

## The Effect of Martial Law on Transfer Pricing in Ukraine



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**ABSTRACT:** The purpose of this study was to describe the current state of tax control over transfer pricing in Ukraine. Analysing the effect of war and martial law on the tax system on the whole and transfer pricing as well, I would like to say that the situation shook the system, but nevertheless, it managed to rehabilitate itself and survive, in turn, standing on wartime slats. The practical significance of the study lies in the complex analysis and evaluation of the current situation of the transfer pricing processes taking place in Ukraine. For Ukraine, in practice, the experience of European countries and case law can be found, which have formed a number of important and progressive legal positions and conclusions to improve control in the field of transfer pricing. The practical novelty of the obtained results consists in a comprehensive analysis of the impact of transfer pricing on the current state of tax management in general. While the EU countries and the UK introduce additional temporary taxes on excess profits on electricity production between 2021 and 2023, as well as on excess profits received from activities in the oil, gas, coal and oil refining sectors, Ukraine introduces an income tax for all companies in any industries in the amount of 2% of the turnover, in order to keep the business afloat. In particular, I would like to note the effectiveness of the work within the framework of the EU4PFM international project, which made it possible, even in wartime, not only to preserve the achievements of pre-war times, but also to start the development of new software products and OECD support for the harmonization of Ukrainian legislation with EU norms in the context of the further integration of Ukraine into the European Union. The main goal of this work is to determine the effectiveness of transfer pricing in Ukraine today, as well as to assess the development prospects for Ukraine in this direction.

**KEYWORDS:** Transfer pricing, Transnational companies, Controlled transaction, Implementation of tax legislation, The Tax Code, Martial law

### I. INTRODUCTION

Transnational companies often set their transfer prices, which differ from market prices, that is, prices that would be used by unrelated parties in similar transactions under similar conditions on the open market. International companies optimize taxation by shifting taxable income from countries of origin with high taxation to countries with low taxation by changing transfer prices. Thus, transfer pricing is a powerful tool for increasing profits for both taxpayers and fiscal authorities, since they largely determine the income and expenses, and therefore the taxable income of affiliated enterprises in various tax jurisdictions. Taking into account the constant changes in transfer pricing rules and the complex situation in the state, taxpayers should take into account such changes when planning and structuring for 2022 their economic relations with related non-residents, or topics whose jurisdiction is included in the list of "low-tax" or non-residents, organizationally the legal form of which provides them with tax preferences of the country of registration [1].

It is also worth noting that the majority of companies subject to the pricing process are included in the group of large taxpayers. This group is the largest producers and enterprises of the mining, as well as metallurgical, fuel, defense and food industries of Ukraine. Since the beginning of the full-scale Russian invasion of Ukraine, 25 large industrial enterprises have been seriously damaged or destroyed. Seven enterprises were destroyed and cannot be repaired or restored.

As of July 1, 2022, industry losses from the war amounted to \$ 8.1 billions.

According to estimates, industry is the third sector after infrastructure and utilities in terms of the total cost of losses and lost assets (8.4% of the total amount) caused by the Russian invasion of Ukraine.

According to the PDNA methodology of the World Bank, as of July 1, the total cost of damage to the industry is estimated at \$8.1 billion, which is almost 4.1% of the country's GDP in 2021, 6.3% of total assets and an impressive 24.9% of the total amount of

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equity capital in all industrial subsectors of Ukraine for the 3rd quarter of 2021. In other words, almost a quarter of investments in the sector are under threat, as a significant amount of assets have been destroyed. Most of the damage was done to the private sector - 5.35 billion dollars (66.3% of the total amount); the rest - to the state sector.

Most of the enterprises are completely destroyed and need to be rebuilt from scratch (64.9% or 5.3 billion US dollars).

Among the most affected regions:

- 1) Donetsk - 4.2 billion dollars (51.7%);
- 2) Kharkiv - \$0.9 billion (11.2%);
- 3) Kyiv - 0.6 billion dollars (6.9%).

Asset groups such as equipment (25.6% of total assets) and buildings (21.3%) suffered the most since February 2022. Ukraine is famous for exporting raw materials (metals and minerals accounted for 24% and 12% of exports respectively in 2021), which makes it sensitive to fluctuations in raw material prices. The reconstruction of the industry must be approached seriously from the point of view of the post-war structure of Ukrainian production. Thus, in the process of reconstruction of Ukraine, the need for construction materials will increase, therefore, the extraction of sand, clay, etc. will be in great demand immediately after the end of the war or even earlier. Iron ore and coke production will not be needed immediately, as metal production facilities are severely damaged or destroyed. The production of thermal coal may turn out to be unnecessary if Ukraine is set on a "green" recovery. However, in any case, investments in the conservation of closed mines and minimizing their negative impact on the environment will be necessary.

## II. LITERATURE REVIEW

Many foreign and domestic scientists, including Yu. Kasperovych [10], M. V. Romanyuk [4], M. Zagryadska [3], O. V. Fomina [9], G. M. Kalach [4], have devoted their works to the problems of transfer pricing. [12] and many others.

The development of theoretical and practical aspects of transfer pricing was reflected in important documents of leading international organizations of recent times, such as the Organization for Economic Development and Cooperation [11]. In particular, the State Tax Service of Ukraine issues amendments to the PKU [6] to ensure compliance with the provisions of the Tax Code of Ukraine, and the Ministry of Finance, in turn, approves orders to maintain the development of the economy in proper condition [8].

Despite the considerable number of published scientific works, there is still a lack of theoretical and methodological studies in which the concepts of transfer pricing would be considered more comprehensively, as interconnected and complementary theoretical constructions in unity with practical models. All this determines the need for further theoretical and methodological research and applied development, investigating the problems of transfer pricing.

However, despite the significant contribution of the above-mentioned scientists, transfer pricing needs further research and practical application in modern realities.

## III. RESEARCH METHODOLOGY

The theoretical basis was the development devoted to transfer pricing and the question of the impact of globalization processes on the mechanism of transfer pricing of transnational corporations and the system of international regulation. The methodology of the study consisted of general scientific and special scientific methods of research: analysis and synthesis, induction and deduction, methods of analogy, differentiation, generalization. The information base of the study consists of normative legal documents, monographic research materials of foreign and domestic scientists, textbooks and manuals, international and Ukrainian scientific conferences, articles in periodicals and information bases of the Internet.

## IV. TRANSFER PRICING REVIEW

### A. The Implementation of Transfer Pricing in Ukraine

In connection with the introduction of martial law on the territory of Ukraine, a number of legislative acts were adopted, which provide for changes in tax legislation, namely: until the termination or expiration of martial law, the deadlines for taxpayers to submit any reporting, except for tax reporting, were suspended. Currently, control over transfer pricing in Ukraine has slowed down, old inspections are suspended, and the start of new ones is in a suspended state and their start is impossible at the time of martial law in the country. Looking ahead and taking into account the current realities of doing business in Ukraine, it is possible to predict a significant increase in the number of loss-making uncontrolled operations, which will require appropriate adjustments and, as a result, additional calculations of taxpayers' tax liabilities in the future after the end of martial law [12].

Transfer pricing rules in Ukraine appeared on September 1, 2013. The reporting period for the purposes of tax control over transfer pricing is a calendar year, the first such report on controlled transactions for the period from September 1 to December

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31, 2013 was submitted until October 1, 2014. One of the main prerequisites for the appearance of this "phenomenon" can be considered:

according to the Ministry of Revenue and Duties of Ukraine, only in 2012, 54% of Ukrainian commodity exports were exported through third parties, often affiliated persons, and the total volume of exports under indirect contracts amounted to UAH 260 billion. As a result, almost 30% of the income of goods remained outside of Ukraine. The situation is not unique: all over the world with the help of such schemes, up to \$ 21 trillion was taken offshore. Therefore, these transactions with unreasonably low prices with counterparties located in "tax havens" - capital outflow from Ukraine. It is worth noting that almost 90% of investments in the form of equity capital go to Cyprus and the Virgin Islands (Great Britain), whose income tax rate is 12.5% and 0% (for certain types of enterprises), respectively [2], which indicates an outflow capital to offshore zones. In such a situation, the national economy lacks financial resources in the amount of uncollected tax revenues and the share of GDP that remains at enterprises in offshore zones. Therefore, all the prerequisites for the functioning of transfer pricing in Ukraine were created (government bill No. 2515 "On amendments to the Tax Code of Ukraine regarding transfer pricing", which entered into force on September 1, 2013). This law introduced fundamental rules for determining controlled transactions, methods and the principle of "outstretched hand", which aims not only to fight fraud or tax evasion, but also to support the market pricing mechanism [4].

This was the first step forward in the fight against capital outflow, as well as a big step to increase tax revenues. The principle of integration into international markets, the exchange of tax information and the most favorable investment climate in Ukraine, taking into account the recommendations of the OECD and the experience of European countries, is involved. Then the goal was only further development in this direction. Through changes to the Tax Code of Ukraine, gaining practical experience and establishing international practices, the vector of control over transfer pricing has expanded over the years [5].

### B. Legislation Changes and Improvements

Thus, the most recent significant achievements have been the amendments to the Tax Code, which relate to transfer pricing rules, through Law 466-IX, effective from May 2020 [6] and Law 1117-IX, effective from January 1, 2021. They include the rules of taxation of controlled foreign companies (CFCs), the submission of three-level documentation from the TCU, new requirements for the justification of the business economic purpose, the documentation from the TCU has been expanded, which will now additionally contain data on natural persons acting as beneficiaries of the taxpayer, the supply chain with disclosure of the formation of value in the conditions of controlled transactions, information on the business purpose, copies of audit conclusions, amended provisions on expected dividends and introduced new rules regarding transactions with goods. The changes provide for a three-level approach to transfer pricing documentation in accordance with the BEPS Action Plan item #13 of the OECD project on base erosion and combating tax abuse [7].

In 2019, the principle of substance over form was added to the rules of the TCU, which involves relying on one's contribution to the substance of the transaction, which gives the right to supervisory authorities to ignore the text of the agreement or contract if there is no economic benefit in it. This principle is similar to the recommendations of the BEPS Plan, which was previously reflected in the OECD Recommendations [9].

Of course, the presence of certain gaps in the legislation in the field of TCU is allowed, there was a problem of international exchange of information with tax authorities of other countries [10], there were various court practices that had both positive and negative results for taxpayers, the main reason for which was the chosen method of pricing with positions of the tax authority, but the main point that I want to note, despite a number of certain shortcomings, development and improvement, as well as the process of implementation of new regulatory rules, kept pace with transfer pricing, starting from 2013 and continuing until February 24, 2022 year - the day when all development processes stopped for a certain time.

### C. The Influence of Martial Law on the State of Development of Transfer Pricing

With the beginning of the full-scale invasion of the Russian Federation, the phrase "transfer pricing" was almost the last thing on the minds of business owners in Ukraine. The most important thing is to save loved ones, develop an emergency action plan to save the company and wait for news from the front. But the first shock passed, the economy was on "military rails" and the issue of transfer pricing returned to the information space.

The following changes can be identified in the features of control over transfer pricing under martial law conditions [5]:

- regarding the submission of reports on controlled transactions and the responsibility of taxpayers for violations of tax legislation: reports are submitted without changes until 10/01/2022;
- regarding transfer pricing documentation (local file) – submitted at the request of the DPS within 30 calendar days from the date of receipt of the request;

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- regarding global documentation on transfer pricing (master file) - submitted at the request of the DPS within 90 calendar days from the date of receipt of the request;
- regarding the Report by country of an international group of companies (CbC Report, submitted when the group's income exceeds EUR 750 million per year): must be submitted for the first time for the fiscal year ending in 2021, but not earlier than the year in which the competent authorities concluded by CBC MCAA [11]. Such a report is a unified standard approved by the OECD and implemented in more than 82 countries of the world. It is submitted only in cases where one of the following conditions is met: the taxpayer is the parent company of the Group, or the parent company of the Group has authorized the Ukrainian company to submit a report by country to the supervisory authority, or in the case when the location of the parent company of the Group does not require the submission of such a report, and therefore, another member of the group was not authorized to submit such a report but in another jurisdiction, or the presence of a signed international agreement on the exchange of tax information [8].
- regarding the conduct of transfer pricing tax audits during martial law, the following can be highlighted:
  - 1) all started checks are stopped;
  - 2) new inspections (on TP issues) are not started;
  - 3) after the completion of the inspection period, the period of imposition of tax fines for the period of martial law in Ukraine shall be suspended.
- regarding the statute of limitations in the amount of 2,555 days (7 years): in terms of control over transfer pricing, it has been suspended since March 18, 2020, taking into account the restrictions of COVID-19 and martial law;
- with regard to the single tax at an interest rate of 2%: after the end of martial law in the country, taxpayers who voluntarily switched to the system of taxation at the rate of 2% will be exempted from this possibility from the first day of the month following the month of termination or cancellation of martial law state and automatically return to the taxation system under which taxes were paid before the transition to the specified taxation features. In other words, the "value criterion" of the controlled operations: the volume of annual income is more than UAH 150 million for the entire reporting year, taking into account the period of stay in the EU at the rate of 2%, but for the volume of transactions with each counterparty, the amount of transactions is more than UAH 10 million without taking into account the period of stay on EP at the rate of 2%.
- regarding the fact of the possibility of fulfilling tax obligations: the taxpayer is released from responsibility, but it is necessary to fulfill them within 6 months after the abolition of martial law[16].

## V. CONCLUSION

Researching the problems of transfer pricing and finding ways to improve its development is becoming a requirement of time. For Ukraine, in practice, it is now possible to rely on the experience of European countries and judicial practice, which formed a number of important and progressive legal positions and conclusions regarding the improvement of control in the field of transfer pricing. At the same time, it can be emphasized that thanks to proper control over transfer pricing tools, it is possible to significantly prevent the erosion of the tax base and, as a result, increase the amount of taxation and ensure the economic security of the state at the appropriate level.

Changes to transfer pricing rules were aimed at increasing the efficiency of tax administration and supervision. Taking into account the constant introduction of changes to the rules of transfer pricing, taxpayers must constantly take into account such changes when planning and structuring for the next year their economic relations with non-resident related persons, or those whose jurisdiction of registration is included in the list of "low-tax" or non-residents, legal the forms of which give them tax preferences of the country of registration. Ukraine is developing a fair taxation system not only by changing its legislation, but also through the Base Erosion and Profit Shifting (BEPS) project of the Organization for Economic Cooperation and Development (OECD). It is important for Ukraine to gain additional experience of European countries in the further implementation of the BEPS plan, in the field of transfer pricing for companies and the selection of appropriate transfer pricing methods in accordance with OECD standards, with the aim of further improving regulatory rules [15].

The unfolding crisis of the Russian-Ukrainian war has broad tax implications for business. Unfortunately, as soon as Ukraine stabilized its development in the field of transfer pricing thanks to the implementation of control rules taken from the experience of European countries, and began to develop economically in accordance with international standards, everything stopped on February 24, 2022. Control in the field of transfer pricing is currently suspended, as is the process of its development. But in the eighth month of the war, it is safe to say that Ukraine has already adapted and the statistics of reports submitted to the tax authority on October 1, 2022 are proof that work is being resumed. Their verification and analysis will begin soon.

With the help of the transfer pricing system, the state protects its revenues to the budget and stimulates the inflow of foreign

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investments. The economic growth of the country and, in particular, the creation of a favorable competitive environment, the development of national production, the level of transaction costs and the circulation of production capital depend on the effectiveness of transfer pricing control and the establishment of an adequate price for goods and services.

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