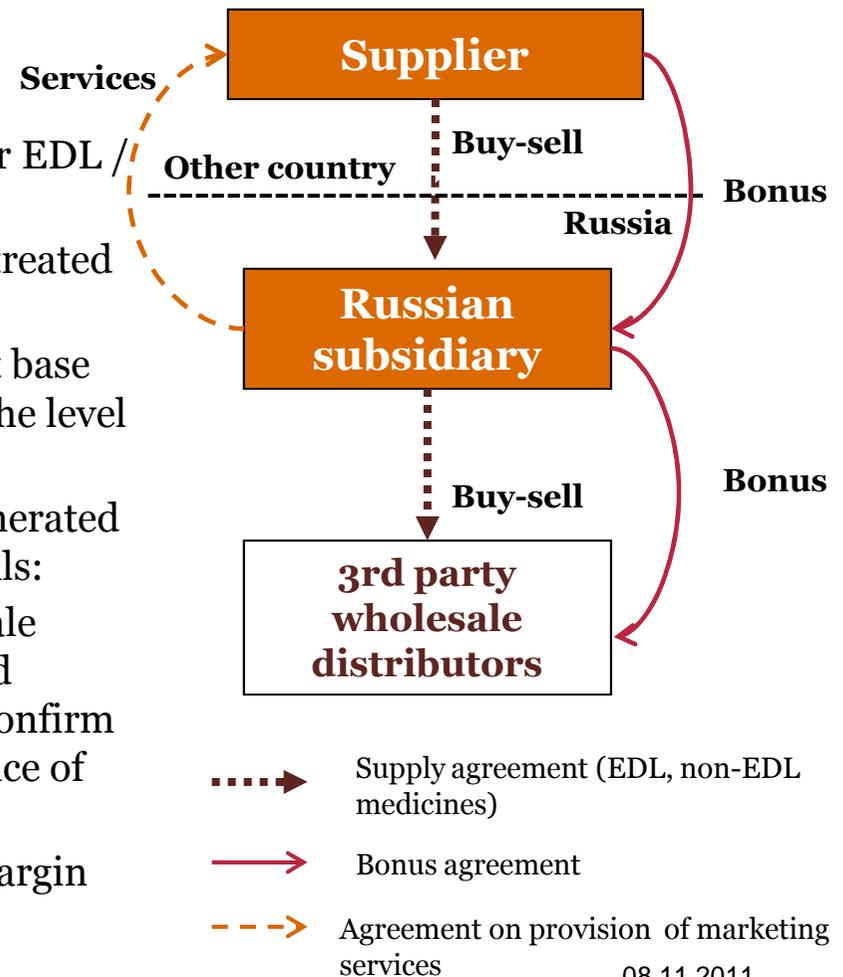


Typical operational model

Issues / questions to consider

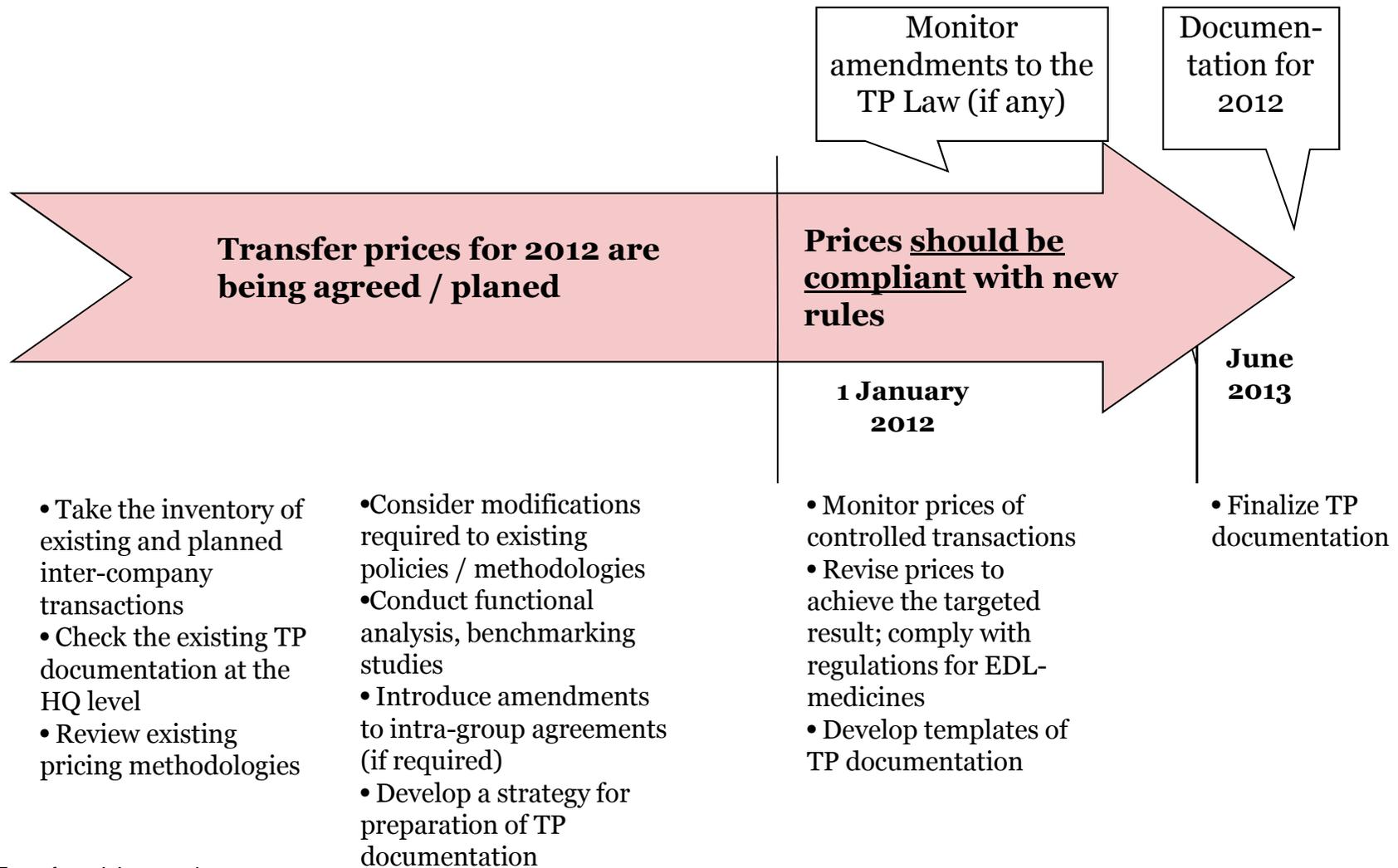
Distribution of medicines:

1. Practical options to deal with losses from EDL sales:
 - **Combined portfolio of EDL / non-EDL pharmaceuticals**, e.g. possibility to consider profitability of sales as combined or separately per EDL / non-EDL;
 - **Bonus arrangement.** How bonuses should be treated from the TP perspective?
 - **Recharge of marketing costs.** Analysis of cost base and necessity of benchmarking study to support the level of mark-up.
2. Benchmarking study to support the profitability generated by Russian subsidiary from resale of pharmaceuticals:
 - Analysis of profitability from EDL / non-EDL sale separately (two profitability ranges) or combined analysis (one profitability range): Difficulty to confirm level of pure EDL sales profitability due to absence of relevant information.
 - Which profit level indicator to analyze? Gross margin vs. operating margin.



What to do next?

What to do next?



How can we help?

- Perform the functional analysis of Russian entities
- Review the current TP methodology
- Mitigate TP risks, if any
- Assist in preparation of templates of TP documentation
- Conduct benchmarking studies to determine the arm's length prices (profitability)
- Develop the business processes for compliance with new TP rules
- Adapt ERP systems for new TP requirements

Thank you for attention!

Alina Lavrentieva

Partner

Pharmaceuticals and Life Sciences Industry Leader

Tax Services

tel.: +7 495 967-6025

alina.lavrentieva@ru.pwc.com

Anna Ruvinskaya

Senior Manager

Tax Services

tel.: +7 495 967-6237

anna.ruvinskaya@ru.pwc.com

Ilarion Lemetyuynen

Senior Manager

Transfer Pricing Services

tel.: +7 495 967-6164

ilarion.lemetyuynen@ru.pwc.com

This presentation is confidential and is intended only for the use of the party for whom it was addressed. Presentation is prepared for general information only and is not classified as professional consulting services. Users of this presentation shall not take any actions based on this presentation without obtaining professional advice. This presentation was based on publicly available information, documents and expert opinions for which no representation or warranty (express or implied) is given. Translation of certain terms in this presentation shall not be considered official interpretation of these terms. Use of any information given in the presentation shall be the user's sole risk.

This presentation does not constitute an offer under Article 435 of the Civil Code of the Russian Federation.

© 2010 PwC. All rights reserved.

"PwC" refers to PricewaterhouseCoopers Russia B.V. or, as the context requires, other member firms of PricewaterhouseCoopers International Limited, each of which is a separate legal entity and does not act as agent of PwCIL or any other member firm. PwCIL does not provide any services to clients. PwCIL is not responsible or liable for the acts or omissions of any of its member firms nor can it control the exercise of their professional judgment or bind them in any way. No member firm is responsible or liable for the acts or omissions of any other member firm nor can it control the exercise of another member firm's professional judgment or bind another member firm or PwCIL in any way.

Transfer pricing seminar

PwC

08.11.2011

Slide 21