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Transfer Pricing and market price in Azerbaijan Tax Code

Integration of transfer pricing was among a bulk of modifications and amendments to the Tax Code of Azerbaijan (“the Code”) in December 2016. Target of transfer pricing amendment to the Code is to involve to taxation certain transactions between associated parties which accrue income to neither party, consequently are not subject to taxation, but would have accrued taxable income if the transaction would have been occurred between independent parties. Associated parties are referred in the clause 18 of the Code, among others, as interrelated enterprises, where one entity directly or indirectly owns at least 20% of share capital of the other entity. There are a number of methods and guidelines for defining associated parties as well as determining types of transactions which fall under transfer pricing regulations. These methods are described below in *defining transfer pricing* section.

In fact, the concept and target which transfer pricing functions for, always existed and now remain in the Code as market price rules. Issues like application of transfer pricing, implications of presence in the Code of these two clauses with the same functions and methods, as well as whether it is a safe harbor are discussed herein under the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 (OECD Guidelines). The OECD Guidelines are applied by OECD members and increasing number of non-member countries. The principal United Kingdom transfer pricing legislation (the Taxation Act (TIOPA) 2010) expressly refers to the OECD Guidelines and states that UK transfer pricing legislation is to be interpreted to secure consistency with the OECD Guidelines.¹ The Law on Transfer Pricing of the Russian Federation, which is in force since 2012 aims to make Russian transfer pricing rules work in practice and bring them closer to the OECD Guidelines.²

Defining transfer pricing

¹ Transfer Pricing 2016, Slaughter and May 2015, available at <https://www.slaughterandmay.com/media/2534708/transfer-pricing-2016-united-kingdom.pdf>

² <http://www.pwc.com/gx/en/international-transfer-pricing/assets/russia.pdf>

Transfer pricing is treated under arm's length principle which is an international transfer pricing standard that OECD member countries have agreed should be used for tax purposes.³ The arm's length principle applies to transactions between associated parties and for tax purposes such transactions are treated by reference to the profit that would have arisen if the transactions had been carried out under comparable conditions by independent parties.⁴

Arm's length principle is referred in Article 9 of the OECD Model Tax Convention as following:

Where conditions (including prices, but not only prices) are made or imposed between the two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Therefore, OECD member countries have agreed that the profits (and/or price of transaction) of associated parties may be adjusted to ensure that the arm's length principle is satisfied.⁵

Tax legislations apply several transfer pricing methods to adjust the price of transaction and profit of associated parties. The OECD Guidelines determines five main transfer pricing methods most of which are based on comparability analyses. In order to adjust profits these methods compare conditions of transactions between associated parties to the conditions which would have been obtained between independent parties. The code applies four of the five OECD methods. The Transfer Pricing Regulation that approved by the Ministry of Taxes on 27 January 2017 applied the fifth method.

Transfer Pricing and Market Price in Comparison

The way in which transfer pricing was integrated in the Code has brought disputes and concerns as well as most likely potential problems for tax administration. So that market price was present prior to the integration of transfer pricing in the Code and inclusion of transfer pricing did not adjust or replace market price. Like transfer pricing, one of the targets of market price rule is to determine taxable income from certain transactions between two associated parties which is not accrued but would have accrued if the transaction would have been occurred between two independent parties. In this respect the OECD Guidelines uses only transfer pricing methods for adjusting price of transaction between associated parties. In

³ OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris, p.33, available at <http://dx.doi.org/10.1787/tpg-2017-en>

⁴ *International tax and Tax agent and adviser guidance*, 22 April 2014, available at <https://www.gov.uk/guidance/transfer-pricing-transactions-between-connected-companies>

⁵ OECD, *Supra* note 3, at 36

regards to the presence of both clauses in the Code the following concerns are outlined.

One of the concerns in the Code is about defining associated parties. Although market price remains also in the Russian Tax Code after inclusion of transfer pricing, Russians tried to eliminate misperception by making certain adjustments to the market price clause. According to the adjustment, associated parties are defined as only Russian entities, permanent representations of foreign entities in Russia and (or) foreign entities receiving incomes from Russian sources. Unlike Russian tax code, in market price clause of the Azerbaijan Tax Code associated parties are referred in general covering both resident and non-residents but transfer pricing clause refers to transactions of associated parties one being a resident and the other being a non-resident party which excludes transactions between two resident parties. This can be a deliberate safe harbor treatment applying transfer pricing to international transactions, thus giving domestic taxpayers transfer pricing exemption. Most practitioners recommend that tax administrations have the obligation to provide equal treatment to all taxpayers.⁷ The availability of safe harbors in tax laws for a given category of taxpayers or transactions may have adverse consequences.⁸ The potential problems for tax administration is that in case of a dispute between taxpayer and tax administration, there is a potential of request for application of the clause of the Code that collision between the articles of the Code shall be treated in favor of tax payers.

Since both market price and transfer pricing clauses of the Azerbaijan Tax Code are based on the same concept and have the same target it is recommended that, to eliminate the concerns, 'associated parties' should be remove from market price clause to provide division of the both clauses. So that transfer pricing to be applied to adjust conditions between associated parties and market price to be applied in adjusting prices in other cases, including between independent parties when required according to the market price clause.

⁷ Robert Feinschreiber, Margaret Kent, Updating the OECD's Safe Harbour Transfer Pricing Provisions, available at <http://www.oecd.org/tax/transfer-pricing/48330739.pdf>

⁸ OECD, *Supra* note 3, at 208

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