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Candidate name: Pobedina Anna

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Abstract

Transfer pricing policy in vertically-integrated company is an integral component of the efficient management. The way it is exercised defines the profitability and the level of competitiveness of the firm. Russian oil and gas sector possesses prominent resources and its revenues are one of the biggest in Russia. Though Russian market is a young one, it is to catch up with developed countries and to implement the successful international experience within a shorter period of time. Thus, Russian oil and gas sector faces problems regarding transfer pricing which is due to the lack of understanding, and trust between regulative authorities and companies. New rules were introduced in 2012 and the consequences of them are just showing up. That is why, emphasis in this paper is put on how is transfer pricing defined in oil and gas sector Russia nowadays.

At first, I conducted a literature study to get a proper understanding of transfer pricing and related international practices that helped me to elaborate theoretical framework for future research. In the next part I developed methodology that was about choice of the legislative documents; construction of questionnaires and interview guide developing. It allowed me to look at the problem from a triangle perspective, by this increasing the validity of my research. As a result, I got a legislative base structured according to the examined topics, questionnaires filled in by the consultants from the Russian brunch of the Big 4 and the in-depth interviews with the experts from Russian oil and gas companies. At last, I compared the results received from three different types of sources.

This study helped me to define transfer pricing in oil and gas sector in Russia. It showed that Russian regulative authorities are trying to incorporate experience of foreign countries. However, the implementation of the successful international practices is not always efficient as it contradicts with the national legislative base. Moreover, the suggested by the theory guidelines on transfer pricing do not meet the reality. Still, the basis for its development in oil and gas sector in Russia is promising. Regulation authorities are elaborating clarification letters to make the laws understandable for companies.

As a conclusion to this master thesis, I made several proposals for improvements that will help to accelerate the process of transfer pricing integration into the Russian business environment.

Preface

Writing this thesis has been an unprecedented and an outstanding experience for me. I will not lie and say that I have had to face many challenges during this period. There have been successful days that have brought a lot of progress to my work as well as days with no progress at all when I was at a stand and did not know where and how to move further. Hopefully, I have had a support and motivation team of supervisors, experts and close people whose advice made me accomplish my work. I highly appreciate their input into my work and would like to give my thanks to:

- My Norwegian thesis advisor, Elena Dybtsyna for a supportive advisory process and all the constructive feedback you contributed.
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- All the consultants who found time to fill up the questionnaires and answer additional questions.
- All the experts who were willing to participate in the interviews and later clarify some obscure moments
- My friend, Artem Starostin, a lawyer, who contributed insights about the legislative base of the Russian transfer pricing system and was calm enough to thoroughly explain all the points which I was weak at.
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The process of writing this master thesis enabled me: to enhance my knowledge base, to get deeper insights into the professional level and to sharpen my personal skills. I have gained confidence that I am ready to undertake the projects of even bigger scale. Transfer pricing is a topic that spans across several different fields of economic theory. Due to the globalisation process its importance is constantly increasing in international business environment and Russian developing economy is not an exception in this question. I hope that this thesis will contribute positively as a source of information and motivation for future research and for the possible changes in the real sector.

If you have any question about the contents or sources of this thesis, or if you find it interesting to discuss any questions raised in the thesis concerning transfer pricing in oil and gas sector in Russia, please do to hesitate to contact me on apobedina@gmail.com.

Moscow, April 28th 2011. Anna Pobedina

Key words: transfer pricing, tax, centralization in management, arm's length principle, oil and gas sector, Russia, transaction cost economics

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Main terms and definitions

Transfer pricing – “A transfer price is a price, adopted for book-keeping purposes, which is used to value transactions between affiliated enterprises integrated under the same management at artificially high or low levels in order to effect an unspecified income payment or capital transfer between those enterprises” (OECD Glossary of Statistical Terms, 2003). “Transfer price – an amount of money charged by one department in a company to supply goods or services to another department in the same company, or from one company to another in a group. Some firms use transfer prices as a way of moving profits into “low-tax countries” (Cambridge Business English Dictionary, 2015).

Associated enterprises - are unit, subsidiary, business unit, division, affiliate, affiliated company, dependent company, a company of a group and so on.

The subsidiary: “a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; b) or the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two 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 not so accrued, may be included in the profits of that enterprise and taxed accordingly” (Article 9, OECD Model Tax Convention, 2003).

To decentralize – “to move the operations of a business or other organization from a single, central place to several smaller ones. Transfer of decision making power and assignment of accountability and responsibility for results. It is accompanied by delegation of commensurate authority to individuals or units at all levels of an organization even those far removed from headquarters or other centers of power” (Cambridge Business English Dictionary, 2015).

Transaction – “is an agreement between a buyer and a seller to exchange goods, services or financial instruments” (Investopedia, 2016).

Controlled transaction – “transactions between two enterprises that are associated enterprises with respect to each other” (OECD Glossary of tax terms, 2016).

Comparability analysis – “comparison of controlled transaction conditions with conditions prevailing in transactions between independent enterprises (uncontrolled transactions). Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or if

reasonably accurate adjustments can be made to eliminate the material effects of any such differences” (OECD Glossary of tax terms, 2016).

APA (Advance pricing agreement) - “An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional mechanisms fail or are difficult to apply” (OECD, 2010). Or to put it more simple it is a contract, usually for multiple years, between a taxpayer and at least one tax authority specifying the pricing method that the taxpayer will apply to its related-company transactions (PWC, 2016).

The OECD (Organisation for Economic Cooperation and Development) - “is a multilateral organization comprised of 30 countries, which are mostly Western European countries and other industrialized countries including US and Japan. Founded in 1961, the OECD provides a forum for representatives of countries to discuss and attempt to coordinate economic and social policies. It has an especially significant role in international tax matters” (OECD Glossary of tax terms, 2016).

Functional analysis - “an analysis of the functions performed (taking into account assets used and risks assumed) by associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions” (OECD Glossary of tax terms, 2016).

Mutual agreement procedure (MAP) - “A means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorized by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment” (OECD Glossary of tax terms, 2016).

Introduction

The application by the corporation of transfer prices is an objective process of doing business. It helps to minimize tax liability, which sometimes has a negative impact on budget revenues.

In international practice, the "arm's length" principle is used when the control over controlled transactions is exercised. According to this principle the transaction price should be equal or close to the price between independent companies that are comparable to those of the controlled transaction and operate in the same economic conditions. The "arm's length" principle is used as a comparison price for the transactions between independent companies, as well as to compare the level of profitability of companies involved in such transactions.

In the Russian Federation on the basis of OECD recommendations, the Federal Law of 18.07.2011 № 227-FZ "On Amendments to Certain Legislative Acts of the Russian Federation in connection with the improvement of the taxation price determination principles" (hereinafter - the Federal Law № 227-FZ) was introduced.

Why is it particularly important for Russia? This phenomenon is rather new to the Russian economy compared to the international experience as the new law about the Transfer pricing system in Russia was introduced only in 2012 and there is a lack of that type of experience in the history of the Russian Economy. However, the Russian economy has been a market one for merely 25 years now and this issue needs to be studied carefully.

Russian tax system is not that sophisticated and still needs to be improved. One of the instruments that contribute to the use of the tax system in favor of companies is transfer pricing. As it has been stated by Purvez F. Captain, American Director of the Transfer Pricing and Economics practice for Ernst & Young LLP, and Margaret Brown, member of EY's Transfer Pricing and Economics practice for the Southwest Region, transfer pricing is being misunderstood as a way to shift profits to affiliates in low-tax jurisdiction (Brown, Purvez, 2014).

They say that this view is very narrow-minded. Transfer pricing can both contribute and deteriorate the country's economy. On the one hand, transfer pricing if it is well managed can be used by authorities and enterprises to "reduce audit controversy while proving to apportion income fairly among the multiple taxing jurisdictions worldwide" (Brown, Purvez, 2014).

On the other hand, transfer pricing can not only lead to the shift of profits to the low-tax jurisdiction that will deteriorate the country's economy and decrease the social benefits to the population (natural resources in Russia are considered to be used and protected as a base of life and activity of people living on its territory (Article 9, The Constitution of the Russian Federation, 1993) and the oil and gas

companies get the rights to extract natural resources undertaking certain obligations in regard to the society and the citizens (Federal Law of the Russian Federation of 21.02.1992 № 2395-1). Moreover, it can bring losses to other stakeholders, implying additional audits and litigation, possible nondeductible penalties and double taxation.

This project aims to describe and analyze the transfer pricing in Russian oil and gas companies.

The first pillar of my research is that Russian tax system has just recently incorporated some international practices. Even the analysis of the cases with controlled transactions that took place in 2012 investigated by regulative authorities is going to be presented this year. Up to now, it is quite difficult to evaluate the efficiency of the new rules and the way they have influenced the modern economy. Some of the Russian experts made an attempt to analyze and made an overview of the new rules (Simonov, 2014, Lemeskina, 2012). Though they did not apply the new system to the companies, they did not try to analyze the way companies will react on it. Russian researchers (e.g. Pashkus, 2000), examined the rules that used to be before the innovations of 2012. However, he studied the transfer pricing problem from the view of information management. Korabelnikova and Serov in 2011 tried to compare the tax peculiarities of the transfer pricing in Russia with those in some other foreign countries, however, they did not dwell on the companies. Nepesov (2007) studied the way the arm's length principle can be applied but did not explain how can it be introduced in Russia. Shapovalov (2012) tried to outline the points of the new law that can be interpreted differently. This ambiguous interpretation found endorsement in the appearance of the big amount of clarification letters published by Ministry of Finance of the Russian Federation. It shows that this topic is important for Russian economy and Russian authorities pays a lot of attention to it.

The second pillar is that Russian companies are not used to operate in the transparent environment. Being always unsure about where exactly their taxes will go many Russian vertically-integrated companies are tend to have their accounts in the law tax jurisdictions outside the territory of Russian Federation. It is normal that any business tries to maximize its profits and minimizes its taxes within the legal framework. However, it is not always the case for Russia. We know enough cases when the companies tried to shift their profits illegally, as YUKOS, for example. Nevertheless, nowadays the Russian government is trying to implement successful international practices and improve the system, make it transparent and make the business trust the government. That is why it is high time for companies to try to learn to minimize their taxes within the legal frameworks. For instance, as the arm's length principle is to be applied to the controlled transactions the companies should themselves determine that transfer prices that are comparable to the market prices.

The third pillar of this research is that especially Russia oil and gas sector encounters the problems tied to the transfer pricing. Why? Oil and gas companies generate huge profits: being able to extract natural resources they are bound to pay relevant taxes. For most Russian oil and gas companies it is easier to be present at and control every stage of the value chain process. Thus, they form companies that encompass many subsidiaries being responsible for certain functions. They are called vertically integrated companies. The relations between the units are to be realized at a certain price that is a transfer price. The taxes from Russia oil and gas sector form 20% of the GDP of the Russian Federation and 55% of the federal budget (Medvedev, cited in Kommersant, 2015). For example, Khanty Mansiysk Autonomous District where are most of the oil and gas production activities are concentrated accounts for 28% of the receipts to the federal budget (Report of Ministry of Finance of the Russian Federation, 2015). Thus, it is particularly interesting to examine the question of transfer pricing in relation to the oil and gas sector.

Research questions.

In my study I have decided to state the following research question:

How is transfer pricing defined in oil and gas sector in Russia?

In order to find an answer to this question I will discuss the following issues. I will study the concept of transfer pricing, the current situation in Russia with transfer pricing. I will examine the way international practices taken into account. In order to do it I will analyze how the authorities approach the problem, how do consultants view the transfer pricing and what managers of the companies think about the current situation in transfer pricing.

That will help to gather sufficient and credible data to find the answer to the main question of the research that will find out how the transfer pricing actually defined in oil and gas sector in Russia from a triangle perspective.

Firstly, I will explain the background of the research. Then, I will make a theoretical framework for my research that is based on theory of transaction cost economics, the principle of the decentralization in management and different approaches to the transfer pricing methods. In methodological chapter I will explain the methods used to study the problem, how the data was gathered. In empirical chapter I will describe the results of the conducted research: analysis of documents, questionnaires filled by the consultants from the biggest advisory companies such as Deloitte, E&Y, PWC and conversations with the managers from the oil and gas companies. And in the analytical chapter I will examine and confront theory and practice and outline the most important results in the conclusion.

1. Background of the study

1.1. Transfer pricing in Russia. Overview

This year it has been 25 years since the Russian economy turned to be a market. In some cases, a period of 25 years can be considered being rather a long one, but not when it deals with economy. Especially, when we speak about the economy of a country with the biggest territory in the world that provides its population with amount of various resources that can be beneficially used. It is not a surprise that at the beginning of the 90s, with the collapse of the Soviet Union, Russia had to face a number of challenges that not every country can cope with.

During this 25-year period, Russian Federation has developed from a country with a ruined economy to the one that is spinning up from day to day. If in 1991 Russian GDP was equal to 571 US Dollars (current price), in 2016 it is equal to 1 860,6 US Dollars even though there has been a slump in the economy recently due to the existing oil crisis, the consequences of which many extracting countries had to encounter (Trading Economics, 2016).

In order to keep pace with the world leading economy, Russian government implements and introduces new rules that will put the country on the next stage of the development process. Transfer pricing is not an exception in this question. Being a country with a huge amount of natural resources Russia has a certain number of vertically-integrated oil and gas companies that present the whole value chain process. Consequently, these companies have to have different units that fulfill their functions: production, refining, transportation, distribution, retail, some of them have subsidiaries in other countries as they sell the products to the foreign markets. Here comes the issue of transfer price when the one unit of the organization has to sell a good or a service to another unit of the organization. What is this price? How is it calculated? All these questions are seeking for answers, as the price at which the product is sold will be later tax assessed. When we deal with the oil and gas industry, which is represented by Russian majors, it is easy to imagine what volumes pass between the units.

That is why, on January 1st, 2012, new rules for tax control for transfer pricing were introduced into the Russian legislation by the Federal Law № 227-FZ. More than three years have already passed since the adoption of the new law. The understanding of the application of the new rules has been developing gradually during this time. The Russian Ministry of Finance of Russia and the Federal Tax Service of Russia are actively educate on various issues evolving in connection with the use of new transfer pricing legislation: hold conferences, participate in round tables with the business community, give explanations and letters, provide comments on the application of certain articles of Section V.1 of the Tax Code.

In 2012, taxpayers rebuilt intercompany relations in accordance with the new rules of transfer pricing: they determined the controlled transaction, reviewed the existing approaches to pricing, prepared documentation, applied for the conclusion of the advance pricing agreements (there are about 15 agreements on the domestic controlled transactions). By November 20th 2013, taxpayers documented the controlled transactions for the first time (PWC, 2016). Currently, the tax authorities have initiated the first inspections on the compliance with the transfer pricing normative legislative acts for the 2012 – 2013 period. In addition to that, the legislation on the compliance with the arm's length principle in the controlled transactions transactions made prior to the entry into force of the new provisions of the Tax Code is still ongoing.

As the basis for the new rules the principles and guidelines were elaborated by the OECD, as well as the practice of transfer pricing rules in a number of foreign countries. It is worth mentioning that at present Russian tax authorities are carrying out an active exchange of experiences with foreign colleagues within the framework of the concluded agreements, as well as during the international conferences and round tables on the topic of application of transfer pricing rules, conduction of tax audits and conclusion of pricing agreements.

The development of the Russian legal framework for transfer pricing is significantly influenced by changes in the approach to certain issues of transfer pricing in the world. In particular, innovations in guidelines on transfer pricing and other OECD regulations governing the basics of transfer pricing in OECD countries, attracted close attention of the Russian tax authorities. At present, it is possible to say that the revision of the sixth chapter of the OECD Guidelines on transfer pricing (deal with intangible assets) is likely to lead to in the future certain changes in the Russian tax legislation (Lemeskina,2012).

Moreover, in early 2013 the OECD published a plan to counter the erosion of the tax base and shift of profits to the low tax jurisdictions (BEPS - base erosion and profit shifting). The report also contained specific directions on the development of the international legal framework to reduce the opportunities for the erosion of the tax base and the reduction of the taxes that suppose to come to the state budget. These issues are discussed at the meetings of heads of state and finance ministers as well as during round tables organized by the Russian tax authorities to exchange experiences in the application of transfer pricing legislation.

Despite the similarity of the Russian transfer pricing rules with the OECD recommendations, the Russian rules have their own specific character, and in some cases are fundamentally different from international practice. Existing rules provide, among other things, an increase in the administrative burden on Russian companies engaged in transactions with foreign interdependent companies. These

regulations affect international companies engaged in the sale or purchase of goods in its Russian subsidiary and other affiliated companies in Russia (Usov, 2014).

Therefore, taxpayers, international companies should pay close attention to how the conditions of intra-global transfer pricing policies correspond to the Russian tax legislation, and what changes need to be made in documentation prepared for the Russian objectives to meet the current regulations of the Tax Code.

1.2. Oil and gas sector in Russia

In order to study the transfer pricing system in oil and gas field in Russia it is necessary to give an overview of this sector of Russian economy.

It is a well-known fact that Russia possesses a big amount of national resources, and oil and gas are on the list. Extraction and refining plays a key role in the development of many regions of the Russian Federation. There are several areas with significant oil and gas resources, which are called oil and gas provinces. These include traditional extraction regions of Western Siberia, the Volga region, the North Caucasus, and new oil and gas provinces: in the European North (the Timan-Pechora region), in Eastern Siberia and in the Far East.

According to OPEC, Russia was the first country regarding world crude oil production in 2014, producing 10, 2211 barrels per day what is 13,92% of the world production (OPEC, 2015). And the amount of world proven crude oil reserves were 80,000 million barrels compared to 36, 520 million barrels in the United States, however the number of active rigs in Russia was equal only to 307 and in the US to 1,881 in 2014. That can be explained by harsh condition on the territories rich in fuel resources and less activity both in time and physical dimensions. Russia supplies 10, 576 barrels per day. However, Russian refining capacity is rather poor compared to the produced volume – only 6, 004 barrels/cd and in the US 17, 859 b/cd. The output of refined petroleum products in Russia is 6, 6361 b/d and in the USA 19, 426 1 These numbers show the incline of Russian economy to the rough production of the resources, however the supply of the refined products could be much more beneficial (OPEC, 2015).

For example, in Yamalo-Nenets Autonomous Area is concentrated about 90% of Russian and 22% of the world gas production. The second world biggest gas field Urengoi is situated there. The volumes of gas exceed 10 trillion cubic meters. One of the biggest discovered Russian oil fields is Tuimazinskoe, it was discovered in 1937 but the production is still on the go. Tuimazinskoe is the fifth biggest oil field in the world. The biggest Russian oil field is Samotlor. About 2,3 billion tons of oil have already been recovered from this field and 2,7 billion are still remain in the ground (Rospriroda, 2016).

Currently, about 84% of oil exported from Russia, enters the pipeline system. Of the remaining 16% - 13% are supplied by trains and the remained 3% - are shipped by vessels. The sole operator of oil pipelines in Russia is OJSC "AK" Transneft", which accounts for 97% of shipments of all oil produced in the country. The total length of the pipeline system is more than 217 000 kilometers, 46 700 of which are oil pipelines and 19 300 are pipelines for oil products. They connect the main oil and gas regions of Russia with sales markets in Western and Eastern Europe (Rospriroda, 2016).

At present the main export oil pipelines are the Baltic Pipeline System (Yaroslavl-Primorsk, throughput of this system is 74 million tons per year), Druzhba pipeline, the northern branch of which goes to Poland, and Southern - to Slovakia (its throughput is 90 million tons per year); Black Sea pipelines - Samara-Odessa (throughput - 12 million tons per year) and the Samara-Novorossiysk (43 million tons per year) (Mirnefti, Rosneft, 2016).

Currently, there are four directions of the export and of transit of Russian oil through the territory of the CIS countries from Russia are being developed: Caspian-Black Sea - Mediterranean, Northern Baltic, Central European and East-Siberian. One of the most promising is the East-Siberian area due to the growth in oil consumption in the Asia-Pacific region, especially in China. This last direction still remains encouraging despite the recent slump in the Chinese economy (Mirnefti, Rosneft, 2016).

The outcomes of the activity of the Russian oil and gas sector is the basis for the provision of the country's balance of payments, it supports the national currency and plays a major role in the formation of investment resources. The economy of the Russian Federation still depends on the oil and gas companies' profits. About 55% of the Federal budget is formed from their revenues (Medvedev, cited in Kommersant, 2015). Market value of equity of the oil companies is a half of the Russian stock market capitalization. By virtue of the high economic indicators of oil companies, the Russian National Welfare Fund and the Reserve Fund were founded.

Among the biggest Russian oil companies there are: Rosneft, Lukoil, Surgutneftegaz, Gazpromneft, Tatneft, Slavneft, Bashneft, Rusneft and Gazprom. All these companies are vertically - integrated oil companies. Some of them control the whole value chain process from up-stream to down - stream, some of them use the services of the Russian major mid-stream company Transneft. Still they can have production, distribution and retail components of the value chain process. Moreover, they are presented in different industries. Every vertically integrated company possesses a certain amount of divisions. In order to establish effective cooperation between the units and increase the competitiveness a company has to determine a transfer price. However, doing business companies try to optimize their taxes and they use transfer pricing system to shift the profits from one business unit to another, moving the tax assessment base to the low tax jurisdiction. Though, it is not always the

case and the question of transfer pricing remains acute both for the companies and for the tax authorities.

These facts show that transfer pricing is essential for Russian economy. Many companies being vertically integrated are to use transfer prices to pursue their goals. The only problem is that their goals can contradict with the government and the social view on the use of natural resources.

2. Theoretical framework

The concept of transfer price is relatively new to the Russian economy which can be proved by the recent constituting of the Federal Tax Service of the Russian Federation in the view of specificity and uniqueness of the history of the Russian Federation. However, the international practice of transfer pricing is highly experienced and counts practically one hundred years due to the presence of market economy in Western countries. That is why in the theoretical part of this paper I will appeal more to the international practice and to the works of the western scientist as a basis of my further research.

Firstly, there was a need to address Coase (1937) where the roots of transfer prices were examined such as the growth of the company's size, the dependence between the size and its efficiency. Coase made a huge input into the generation of the «transaction cost» theory that was later elaborated by other scientists. Moreover, he included the risk problem studied by Knight (1921) who connected allocation of responsibilities with risk taking in companies. Furthermore, Coase examined the impact of the new technologies on the managerial techniques. The ambiguous point of the interdependence of the further components was studied. As a result of the new technologies interference managerial techniques will tend to improve. This fact leads to the company's growth in size though the size as it is, is considered to bring inefficiency. From the starting roots I moved to the theory of transfer pricing.

Wissema (1992) studied the level of the company's centralization and its impact on the transfer pricing. In this context there were examined the responsibilities centers, their types and involvement in the transfer pricing process. Also the problem of the consistent information by was raised. Top management can settle a proper transfer price only if the units' managers provide relevant information (Pashkus and Pashkus, 2000). The level of the disclosure of the information depends on the nature of the market (Verrechia, 1983). Thus, a main task of a manager is to construct a model of measurement of the divisional activities which implies motivation for the highest information disclosure. Williamson mentioned other factors that he considered to be important with the reference to this problem, among them there are: the specificity of the assets, opportunism and organic rationality (Williamson, 1979).

And thirdly, the different models and approaches to the transfer price settlement were examined. Among them there were defined: negotiated price, the adjusted external- market price and the cost based price.

The first to provide an economic basis for transfer pricing was Hirshleifer who showed that under static conditions and under certainty the generally correct transfer price for a product is the marginal cost of the producing division. His theory was based on the assumptions but the single objective of a

firm is to maximize its profit. After that Kanodia tried to extend the model to the environment of uncertainty, however the problem of divisional autonomy was left behind (Kanodia, 1979). The next examined approach was the accounting approach to the transfer price settlement. In this case, transfer price is calculated on the basis of the corporate information about the costs. The price is a profit of the selling unit and costs of the buying one. The main drawback of this approach is that it does not take into account the organizational and psychological components (Solomons, 1965). In order to include these components, the principle of negotiated price was settled. It was discovered that the units of organisation can have different even contradictive interests and that the transfer price is a result of a long negotiation process (Cyert, March, 1963).

The summary of the empirical research concerning different approaches to transfer pricing was described in the Emmanuel and Mehafdi's book "Transfer Pricing" (Emmanuel & Mehafdi, 1994) and in Borkowski's 1996 article (Borkowski, 1996).

After that, I tried to examine the transfer pricing methods, especially those yielded from the arm's length principle, where I found out a division between traditional transaction methods and transactional profit methods. The OECD guidelines provide thorough explanation of the strength and weakness of the suggested methods and the conditions which they suit the best. However, still each situation is unique and especially in such a new economy as Russian, where the rules of the well established market economy can not always work in their best way.

The phenomenon is rather new to the Russian economy comparing to the international experience. As the law about Transfer pricing system in Russia was introduced only in 2012, and there is a lack of that type of experience in the history of the Russian Economy. However, the Russian economy has been a market one for merely 25 years now and this issue need to be studied carefully.

This examination of the written material on the topic enabled to immerse in the transfer pricing problem in order to carry out qualified research that will include all the international experience, still, taking into account the peculiarities of the Russian economy.

2.1. Transaction cost economics

The transaction costs theory derived from the neoclassical economics where have been made certain assumptions about the behavior of the human agents. While in the neoclassical economics humans are viewed to be rational agents who try to choose the alternative regarding the maximization of their utility function. However, transaction costs economics, according to Williamson, can be distinguished from neoclassical economics by the recognition of the possibility that people are subject to bounded rationality and the assumption that people can react opportunistically. That means that the utility is not the only factor taken into account by a human agent and that there are other

factors relying on which an agent acts with bounded rationality. However, the bounded rationality should not be considered as hyper rationality or irrationality as although the “organization man” who is examined in the transaction costs economics differs from the “economic man” examined in the neoclassical economics the intrinsic by him/her rationality is the intended one. Here comes the economic theory of comprehensive contracting that helps to effectively organize the exchange process between the agents with bounded rationality with a help of contracts. Still due to the possibility of the opportunistic behavior it can be difficult to predict all the cases. That is why the incomplete contracting is the solution to control an agent (Williamson, 1981). All the mentioned factors show that the “organizational man” is more complex agent than an “economic one” and the aim of the transaction costs economics is try to eliminate the deviation of the “organizational man” from his principles and intentions that implies transaction costs. More generally, the purpose of the transaction costs economics is to explain the problems of the efficiency of some economic operations within the certain institutional limits, which is to say the ability of different organizational forms to proceed positive development and the achievement of the economic goals, where any economic act is aligned with costs.

The transaction costs theory in the frame of the neoinstitutional approach also explains the vertical integration by the existence of the costs of the interaction of the different market agents. Oliver Williamson outlined the factors when the transaction costs become maximal, and their minimization demands vertical integration. According to his experiments, the level of the transaction costs depends on the:

- 1) specificity of the resources involved in the transaction process;
- 2) frequency with which a certain transaction occurs;
- 3) the level of uncertainty.

He also pointed out that the specificity is the most important factor among those, and that it can be divided into three groups: site specificity (closer location makes the transaction easier), physical asset specificity (tangible assets contributes to the efficiency of the transaction) and human asset specificity (“that arises from learning by doing”) (Williamson, 1981). In other words, the more specific, frequent and uncertain the act is the higher are the transaction costs during the realization of the operation in the market.

Developing this research with the examination of the conditions where market failures may occur (market statics, contract incompleteness, information processing, institutional adaptations), Williamson defined the conditions when the vertical integration in the company becomes more favorable than the market.

Moreover, the transaction costs theory not only examines the mechanism of the vertical integration that diminishes the transaction costs but also defines the frames of the company's explanation and consequently the limits of the vertical integration.

As it has already been mentioned in this paper before, Ronald Coase, one of the founding fathers of the theory, pointed out that a company can expand to the extent when the marginal costs related to the use of the market are equal to the marginal costs related to the use of the mechanism of vertical integration.

2.2. Transfer pricing

Here I will discuss the goals of the transfer price settlement, what was it initially aimed at and the transfer pricing process as a basis of the corporate relationships.

The importance of transfer price can be described by the following arguments: it estimates the quantity and the frequency of the transfers, it has an impact on profits and costs of business units, it allows to calculate the earnings and costs of each unit, it is a basis for the estimation of the financial result of the divisions and it is a basis for the motivation of the managers' divisions and its efficient management.

The aims of transfer pricing are also outlined by Anthony and Dearden (1984). Among them there are such as:

- A system of transfer pricing should motivate divisional managers to make effective decisions and provide information for their justification. This case is only possible when managers trying to increase the profit of their units, contributes to the growth of the profit of the company as a whole;
- Decisions on the size of the transfer price should reflect the division's profitability and present a criteria for estimation the efficiency of the unit's activities, as during the process of transfer of the goods or services the profits of one division become the losses of another unit;
- A system of transfer pricing should not interfere into the division's autonomy. It is impossible to do these two processes at the same time: to give managers additional responsibility and to settle the internal prices in a centralized way (Anthony, Dearden 1984).

Transfer pricing exists when there are transfers of goods and services within one company. Thus, corporate commercial activity is a premise for the settlement of the transfer pricing system. The question is why do all these types of activities take place inside the enterprise?

Here it is necessary to pay attention to the transactional cost economics. From this angle, depending on the nature of the transaction, there can be either the managerial structure or the contraction. According to Oliver Williamson who used Coase's ideas to construct market models that reflect the economy of the transaction costs, in case of complex transactions, hierarchies substitute markets as there are high market transaction costs and the risks caused by the external exchange. It is more appropriate for the "like" repeated operations, which demand the investments into the particular human and capital assets (Williamson 1979).

The empirical studies conducted by the Emmanuel proves the dependence between the specificities of the product and a decision to produce or to buy and the choice of the transfer price settlement. These are mostly common for the sectors which is a subject to the technologic changes. Some companies internationalize the commerce at all the stages of the production and distribution and become vertically integrated companies of the high level. For example, enterprises from the oil and gas sector which is particularly interesting for this paper (Emmanuel 1976).

Although the case with the transaction costs is not the only reason for the shift to the transfer pricing. According to the Hirshleifer, the existence and the type of the transfer price system had the nature and goals of the decentralized management as a basis (Emmanuel, 1977). It means that the system of transfer pricing should be in compliance with the business strategy and the organizational structure of a particular firm. From that point of view, McAulay and Tomkins distinguished four groups of the transfer price settlement:

- Functional need;
- Economic need;
- Organizational need;
- Strategic need (McAulay, Tomkins, 1992).

The concept of functional need relates to the division of the firm into the responsibilities centers or profit centers. This leads to the evaluation of their activities and the motivation of their managers.

The economic component states for the efficient distribution among the responsibilities centers the finite resources in order to achieve the company's goals.

In the frame of the organizational part of the firm with a divisional structure the system of transfer pricing is used as an instrument of integration and differentiation.

And though, the traditional approach to the transfer price settlement was focused on the operational decisions and left behind the strategic component, nowadays transfer pricing system is considered to be a vital to the elaboration of the proper strategic decisions.

If transfer pricing is considered to be a system that helps to analyze the company's strategy, then it is possible to look at it from the point of view of the value chain (Porter, 1980). Porter's value chain is a complex phenomenon. Before the market economy the only goal of the firm was to create the value for the company itself. The main focus of each manager was to gain as much profit as possible creating value just for the firm. But the time has passed and today all the companies as a long term strategy choose a creation of the value for their customers for society and for other stakeholders. I will elaborate on this topic later in my work, discussing the negative aspects of transfer pricing.

Coming back to the company's value chain it is possible to outline its three features:

- Determination of the competitive advantage;
- Identification of the relationships in the creation of the value chain;
- Formulation of the common strategies in order to achieve and maintain competitive advantage (among them there could be differentiation, concentration, costs leadership).

A company achieves competitive advantage creating value and generating earnings. The components of the value such as low costs, the growth of the sales rate and margin level or the ability of a company to create value depends on the fields attractiveness, a competitive position of the company and on its strategy.

The value chain of the whole company is focused on the certain units which work is to achieve and maintain a firm's competitive advantage. This fact helps managers to analyze which divisions generate and increase earning and which are not (Herbert, Morris, 1989).

A system of transfer pricing consists of different types of activities which contributes to the company's competitive advantage. If the transfer price is not profitable for one of the participant of the internal trade then this activity does not make profit. This fact decreases the ability of single units and the whole company to generate earnings.

Though this approach of the value chain is rather limited as it can not answer the question whether the transfer pricing contributes to the creation of value and how much the ability to create value of one responsibility center depends on this ability of another one.

It is important to mention a multi-disciplinary framework for transfer pricing presented by Emmanuel and Mehafdi (Emmanuel & Mehafdi, 1994). It does not only give an overview of the whole transfer

pricing problems but shows the causes, effects and purposes of transfer pricing. Furthermore, the authors combined the organizational theory with transaction cost economics and add the factors examined by other theories that had been previously neglected. Among these theories there are a value chain theory that has been examined above and the agency theory.

Coming back to the functional need of the transfer pricing mentioned above and the role of decentralization in the firms it's important to examine the concept of the responsibility center and its place in the transfer pricing theory.

2.3. Responsibility centers in transfer pricing

Responsibility center is the key element of the transfer pricing system. It is a business unit of the organization which can be distinguished by specific features. In order to present all of them correctly it would be helpful to refer to the work of J.G. Wissema "Unit management: entrepreneurship and cohesion in the decentralized firm" of 1996 where he outlined the following characteristics of the division:

Responsibility for its profits and losses where responsibility encouraged or guaranteed as it has been mentioned by the Professor Knight and earlier in the paper contributes to the further development of the divisions, the growth of its productivity and ability to make appropriate decisions which all in the end become a benefit for the whole firm.

The second point is its own goods or services. Each business unit produce certain goods or services that later will be delivered to the internal or external market at a certain price.

Distinctive functions. Responsibility center represents a separate division within a firm which has its own specific functions.

A manager. Each center has its own manager who monitors the activities of the unit, make decisions and take responsibility within his powers.

A connection with a firm. As each responsibility center is a business unit of the whole firm, a manager has to report to the top management on a regular basis and also informs or asks for approval of certain decisions. At the same time top management has to be sure that the activity of this particular business unit and its development is not far behind the development of the whole organization. Moreover, as a part of the connection process a unit adopts a company's corporate culture, its goals and mission (Wissema, 1992).

The scientist tends to distinguish several kinds of responsibility centers:

- Profit-center – a type of division which has a right to monitor its profits and losses itself. The effectiveness and productivity of this type of centers is evaluated according to their profit performance;
- Cost-center – a unit which controls only its costs. This unit of the company usually does not interact with the external market directly. Its main objective is to minimize the costs of the output. Their performance is measured by the amount of deviation from the planned costs;
- Expenses-center (cost account center) – is a type of center for which it is difficult to establish the dependence between earnings and costs. For example, a research department. Its performance is measured by amount of patents or innovations;
- Investment-center – a unit which supervises costs, earning and investments. It is responsible for the equity and debt capitals. Its performance is mostly evaluated by the ROI (Return On Investments) ratio;
- Revenue-center – a unit which is responsible only for its revenues. Its performance is estimated by the achieved corporate cash flows or profit margin. One of its objectives is to increase the sales rate. The more goods or services are produces by the firm the more responsibility centers it will tend to have.

What does this division into centers give to a company? It helps to decrease the time needed to make a decision and to react to the customers' requests, to raise the efficiency of the accounting system, to monitor revenues and to evaluate the results of the divisional activities.

However, in order to be responsible for this or that type of activity to achieve and show better performance a unit has to possess certain powers. And it as it has already been mentioned before it is one of the main problems of the divisions of the company.

2.4. How is transfer price settled in centralized and decentralized firms

In the context of the delegation of powers it will be interesting to compare the differences between centralized and decentralized companies. As a continuation of the ideas presented above it is interesting to take a look at a “produce or sell” model in these two types of companies presented by the Pashkus. He outlines three main components for the comparison: availability of alternatives, powers and the informational flows, especially how much do top managers need to get the detailed information about the divisional activities. It is possible to present the result of his comparison in the table.

Decentralization	Centralization
Available alternatives	
Existence of the internal market Multi-functional assets	Absence of the external market Company's assets has a particular function
Powers	
Freedom of using of external market	Absence of the ability to use the external market Absence of the permission of the top management to change the use of the assets
Informational flows	
Freedom of the transfer price settlement Lack of reporting to the top management	Top management settles the transfer price Full reporting to the top management
An actor responsible for decision making	
Manager of the unit	Top management

Table 2.1 Comparison of the systems with different level of centralization. Pashkus N.A., Pashkus V.Y., 2000

Though this table provide systematized a clear comparison it is important to take a closer look at the problem of the information flows. The ability of the top management to settle the proper transfer price is based on the quality of the information provided by different units of the organization (Pashkus and Pashkus, 2000). That is why in the decentralized company the management of the informational flows has a special role. These flows can be involved both in external and internal activities of the company. The information is analyzed by different participants and is delivered to the further as managerial recommendations.

To enhance the efficiency of the transfer pricing system there is a need to:

- to have an integrated data base which operates in real time and provides centralized and simultaneous access to the information for all the units;
- top managers and unit managers should on time receive the reliable information about the changes of the internal accounting;
- to have possibility to get an additional information after the specific request;
- to have special systems of the quick analysis of the available information.

However, even technologies and these managerial measures can not deal with the conflicts of interest. As a result of such a problem a unit manager decides not to provide the information at all or to disclose only part of the information.

It is obvious that the manager tries to hide information that is usually not present in the financial statements. The level of the disclosure of the information depends on the nature of the market (Verrechia, 1983). This is the informational management of the organization that influences the disclosure of the reliable information. However, the level of the soundness of the information depends on the measures of its estimation. Thus, a main task of a manager is to construct a model of measurement of the divisional activities which implies motivation for the highest information disclosure. Williamson mentioned other factors that he considers to be important with the reference to this problem, among them there are: the specificity of the assets, opportunism and organic rationality (Williamson, 1979).

It is only in power of the top management of the firm to analyze and evaluate the impact of a certain decisions of a unit on a whole company, as only he possesses all the available information.

Consequently reliable and relevant information has to be sent to the central department in order to maximize the efficiency of the firm as a whole. On the other hand a top manager should not interfere a lot with the divisional activities as otherwise, the whole system of transfer pricing will stop working. All the managers should operate within certain frameworks. In most cases these limits are presented in quantitative terms. For example, the investment department can take decisions upon the projects the budget of which does not exceed 1 million dollars. The higher the level of hierarchy the more powers a manager has. It is also important to limit the divisional activities with the external market. For instance, a big portion of the unit's goods distributed to the external market can affect the whole firm.

Thus, a wise combination of limits and delegated powers gives the best results for the efficient operation of the transfer pricing system. In this context, these are new technologies which provide current managers with an unprecedented set of tools and techniques that enables to simultaneously analyze enormous amounts of information and do projections for the future in order to define possible risks and find ways to mitigate them.

2.5. Transfer pricing methods

The initial goals of transfer pricing and the theoretical framework for it, in particular transaction cost theory have been studied. Now, it is important to consider different models of transfer pricing. The economic basis of transfer pricing was provided by Hirshleifer who showed that under static conditions and under certainty the generally correct transfer price for a product is the marginal cost of

the producing division. His theory was based on the assumptions, but the single objective of a firm is to maximize its profit. Moreover, under his analysis all the divisional decisions are made in the environment of certainty. However, as it has already been studied companies operate in the environments with a certain level of uncertainty. Moreover, the company he examined does not depend on the demand or technologies. Thus, a transfer price in this case is price equal to the incremental costs (Hirshleifer, 1956). That is why there are other drawbacks of this model such as absence of the divisional autonomy and deviations in the managers' behavior, such as inconsistent information transfer, particularly unreliable information concerning the divisional costs or negligence of risk or uncertainty.

There were several attempts to optimize this model. Among them there is a work of Ch. Kanodia. She tried to extend the model to the environment of uncertainty, however the problem of divisional autonomy was left behind (Kanodia, 1979). However, the methods of linear and object-oriented programming that took into account the external factors and divisional restrictions made a progress in this field. She examined imperfect competition and tried to settle that type of transfer price which reflects optimum resources allocation considering restrictions and managerial behavior and motivates managers to disclose the information.

Now it is important to study the accounting approach to the transfer price settlement. In this case, transfer price is calculated on the basis of the corporate information about the costs. The price is a profit of the selling unit and costs of the buying one. When the units are dependent each unit makes its own input into the revenue received from the final product. Here the role of the transfer price is to distribute this revenue and calculate the input of each division. That is why the top managers try to decide what to use as a transfer price – market price, universal formula or negotiated one. The main drawback of this approach is that it does not take into account the organizational and psychological components (Solomons, 1965).

Thus, it is possible to conclude that the stated above models focus only on profit maximization at the market with perfect competition absence of risk and proper behavior of its participants. This approach does not explain the company's activities but adopt the price setting mechanism to the internal corporate market.

When the assumption of the project maximization was considered to be not the only goal of each company, the people engaged into the corporate process, their input and interests were studied more thoroughly. It was discovered that they could have different, even contradictive interests and that the transfer price is a result of a long negotiation process (Cyert, March, 1963). Sometimes different units of the organization can follow oppositely directed interests. Thus, any decision concerning

transfer pricing implies the conflict of interests. For example, on the one side of the transaction there is an internal seller who wants to receive the highest price for his goods or services, however, on the other side of the transaction there is an internal buyer who wants to get the lowest possible price for the goods or services that he gets. Still, these both parties are on the same side, as what is the most important for the company as a whole, and for the top management is the final profit. That is why these units have to work on the same goal trying to maximize the total profit.

However, sometimes the salary of the managers of a specific unit, their bonuses can depend on the income of their unit and the only goal they pursue is to maximize the profit of their particular unit, despite the indications provided by the central management of the company. That is why, negotiating the transfer price, the managers of the unit try to make other factors like quality, quantity, required investments etc. to be considered during the process of the determination of the transfer price (Emmanuel & Mehafdi, 1994).

These additional interactions between the units impedes new factors that influence the transaction and consequently increases the complexity of the transfer price settlement. Negotiations are viewed to be the best way to find the correct transfer price that will help to include the factors of the relationship between the units that can be neglected when other methods are being used.

However, the close relationship between the parties can bring an emotional aspect into the negotiation process that can negatively affect the determination of the transfer price. That is why in order to avoid the opportunistic behavior that the transaction cost theory tries to tackle, it can be relevant to let the parties negotiate the price themselves in order to avoid this type of behavior. It can be provoked by the central management's forwarded tasks that can neglect the peculiarities of the relationship between the units of the company.

This type of transfer price was supposed to contribute to encourage the motivation of the managers and to add the integrational component into their activities which will decline the possible risks provoked by the aggressive and inconsistent behavior (Ackelsberg, Yukl, 1979).

In conclusion, it is possible to say that there are three main approaches to the transfer price settlement – the negotiated price, the adjusted external-market price and the cost based price (Cravens, 1997). These approaches vary in the amount of subunit autonomy. A negotiated price is «direct negotiation, between the seller and the buyer divisions. This approach involves little or even no higher-level management. Internal-market prices are employed when external referent prices do not exist or the firm's strategy requires divisional flexibility. An adjusted external-market price is set in proximity to the external market prices and hence reduces the division managers' autonomy to set the transfer price. For instance, an adjusted external-market price may be determined as the market price minus a

fixed discount, the best price to an outsider during a specific period, or the negotiated price with a listed price range. A cost-based price is set drawn from the supplier's costs. This approach allows the selling division to charge a markup on the cost to cover overhead and provide a profit margin. This solution leaves the selling division with little flexibility in manipulating transfer prices because it requires the division to expose all cost-related information» (Dan Li. M.P. Ferreira, 2008).

Table 1.2 summarizes these approaches and provides examples. All of them have their advantages and disadvantages and a particular model, for a certain form should better integrate different elements of the studies approaches to eliminate risks and cover all of the soft points.

Table 1 – A typology of transfer pricing		
Low subunit autonomy		High subunit autonomy
Cost-based price	Adjusted external-market price	Negotiated/internal-market price
Information on supplier costs is referred to while setting transfer prices.	Prices on the external market serve as the referent for determining the values of internal transfers.	Managers of the trading profit centers establish a price that is acceptable to both the seller and the buyer before the exchange can be consummated.
e.g., actual full production cost; standard production cost; full production cost plus a mark up; etc.	e.g., market price less a discount; best price to an outsider during a specific period; negotiated price with listed price range; etc.	e.g., negotiated prices between subunits, bidding.

Table 2.2. A typology of transfer pricing. Dan Li. M.P. Ferreira, 2008.

2.6. Transfer pricing methods in compliance with the arm's length principle

In the previous sections there were examined different theories and frameworks that help to design a certain transfer pricing models. Now it is time to study the methods of the transfer price settlement regarding arm's length principle.

In order to settle correct transfer prices OECD members have agreed upon the arm's length principle that is to be considered as an international standard for tax purposes. The principle states that *transactions between closely related corporations have to be entered into with the same terms as if the transaction was between independent corporations under the same conditions and circumstances.* All the methods developed in accordance with the arm's length principle were combined by OECD in two groups: Traditional transaction methods and Transactional profit methods. Among the traditional methods, that are considered to be preferred, there are: comparable uncontrolled price method, resale price method and cost plus method. The transactional profit methods are used to reflect the specificity of the transaction better, for example, when the parties are engaged in closer mutually

profitable business relationship or when there is a lack or absence of the information on the similar transactions. Among that type of methods there are: transactional net margin method (TNMM) and transactional profit split method.

OECD points out that the transfer pricing method of a certain transaction is always to be chosen as the most appropriate method in relation to its nature and the existing (prevailing) conditions. The selection of the most appropriate transfer pricing method is always a thorough work on the choice of the method that better suits the case. Due to this, a lot of factors should be examined and taken into account. It's essential to be aware of the strengths and weaknesses of a particular method, to which situation it should be applied to. Moreover, there is a need to study attentively the transaction itself: its nature to examine which functional analysis is to be carried out (more about functional analysis - below in the section Arm's length principle); the availability of the reliable information concerning the uncontrolled transactions and as a consequence the assessment of the comparability between controlled and uncontrolled transactions (OECD, 2010).

2.6.1. Arm's length principle

Arm's length principle introduced by OECD literally means not let closer than the arm, keep at the arm's length or keep at a distance. This rule is used in the taxation of the dependent companies. According to it, the taxes are to be withdrawn in compliance with the market prices for the transactions between the dependent tax payers. In other words, every unit in a corporation has to be treated as if it is an independent corporation.

Arm's length principle is formulated in the OECD Transfer Pricing Guidelines for multinational enterprises and tax administrations. OECD's Guidelines Article 9 paragraph 1 says:

"[When] conditions are made or imposed between ... 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 not so accrued, may be included in the profits of that enterprise and taxed accordingly." (OECD, 2001).

According to the OECD approach, two main purposes of the use of these principles are: fair allocation of the tax base between the jurisdictions and elimination of the dual pricing. This principle is also a measure to protect the government from the tax avoidance. As vertically integrated companies can easily avoid paying taxes by shifting their profits to the low-tax jurisdictions.

The use of Arm's length principle assumes, firstly, the comparison of the conditions between the associated companies and the circumstances that could be settled between the independent

companies, and, secondly, the assessment of profit that might occur as a result of interaction between the associated companies on the same principles as those that exist between the independent companies. Thus, when the arm's length principle is used the units of the company are treated as the independent ones. Arm's length principle itself is formulated in the OECD Transfer pricing Guidelines for multinational enterprises and tax administrations. OECD's article 9 paragraph 1 says:

“[Where] conditions 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 not so accrued, may be included in the profits of that enterprise and taxed accordingly.” (OECD, 2001).

When arm's length principle is used the importance of the determination of the comparability of the examined circumstances increases. OECD suggests five factors that are to be applied both to the controlled transaction and to the transaction between independent units. Among them there are the following:

- 1) *Characteristics of property or services* (physical features, possible volume, quality; when the transaction deals with services – their nature, size; if the property is tangible we talk about such characteristics as licensing; type of property – patent, trademark, duration of protection; and it's also important to take into account the possible benefits that the property can bring);
- 2) *Functional analysis* (In the framework of the functional analysis it is to analyze the structure and the organization of the group, to find out the most important economic activities, allocated responsibilities, assets used and the possible risks. The thing that can help to identify the true allocation of risk can be a parties' conduct);
- 3) *Contractual terms* (the contractual terms usually «define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties»);
- 4) *Economic circumstances* (It's necessary to be sure that the markets where controlled and uncontrolled transactions are being proceeded do not have differences. Speaking more particularly it can be market's location, its size, consumer purchasing power, the position of the buyers and sellers, level of supply and demand, cost of land, labor, capital, government regulation and so on. One of the most important factors is the existence of economic, business or product cycle);
- 5) *Business strategies* (Among the business strategies that are to be developed in order to determine the comparability, there are such as *“innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labor*

laws, duration of arrangements”, market penetration schemes, duration of tax administration etc.) (OECD, 2010).

2.6.2. Traditional transaction methods

Generally traditional transaction methods are more preferable, however, they can be used only when there is enough information about the prices for transactions between independent parties in the comparable cases, where other factors can be examined through the determination of comparability (OECD, 2010).

Traditional transaction methods help to determine whether the commercial and financial relations between the dependent parties are established in compliance with the arm’s length principle. The price of the uncontrolled comparable transaction can be easily put on the place of the price of the controlled transaction that ensures the existence of the arm’s length principle between the parties.

There are three traditional transaction methods:

1. Comparable uncontrolled price method (CUP-method);
2. Resale price method;
3. Cost-plus method.

2.6.2.1. Comparable uncontrolled price method (CUP-method)

Comparable Uncontrolled Price method is based on the comparison of the price of the controlled transaction with the price of a comparable uncontrolled transaction. This statement is used to compare the price of the transaction between affiliated parties with the price in an open market:

“The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances” (OECD 95).

It is possible to outline the cases when the traditional transaction methods are to be used.

- *So-called internal comparable transactions*, that means the transactions comparable to a controlled transaction, but carried out by a company with an independent party in comparable commercial and financial conditions;
- *Loan issue transactions*. There is a number of databases, which provide information on specific transactions regarding loans or bond issue, and if the basic conditions coincide (the amount and the currency of the loan, term, interest rate, etc.), these transactions may be regarded as comparable;

- *Transactions regarding trademark.* Also, there are databases with information on the transactions for the provision of trademarks (mainly in the US and Canada, where the disclosure of such information in some cases is a must). Although trademarks (as well as any other intellectual property) initially are difficult to compare because of their uniqueness, though it gives a certain benchmark for comparison;
- *Deals with the goods which have official (exchange) quotations or reliable statistics* (Simonov, 2014).
- Benchmarking that has been mentioned above is widely used in this method of transfer pricing.

The best way to use CUP-methods «is under similar terms, in similar quantities and in a similar market» (ITI, 2010). For this purpose it is necessary to outline the factors that can be compared externally and internally. It is important to find out the internal and external basis for comparison before analyzing which features are incomparable as possible adjustments can influence the variables what can affect the results.

Here is the reproduction of Bjerke illustration (Bjerke, 1997; p. 225) of the internal and external comparables in Figure 2.1.

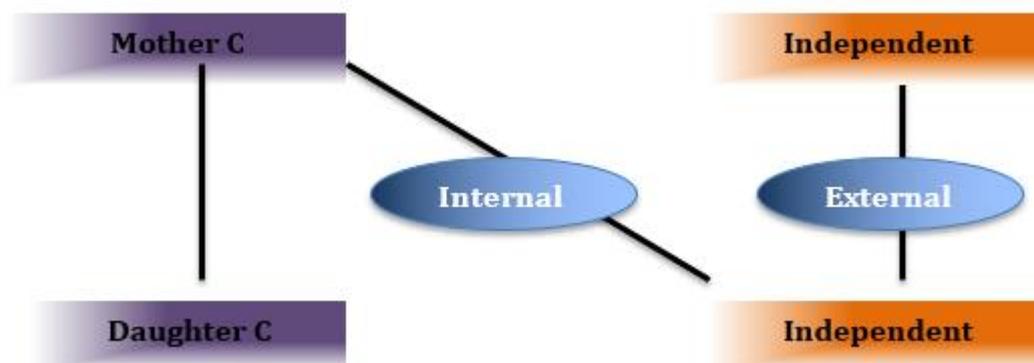


Figure 2.1. Internal and External comparables. Bjerke, 1997.

Thus, depending on the situation studied it is possible to find data on comparable transactions and to apply the first method.

2.6.2.2. Resale price method

This method determines the transfer price by comparing gross profit margin of a controlled transaction with that of uncontrolled transaction or transactions. It is used to set the price at which one affiliated company sells goods or services to another affiliated company if the last one resales goods or services to one or more independent firms.

In this case the price is determined by the reseller regarding the profit margin that will cover the expenses and will still be in plus (the reseller will get some profit). The transactions should be held in the comparable commercial and financial conditions. The illustration of the use of the resale price method is given below in Figure 2.2 (Helland, 2010).

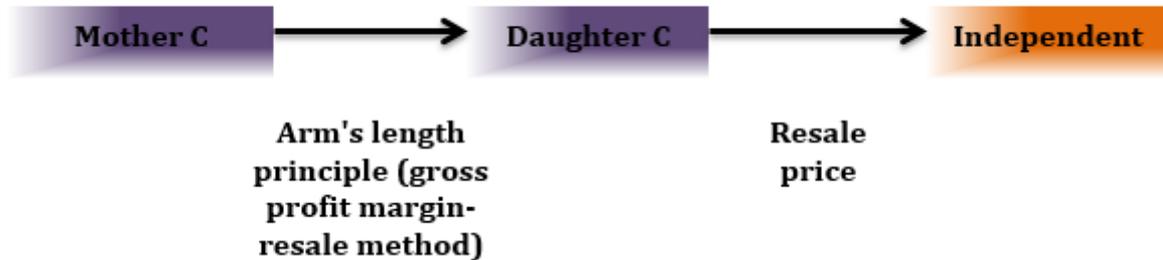


Figure 2.2. The use of the resale price method.

To find the gross profit margin it is necessary to compare a number of factors (ITI, 2010).

Internal comparing: Resale price margin that one of the company of the group got in comparable controlled transaction

External comparing: Resale price margin that “an arm’s length company” got in comparable uncontrolled transaction.

The more comparable are the examined factors the more possibility that the resale price method will determine the true resale price (ITI, 2010).

However, the resale price margin can be influenced by the reseller’s activities. The number of activities can vary a lot from case to case. For example, a reseller can just perform a role of a forwarding agent or can alone take all the risk related to the further realization of the goods or services such as advertising, marketing, distribution, guarantees and so on. If a reseller has a certain expertise in these activities the resale price can increase. In order to analyze to deal with this case in appropriate way a cost-plus method can be issued in order to complement the resale price method (OECD, 2010).

It is worth mentioning that the logic of the resale price method and the cost-plus method is quite similar: it is necessary to compare the gross margin (in the case of the method of the resale price) and gross margin of costs (in the case of cost-plus method) which the company has received in the transaction with the affiliated party with a market gross profit margin that the independent parties received in the comparable transactions.

Whereas, the choice of the methods between the resale price method and the cost-plus method will depend on the stage of the value chain process occupied by the examined company and the independent party (Simonov, 2014).

The resale price method and cost-plus methods are illustrated by Simonov and is reproduced in Figure 2.3.

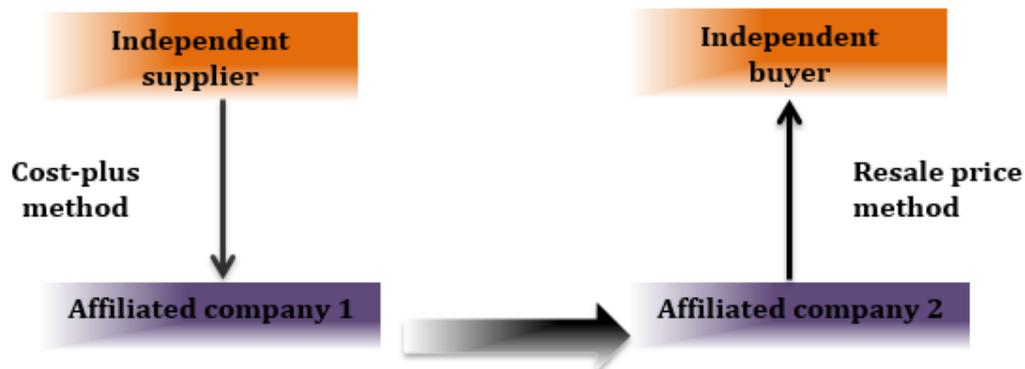


Figure 2.3. The use of resale price and cost-plus method. Simonov, 2014.

2.6.2.3. Cost-plus method

Cost-plus method is a method that is used to determine the price at which the supplier sells the goods of a company's group. The price is determined by adding gross profit margin to the amount of seller's costs that will allow him to receive the profits corresponding to the market conditions and the functions performed by the seller.

The cost-plus method is supposed to be used mainly for transactions regarding provision of services, apart from transactions that involve intangible assets that have a significant impact on gross profit margin. This method is based on the sum of the direct and indirect costs of the supplier. To determine the settlement price of the controlled transaction for tax purposes the prime cost increases for the amount of profit margin, normal for this area of work. On the next page there is an illustration of the use of cost-plus method (Lemeskina, 2012).

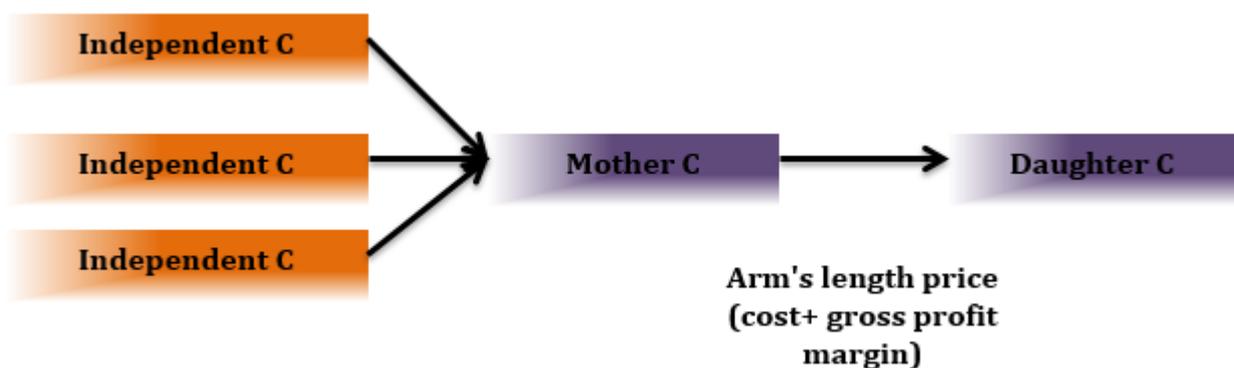


Figure 2.4. The use of the cost-plus method.

The main difficulty of this method is that as a rule, information on costs is a commercial secret, and foreign companies do not disclose information about its costs.

Determination of costs. “Although it is true that an enterprise must cover its costs over a period of time to remain in business, those costs may not be the determinant of the appropriate profit in a specific case for any one year”. As costs have influence on the gross profit margin there is a need to examine them more thoroughly.

The costs are grouped into three categories:

- 1) *Direct costs*: for instance, raw materials;
- 2) *Indirect costs*: for instance, repair and maintenance;
- 3) *Operating costs*: for instance, selling, general and administrative (OECD, 2001).

Moreover, it is important to apply a comparable mark up to a comparable cost basis. For this purpose, it is necessary to analyze the differences between controlled and uncontrolled transactions that can influence the mark up in order to make appropriate adjustments to the uncontrolled transactions.

And another point of the accounting consistency. If there are differences in accounting practices in the controlled and uncontrolled transaction, special adjustments are to be made in order to be sure that the same type of costs are used in each case (OECD, 2010).

In situations where it is impossible to ensure the comparability of financial statements for the purpose of calculating the gross profit margin, and comparability of definition for the purposes of taxation of income (profits, revenue) in the transactions, the parties of which are interdependent bodies, the profit split method and transactional net margin method are used (Lemeskina, 2012).

2.6.3. Transactional profit methods

Despite the fact that traditional transaction methods are found to be to be more preferable, there are cases when transactional profit methods are considered to be more adequate. Those are the cases when “*each of the parties makes valuable and unique contributions in relation to the controlled transaction, or where the parties engage in highly integrated activities, may make a transactional profit split more appropriate than a one-sided method*”, or when there is available reliable information (OECD,2010).

The application of the arm’s length principle in the case of these methods changes comparing with the application regarding traditional transaction methods. According to paragraph 2.108 of Review of Comparability and of Profit Methods, OECD: “*Arm’s length principle in the case of a transactional profit split method, it is based on an approximation of the division of profits that independent*

enterprises would have expected to realize from engaging in the transaction(s)” (OECD, 2010). Still, they are only appropriate if they are in compliance with the Article 9 of the OECD model Tax Convention.

There are two transactional profit methods:

- Profit split method;
- Transactional Net Margin Method.

2.6.3.1. Profit split method

It is known that when a company redistribute the income in favor of the parent company affiliated divisions hold up prices not only when they supply goods, but also when they forward various services, patents, licenses and "know-how". When this type of situation is encountered, to justify the application of transfer pricing it is recommended to use the method of profit distribution.

Application of the profit split method is based on the calculation of gross margin (loss) from the affiliated companies marketing products that is later divided between them based on the actual contribution to the formation of the total profit. In practice, as a criteria for the distribution of profit it is possible to use the indicators of average number of employees or the amount of labor costs.

The basis for the choice of the method of determination of the transfer price both by the taxpayer and the tax authority should take into account the advantages and the disadvantages of the examined methods, their compliance with the requirements, as well as the availability of the information on comparable transactions and companies.

For example, in Russia, the Federal Law № 227-FZ makes it possible to conclude Advance Pricing Agreements for tax purposes between large taxpayers and tax authorities. The object of such agreements is to establish methods for determination of the transfer prices, which must include: sources of information on comparable companies, transactions, prices; Comparable objects; the procedure for making allowances; the calculations, determination of the gross profit margin.

The fulfillment of the provisions of such an agreement by the taxpayer should facilitate the release from taxpayers' liability (Lemeskina, 2012).

Talking about the strengths, the profit split method can be the most appropriate method when both parties make unique and valuable contributions to the transaction. Moreover, this method can take into account *“possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same*

circumstances” (OECD, 2010). Furthermore, it evaluates all the parties that make any contribution to the transaction.

- Despite its advantages, the profit split methods have some drawbacks;
- It is quite difficult to apply this method as you can face obstacles trying to get information from foreign affiliates and analyze combined revenue and costs of all the parties participated in the transaction;
- It is used quite seldom and is more considered to be a theoretical method;
- It can be difficult to differentiate between transaction and the rest of the processes income, costs and property;
- The method is used on a basis of historical data, not on the current one. It is always easier to analyze what has already happened (Bjerke, 1997).

2.6.3.2. Transactional net margin method (TNMM)

Profit comparison methods (TNMM/CPM) – methods of comparing profits. There are two varieties of this group of methods: Transactional Net Margin Method (TNMM) – net margin method and the Comparable Profits Method (CPM) – a method of profit comparison. The basis of these methods is the determination of the price based on the comparison of profit on the controlled transaction with a profit of independent businesses.

This method allows us to neutralize the drawbacks by changing the price of the transaction's gross profit margin to the operating margin of the company. Depending on the circumstances, the different financial indicators can be used. A specific indicator is chosen in the way that better reflects the factor on which the profit depends. The algorithm of this method includes the following steps:

- selection of the source of information;
- functional analysis;
- selection of the examined side;
- choosing a financial indicator;
- selection of comparable companies;
- calculation of the market gross profit margin;
- comparison of profit margin obtained by the test company, with a market gross profit margin (Simonov, 2014).

Advantages and disadvantages of TNMM.

Advantages:

- Comparing this method with the CUP method, net profit indicators (*«e.g. return on assets, operating income to sales, and possibly other measures of net profit»*) are less influenced by the transactional differences, what's more, these indicators are more tolerant to these mentioned differences;
- Sometimes it is hard to get information on the operating expenses due to some problems with public data in some countries and the use of net profit margin can face this problem;
- It is not necessary to analyze the financial statements of all the participants in the transaction unlike it is the case with the profit split method (OECD, 2010).

The point 2.77, B.3.3 says that *«only those items that (a) directly or indirectly relate to the controlled transaction at hand and (b) are of an operating nature should be taken into account in the determination of the net profit indicator for the application of the transactional net margin method»*.

Disadvantages:

- It's difficult for taxpayers to apply the TNMM for controlled transaction when there is no reliable information on the uncontrolled transaction what impose obstacles on the forming the correct sample of the companies.

For example, Russian Classification of the economic activities includes different types of activities that can not be compared one with another (Lemeskina, 2012).

It is applied to only one of the affiliated parties that can give bias results due to the one-sided approach.

The determination of the corresponding adjustment may impose some difficulties as there can appear uncertainty about which of the company's profits of the group should be adjusted.

2.7. Advance pricing agreements (APA)

An advance pricing agreement, according to the OECD guidelines, is: *“An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. APAs are intended to supplement the*

traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional mechanisms fail or are difficult to apply” (OECD, 2010).

In particular, in Russia an Advance pricing agreement is an agreement between a great tax payer and tax authorities which defines the order of the determination of the transfer price and the method used in controlled transactions (Article 83 of the Tax Code of the Russian Federation).

This agreement helps to eliminate the risks tied to the supplement tax assessment that takes place when it comes to the transfer pricing rules.

APAs clarify:

- Transactions covered by the APA;
- Transfer pricing method (TPM);
- APA term;
- Operational and compliance provisions;
- Appropriate adjustments;
- Critical assumptions regarding future events;
- Required APA records;
- Annual compliance reporting responsibility (Guide to Advance pricing agreements by EY, 2015).

Taxpayers can enter both Unilateral APAs - with one tax authority or with two and more tax authorities – bilateral or multilateral agreements through a mutual agreement procedure (MAP). If unilateral APAs help to eliminate the disputes that can emerge in a relation with one government, bilateral APAs address the risks regarding misunderstandings and differences in interpretation of the transfer pricing rules in different countries and the problem of double taxation (HM Revenue & Customs, 2016).

Furthermore, APAs can be a way of time and costs savings. If a procedure of transfer pricing examinations can take up to three-four years that could be followed by a dispute resolution mechanism, the APA process lasts considerably less time and costs less.

If a taxpayer decides to enroll the APA process, there are several steps that have to be followed:

- Prefilling conference;
- Formal APA request;

- Evaluation and negotiation;
- Administration and renewal (EY, 2016).

Ernest and Young provides an illustration of the bilateral APA process. It is presented in Figure 2.5.

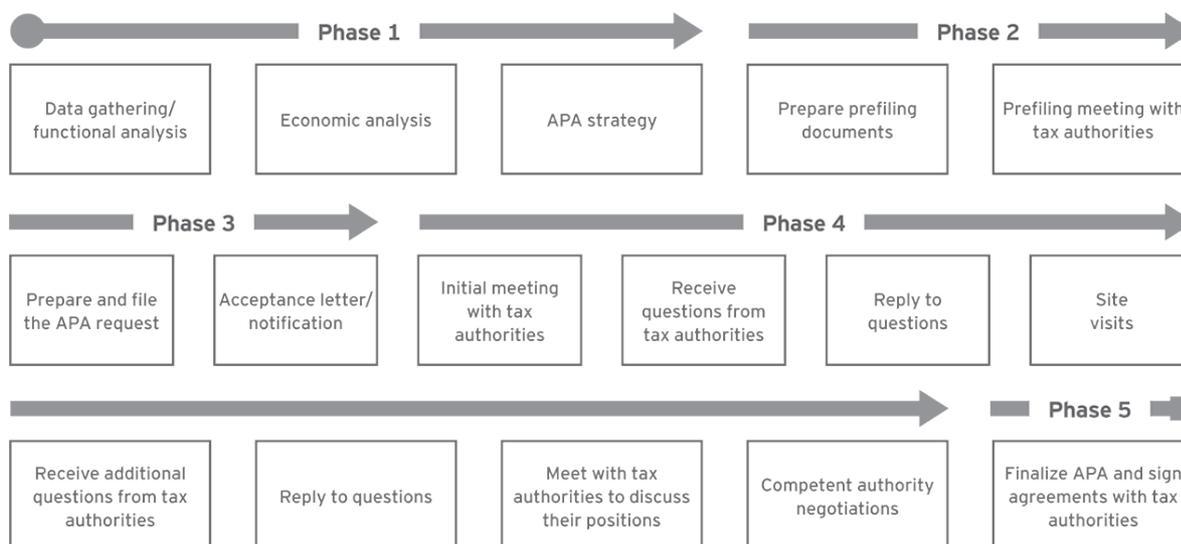


Figure 2.5. APA process: bilateral APA timeline. EY, 2011.

A taxpayer should request a prefilling conference (PFC). During this conference a taxpayer explains the suitability of his request and clarify the information required by the tax authority. In some states, a taxpayer can remain anonymous.

APAs are used in many countries around the world. Thus, in Japan in 2010 the local tax authorities received 127 requests from the taxpayers. And as a result of consideration 100 APAs were concluded (paragraph 3.10.1 chapter 3 UN Transfer Pricing Manual for Developing Countries).

2.8. Benchmarking

Another phenomenon that is to be mentioned in the study of transfer pricing is benchmarking. Why is it used?

Benchmarking is one of the tools that helps to identify Comparable Uncontrolled Price that is used to identify the transfer price between the affiliated parties in the controlled transaction. Companies do use benchmarks in order to find the comparable uncontrolled price to make their prices be in compliance with the arm's length principle.

There are many definitions of the benchmarking nowadays, however, in general, benchmarking is the process through which a company measures its products, services, and practices against its toughest competitors, or those companies recognized as leaders in its industry. Benchmarking is one of a manager's best tools for determining whether the company is performing particular functions and

activities efficiently, whether its costs are in line with those of competitors, and whether its internal activities and business processes need improvement (Reference for Business, 2016).

As it is possible to see from the definition, one of the main purpose of the benchmarking is the increase of the company's performance. In order to do it, it is possible to use the benchmarking wheel suggested by Bjorn Andersen which illustrates the way the strengths of the benchmarking should be used.

There are several classifications of the benchmarking. The first one, is based on the examined areas suggested by Løvland. According to him benchmarking can be internal, external and generic (Løvland, 2001). Another classification has a process as a background for the comparison: performance, process and strategic benchmarking. Nowadays, this last classification is considered to be more relevant than the first one.

Concerning, the benchmarking used in Transfer pricing, it is possible to quote, the Transfer Pricing Benchmarking Review that PWC suggests. According to their experience it helps to analyze whether the current transfer pricing system of a company is appropriate and determine the range of arm's length prices that a company can take as transfer pricing within the company for controlled transactions between the affiliated parties.

According to the PWC, the Transfer Pricing Benchmarking Review can be beneficial for a company in several ways:

- mitigate the transfer pricing risks if the determined prices for the controlled transaction are in compliance with the arm's length principle;
- minimize tax exposure through the benchmarking study and penalty through good cooperation in the case that a tax adjustment is unavoidable;
- effectively gauge company performance against comparable independent companies in a comparable industry;
- establish appropriate transfer pricing for new business (PWC, 2016).

Thus, benchmarking is an important tool in the determination of the transfer pricing policy of the company that helps it to operate in compliance with the arm's length principle and achieve and maintain company's competitiveness.

The provided above theory and concepts enabled me to make a robust theoretical framework for my research. The examined international guidelines helped me to elaborate methodology that will

examine the way international practices are incorporated in Russia and answer the research question- how is transfer pricing defined in Russian oil and gas sector.

3. Methodological chapter.

The purpose of this study is to describe and analyze transfer pricing in oil and gas sector in Russia. The information received from the advisors, insiders and legislative documents is supposed to compel one another and provide a complex overview of the current situation from a triangle perspective.

3.1. Research methodology

Methodology is defined in the dictionary as a «*sum of methods and strategies that are applied for manipulating of the collected data and acquiring knowledge*» (Jary and Jary, 1995). Philosophical background is essential not only to explain the choice of certain methods used to carry out the survey, but it forms the methodology of any research. In order to have all the elements of the research project in compliance with each other and have a strong correlation among them everything should be made through philosophical prism. A certain philosophical position, according to Easterby-Smith (2012, p.17), is a «determinant factor for choosing and adapting a proper research design».

The philosophical ground for the research project consists of ontology and epistemology. Ontology defines “*philosophical assumptions about the nature of reality*” while epistemology is focused on “*the ways of inquiring into the nature of the world*” (Easterby-Smith, Thorpe, Jackson, 2012, p.18).

In this research, I would like the ontological background of my work to be relativistic. Relativists state that there are many «truths» and that the facts depend on viewpoint of observer (Easterby-Smith, Thorpe, Jackson, 2012, p.19). Moreover, they argue that there may never be a definitive answer to the debate and that the truth is only achieved through discussion. Thus, an observer should study the examined through the multiple personal opinion on the problem. The aim of this research project is to find out how does the transfer pricing defined in the oil and gas sector in Russia.

However, the actors that are to be examined have different views on the studied topic: advisors have external view on the transfer pricing situation in companies, the companies' managers have insider view on the subject and the tax authorities, as a regulation body, has their own approach towards the issue. Thus, through the comparison of these three opinions and finding the points of coincidence it is possible to find the truth about the definition of the transfer pricing in oil and gas sector in Russia.

As for epistemological dimension, I am inclined to follow social constructionist approach. In the “Management research” in relation to social constructionism (Easterby-Smith, Thorpe, Jackson, 2012, p.23) states that “reality is determined by people”, not the external influence and objective factors. In this research the emphasis is put on how an individual evaluates and thinks about his/her experience rather than on facts and measurements. Social constructionism better suit in this case as it

is aimed at increase of general understanding of the situation, it can include the overview of the 'whole' situation. Moreover, it accepts the value of multiple data sources, as in this research there is a need to get primary data, in particular, through questionnaires and in-depth interviews and to analyze secondary data in order to find out the description of transfer pricing in Russia. And the research does not have a great number of cases that is why the constructionist approach that enables the generalizations beyond the sample better suits the research.

3.2. Research design

According to explanation provided in “Management research” (Easterby-Smith, Thorpe, Jackson, 2012, p.38), research design is supposed to define what data needed to be collected, in what way a researcher is going to get it and the sources of it. Moreover, research design explains in what way and with the help of which tools the collected data will be interpreted and how the answer to the formulated question will be provided. In compliance with the relativism ontology that is at the core of my study and the constructionist approach chosen as a way to investigate the nature of the issue, I will apply a constructivist design that implies cases and surveys.

This type of methods will help to compare the way people interpret, understand, view the facts and at the same time estimate how respondents describe their experience and focus on their «self-generated meanings» (Flick, 2014, p.204). For example, the analysis of the questionnaires will explain how the advisers view the situation concerning, transfer pricing practices in oil and gas sector in Russia. And the study of interviews from the insiders will deeper inside of the situation where they will share their experience and prescribe self-generated meanings to the observed issues.

As a result of the in-depth interviews the elaborated and broad answers to the several groups of questions were collected: the questions were about the organizational structure, transfer pricing methods used in the company, decision-making, out of company’s activities concerning transfer prices, etc.

Questionnaires consist of following questions: the organization structure of the companies, transfer pricing methods used, how international practices are taken into account, decisions related to transfer pricing practices and so on. However, compared to the interviews, not all the questions in the questionnaires are open-ended, some of them implies short answers or allocation of percentages. Still, it is easy to see the reflection of these examined issues in those studied through the interview.

Data obtained thorough the study of the legislation, rules, recommendations issued by tax authorities was collected and studied in order to understand and interpret their approach to transfer pricing.

The performance of the gathered data and its type is influenced a lot by the place and the role of the researcher in the process, to what extent he or she is going to be involved into the observed issue (Flick, 2014, p.24). Mostly, within the study process I tackle the issue independently, however, the collection of the primary data needs a bit more involvement into the process.

3.3. Data collection

The elaborated and well-considered strategy for data collection is another important moment that helps to find out the answers for the posed research questions. There are two types of data that is to be used in this paper – primary data and secondary data. Secondary data – the existent relevant information will allow to make a sufficient theoretical base and framework for further gathering of the primary data.

In this work, I include the analysis of the written material upon current situation regarding transfer pricing in Russia helped to find out current trend and the particular features of the reflection of transfer pricing on oil and gas sector that helps to formulate better and suitable questions for questionnaire and interview guide. Moreover, I will use the secondary data in order to analyze how the tax authorities approach the transfer pricing and what they understand by transfer pricing.

Still, secondary data is not sufficient to find the answer for the posed questions and analyze the current trends. Moreover, it is rather difficult to be sure in the credibility and the validity of the information as its value can decrease as the time passes. However, the access to this type of information is much easier than to the primary one, it is rather cheap and can be gathered by a single researcher. In addition to this, the secondary data provides the ground work for the study, it shows the level to which the topic is examined, the moments that have not been studied, the weak points and the possible ways to extent the field.

The primary data is to be gathered to complement the information gathered through the analysis of the secondary data. My primary data set includes 12 questionnaires and two in-depth interviews. It enabled me to find out the verification of the most current and recent trends, the attitudes and beliefs of the respondents upon the examined topic, to reveal possible obscure moments that can not be discovered through the analysis of the existent information, the real processes undergoing in oil and gas sphere. This received data helps to study the subject in more details. Among other advantages of this type of data there are: validity, new current information and one of the most important points is that it is gathered in accordance with the goals of the research project, and the research model was designed exactly to meet the needs of this particular study. For the sample of this research 12 experts from audit Big 4 firms have been chosen and 2 managers from the oil and gas companies.

3.3.1. Methodology for the Russian Transfer Pricing tax base study

In order to gather the relevant information about the tax authorities approach to transfer pricing and what do they mean/understand by transfer pricing, there is a need to structure the further search for information. It is important that the examining in the documents issues be in line with those issues that are intended to be found out with the help of interviews and questionnaires in order to consider upon one another in the analytical chapter and describe how the laws, rules and recommendations reflected in the business practices.

For this purpose there is a need to answer the following questions:

4. What were the initial aims of tax authorities when they introduced the new rules?
5. What are the main documents regarding Transfer pricing regulation?
6. How are interdependent persons determined in the Russian legislative system?
7. What transactions are to be studied?
8. How do Russian tax authorities incorporate international practices, international guidelines (OECD recommendations and guidelines)?
9. What is written about the use of transfer pricing methods?
10. Which cases are selected?
11. What is the procedure of the information disclosure? (the procedure of the documentation of the controlled transactions)
12. What are the Advance pricing agreements in Russia?

To find answers to these questions the Russian legislative and regulatory acts, Tax Code of the Russian Federation, amendments to the Tax Code, letters and clarifications provided by the Ministry of Finance of the Russian Federation, Federal Tax Service, regarding the use of Transfer Pricing rules were thoroughly examined. The documents were accessed via online database like “Consultant” that unites all the legislative acts that were introduced and amendments to them, as well as the resources provided by the Ministry of Finance of Russian Federation as governmental acts and clarification letters that are also available online.

3.3.2. In-depth interviews

According to the intended study, the interview-guide consists of questions that were made in line with the theoretical framework and the research design. However, the pilot study was needed in order to avoid the possible misunderstandings and the inaccuracy of the stated questions.

I made a pivotal study to fix and adjust the questions and make them respondent friendly. In order to conduct it I asked a manager who used to work in oil and gas sector but quit this job several months ago. At the pivotal interview I found out that the managers can not be aware of the arm's length yielded transfer pricing methods that is why I provided an explanation to all these methods during the further interviews. Moreover, I put some examples to the questions related to the organizational structure when the managers were asked to identify the level of diversification of the company or parts of the value chain process. This helped me to eliminate the ambiguity of the interpretation.

It showed which terms are difficult to comprehend. Moreover, some obscure points were revealed which needed more sub-questions to be stated. The final version of the interview guide reflects the aims of the study, incorporate all the details, is elaborated enough and consider the deficiencies revealed at the pivotal stage.

- The final variant of the interview guide comprises 22 open questions that are divided into several groups:
- Organizational structure of the company;
- transfer pricing methods used in the company;
- how are international practices taken into account;
- decision-making regarding transfer pricing issues;
- external activities concerning Transfer pricing;
- recommendations.

The interview guide was semi-structured and in-depth in order to get more insider information about the transfer pricing system and to let the respondents share their experience and extra thoughts on the topic that can be relevant, and so it will suggest an idea for further research. The interview guide is attached in the Appendix 2.

As for respondents, two top managers dealing with transfer pricing issues from the Russian oil and gas companies have been chosen. Such a choice has been made, to get valid in-depth information.

One of the managers was found via LinkedIn and was asked to participate in the interview about Transfer pricing practices in the company he worked (expert A). He agreed to give an interview by phone due to the time shortage and the interview lasted approximately 10-15 minutes. Though the interview was not long I was able to get a deep insight into the acutest issues, in particular concerning the communication with the authorities regarding transfer pricing policy.

The manager from company B was giving us a master class. I contacted him via e-mail asking whether he would agree to participate in the interview concerning transfer pricing practices in his company. It was a face-to-face interview that lasted about 40 minutes and gave me an opportunity to get a big amount of data covering all the managerial aspects of transfer pricing in the company.

3.3.3. Questionnaires

There are 21 questions in the elaborated questionnaire. They are grouped into several categories.

Those related to the Appendix 1:

- organizational structure of the company (level of vertical integration, level of diversification, level of centralization)
- transfer pricing methods used (traditional or transactional profit methods, questions about APAs);
- how are international practices taken into account (OECD guidelines, use of international experience);
- decisions related to the transfer pricing practices (who is responsible for decisions – top management or unit management);
- motivations for the use of transfer pricing for the oil and gas companies (purposes of use of advisory assistance);
- preparation of the transfer pricing documentation (what is the advisors' attitude to the current situation in relation to TP);
- interaction between TP advisory and the company.

As it is possible to notice there is a strong correlation between the groups of questions provided in the interview guide and in the questionnaire. They reflect each other and have a lot in common. This positioning helps to get different views (external and internal) on the same problem.

Talking about the sample, there have been chosen 12 advisors from the Big 4 company from tax departments that deal with transfer pricing issues or from the relevant ones. The respondents were informed that all the stated questions are related to the oil and gas industry. However, some people may argue that 12 responses are not enough for the quantitative study but too many for the qualitative one. Despite this fact, the validity to the carried out research is brought by the advisors themselves. They work with many companies and have a lot of experience in the particular field. In contrast with the managers that have been chosen for receiving insider information who mostly work for one

company and have constrained experience, the advisors have an overview of the situation as a whole by assisting variety of organization of the examined field. Another strength of asking consultants from the Big 4 is that they are familiar with all the concepts and terminology as they tend to have better knowledge of transfer pricing in general and their answers are less biased when it comes to the transfer pricing practices observed. Thus, the answers are probably more objective than if the firms are examined directly. Still they do not have such an insight into the company's operations as its employees do. That is why the answers will compel one another.

There are different types of them that help to gather the desired information. I have made a focus not on the closed questions but on a semi-opened questions where a respondent has an ability to allocate a certain amount of percentages he/she thinks the listed variants deserve. If the right answer is not available a respondent can tick the box other and add his own variant ascribing a number of percentiles.

Such a questionnaire unlike in-depth interview requires not only less time and money resources, but also enables to receive answers from greater amount of respondents.

3.4. Limitations of the research

It is highly important to pay attention to the possible limitations of the research. For this particular research project, it is necessary to mention the limitations tied to the data collection. This project implies the analysis of the legislative documents, interviews and questionnaires. It is obvious that the obtained data will vary.

On the one hand, the information received from the one source will be compelled with the information from another one, however, for this paper some questions that can be posed to the consultants and managers can not be answered by the study and the analysis of the legislative documents. For this purpose, there is a need to address the representatives of the regulation authorities. To search for the information in the written material is not enough to face this issue.

3.5. Validity, reliability and ethical issues

For any research project validity and reliability of data are highly important. The data needs to be true and accurate. When the research implies quantifiable parameters it is easy to check the data but when it comes to the personal feelings and beliefs its far more difficult task.

As for constructionist design it's difficult to indicate its quality. Although the results that have been gathered should be valuable and be conducted through transparent methods. Therefore, its vital to explain how the data was created, interpreted, how the sample was chosen (Easterby-Smith, Thorpe, Jackson, 2013, p.54).

The authors suggest to think of that question in order to increase the validity: “*Have a sufficient number of perspectives been included*” (Easterby-Smith, Thorpe, Jackson, 2012, p.71)

In my research project in order to find out “*How the transfer pricing is defined in oil and gas sector in Russia?*” I decided to look at the problem from a triangle perspective:

- the approach of the authorities through the analysis of the legislative documents;
- the external point view to the problem with a help of questionnaires filled in by the consultants;
- the point of view of the insiders with a help of interviews with managers from oil and gas companies.

Here it is important also to talk about the number of cases selected:

For the first part – the analysis of the legislative documents concerning transfer pricing practices was carried out. The cases were selected according to the posed questions.

For the second part – 12 consultants have been chosen, 3 from each company of the Big 4. Though some people may argue that 12 respondents are not enough for a quantitative research I would say that the consultants work with different companies from the sector consequently they have enough experience that cover many situations. That is why the data received from them will be valuable.

For the third part – two managers from different oil and gas companies have been chosen – one a state one and another a private one. That part of the research project is qualitative, thus it was important gather deeper insight from the experts who were actually chosen. They provided valuable data as both of them are professionals with a great experience in the relevant sphere though at the same time presenting private and state public sector what is also important.

As for external and internal validity it is possible to apply to Cook and Campbell 1979 work. The internal validity “*refers to the approximate validity with which we infer that a relationship between two variables is causal or that the absence of a relationship implies the absence of cause*” (Cook and Campbell, 1979, p.37). In my research design it could be achieved through explanation buildings. And the external validity “*refers to the approximate validity with which we can infer that the presumed causal relationship can be generalized to and across alternate measures of the cause and effect and across different types of persons, settings, and times*” (Cook and Campbell, 1979, p.37). Concerning the external validity of my research project, it is reached by the applicability of the empirical data regarding some statistics on transfer pricing practices.

In order to verify the reliability of data it is necessary to answer the following question:

“Will similar observations be reached by other observers?” (Easterby-Smith, Thorpe, Jackson, 2012, p.71). The reliability is achieved with a help of conformity of the empirical data to research questions through the procedures that can be later repeat and lead to the same results. In this research project it is described in details how the data was gathered with a help of what tools, consequently other observers suppose to achieve the same results if they follow the presented procedure and techniques.

The ethical issues of the research project are also to be discussed. Here it is important to protect the interests of individuals/organizations involved into the research project. As transfer pricing is a lot about possible ways to minimize tax base within legal framework for companies and for governments this minimization of tax base means the decrease of budget revenues consequently companies are not willing to disclose insider information about transfer pricing policies. That is why it is highly important to be sure that the information received state confidential and persons involved remain unknown. Especially when it comes to the managers of the company it is important not to reveal even the name of the companies. All these recommendations I tried to follow in my research project and left the individuals anonymous.

4. Empirical chapter. Data analysis

4.1. Tax authorities' view

In the empirical part of this paper, I will start with the description of the legislation, rules, regulations, recommendations issued by tax authorities. It is structured in accordance with the questions posed in the methodological part of this paper:

In Russia as in many other countries it has become popular among the companies to minimize taxes by manipulating the prices of goods and services in transactions between affiliated or dependent units (controlled transactions). Among the possible ways to minimize the taxes it is possible to name: a registration of the conduit companies in jurisdictions with low or nonexistent taxes, a use of "one-day firms", concluding service and license agreements with no commercial reasonability, and generating losses for the company for tax purposes. The basis of minimization of taxes is the use of the transaction price that deviates from the price which would have been applied by independent parties who are not bound by relations of equity, common control or other relations that can influence economic performance and (or) the conditions and the results of the transactions (Clarification letter of Federal Tax Service of Russia, 2013).

The ensuring the counteractions to the use of transfer pricing in order to minimize taxes by affiliated companies is an important issue for Russia. In this regard, the main purpose of the law is the harmonization and the increase of the efficiency of tax control over the correctness of the calculation. As well as the control over the full payment of taxes in the cases of transfer pricing application, specification of the list of the affiliated parties and improvement of the foundations for the price determination in the controlled transactions.

The bill can be applied by tax authorities to the organizations and individuals carrying out controlled transactions, defined by the bill.

The main legal act that describes the transfer pricing issue in Russia is the Tax Code of the Russian Federation. The new measures of tax control for transfer pricing were put into effect in Russia on the January 1st, 2012 by the Federal Law № 227-FZ. There are also letters and clarifications provided by the Ministry of Finance of the Russian Federation and the Federal Tax Service, however, they are not considered as normative legislative acts and are not binding on taxpayers, just on tax authorities.

Section V.1 of the Russian Tax Code, Chapter 14.1 describes the procedure for determining the participating interest held by one organization in another organization or held by a physical person in an organization. Article 105.1, Chapter 14.1, Section V.1 of the Russian Tax Code defines interdependent persons in the following way:

“Where specific factors in relations between particular persons may exert an influence on the conditions and (or) results of transactions concluded by those persons and (or) the economic results of activities of those persons or activities of persons represented by them, the persons referred to in this clause shall be deemed to be interdependent for taxation purposes (hereinafter referred to as “interdependent persons”)” (Tax Code of the Russian Federation, 1998).

After the general definition there are more detailed explanations for the determination of the interdependent persons.

The transactions that should be supervised by the tax authorities are called “controlled transactions” and are being determined in the Article 105.14 of the Tax Code of the Russian Federation. The purpose of this control is that the regulation authority is in power to compare the prices established by the parties with the market prices, and if they differ from the market prices to assess additional tax liabilities on the basis of the market price. It is worth mentioning that rather small number of taxpayers have been in the list of the controlled transactions since 2012. According to Russian transfer pricing legislation among controlled transactions there are:

- Any transactions between affiliated foreign persons (both legal entities and individuals). This type of transaction is being supervised regardless of the deal value;
- External transactions of goods of international exchange trade;
- Transactions in the area of foreign trade in goods traded in global exchange trading;
- Transactions with the “offshore states”;
- Transactions between Russian interdependent tax payers are determined to be controlled only when the deal value exceeds the established monetary limit (art.105.14 Tax Code of Russian Federation).

This limit still remains rather high though it has been reduced. In 2012 – three billion rubles, in 2013 – two billion rubles and since 2013 – one billion rubles. The detailed clarification is provided by the Federal Tax Service on the information about the controlled transactions (FTS, 2016).

Lower limits are established for certain special cases:

- Minerals extraction transactions, if one of the parties is a taxpayer of the tax on mineral extraction calculated at the rate specified in percentage (if the amount of income from transactions between these bodies exceeds 60 million rubles during the same calendar year);

- Transactions when taxpayers applying the taxation system for agricultural producers (unified agricultural tax) or tax system as a single tax on imputed income for certain types of activity (if the relevant transaction is carried out within the framework of such activities) (if the amount of income from transactions between these parties for the calendar year exceeds 100 million rubles);
- Transactions when an organization is exempt from the taxpayer's income tax obligations of organizations or applies to the tax base for this tax a tax rate of 0 per cent in accordance with paragraph 5.1 of Article 284 of the Tax Code (if the amount of income from transactions between these parties for the calendar year exceeds 60 million rubles). This category includes transactions with taxpayers applying the simplified tax system (STS);
- Transactions regarding a resident of the special economic zone where the tax regime, which provides special benefits for corporate profits (compared to the general tax regime in the corresponding subject of the Russian Federation) (if the amount of income from transactions between these entities exceeds 60 million rubles during the same calendar year).

It should be noted that in the case of the transaction where there is no chargeable consideration, the Tax Code establishes the requirement to determine the tax base from the market prices, with reference to Article 105.3. This means that the tax authorities are to check the accuracy of determination of the tax base for transaction where there is no chargeable consideration according to the rules established for the controlled transactions.

Russian tax authorities try to use successful international practices. It is important to mention that the OECD guidelines are not considered to be normative legislative acts in Russia and are not binding on tax payers nor on tax authorities. However, some of the statutes of OECD guidelines are implemented in Russian transfer pricing legislation.

The Russian Federation being an observer of OECD and a candidate to join the organization, by adding to the existent tax regulation has legally confirmed the use of the transfer pricing methods proposed by the OECD in the transfer pricing regulation process. However, there is no official division of these methods into traditional transaction methods and transaction profit methods.

Federal Tax Service of the Russian Federation tries to incorporate the OECD guidelines. For example, the selection of cases that can be examined is in accordance with the UN Practical Transfer Pricing Manual for Developing Countries. The UN Practical Transfer Pricing Manual for Developing Countries Article 4.4.3.4., chapter 4, October 2012 outlines the factors that tax authorities of different countries use while choosing the company for the tax control regarding the question of transfer

pricing. In Russia, there is a practice of the risk analysis when the tax authorities choose the outstanding cases for the study. Among these cases there are those when an organization:

- *“Reported losses for a number of years or more, especially if the losses begin about the time when a “tax holiday” runs out;*
- *A high value of related party transactions compared to the taxpayer’s turnover and operating profit;*
- *Significant transactions with major counterparts from low or no-tax jurisdictions, non-treaty partners and countries which don’t participate in the agreements on the exchange of information between tax authorities;*
- *an economically unrealistic profit trend compared to the industry trend, with no obvious explanation;*
- *inconsistencies between inter-company contracts, transfer pricing policies and detailed transactional documents such as invoices and customs documents; or*
- *significant royalty payments to related parties, especially if the intellectual property is not legally registered or appears to be in some part locally generated”.*

However, it is important to mention that OECD guidelines can be used by tax authorities while selecting the cases but they are not legally confirmed by the Russian Tax Code. Russia is not a member of OECD and is not bound to follow the OECD guidelines. Still tax authorities are trying to incorporate successful international experience into the Russian legislation.

Taxpayer shall be obliged to notify tax authorities of controlled transactions which they concluded in a calendar year not later than May 20 of the year following the calendar year in which controlled transactions were concluded. Also the taxpayer at the request of the tax authority is required to provide documentation regarding the concrete homogeneous transaction (group of similar transactions) in the manner prescribed by paragraph 1, Article 105.15 of the Tax Code.

According to the legislative acts, the 1st of June of the year following the calendar year in which the controlled transaction occurred - the date on which the tax authorities have the right to request documentation regarding a specific transaction or a group of similar transactions (paragraph 3, Article 105.15 of the Tax Code).

Federal Tax Service recommends stages of preparation of documentation regarding controlled transactions (FTS, 2016). They are provided in the Table 4.1.

Stage	Title	Procedure
1	Identification and analysis of controlled transactions	The identification of controlled transactions in accordance with the terms of recognition of transactions controlled from the provisions of Art. 105.14 of the Tax Code.
2	Planning and definition of the intended volume of documentation and the time for its preparation	Assess the amount of future income tax liabilities, costs of organizing documentation and advantages in preparing the proper documentation.
3	Description of the main characteristics of the scope (type of) those activities committed controlled transaction	The features of the goods (works, services) that are subject to a controlled transaction (group of similar transactions) are identified and their classification with a view to assessing the possibility of a potential comparison with homogeneous (identical) goods (works, services) is carried out.
4	Comparability of the commercial and (or) the financial terms of transactions and functional analysis	Analysis of the rights and obligations of the parties to the controlled transaction (regulated by Article 105.5 Tax Code of the Russian Federation)
5	Description of the parties involved in the transaction, and the selection of the test side of a controlled transaction	Based on the functional analysis of the decision on the choice of the tested party transactions analyzed for economic analysis.
6	The choice of pricing method	The selection of method (combination of methods) for determining for the purposes of taxation of income (profits, revenue) in the transactions the parties of which are interdependent persons, in accordance with paragraph 1, Article 105.7 of the Tax Code is carried out.

7	Economic analysis	Searching for comparable transactions and comparable companies (depending on the chosen method) and calculation of market price interval (interval of profitability). Based on the results of the study determined matching price (profitability) in the analyzed interval transaction market price or profitability.
8	Documenting	The decision of the organization starts the process of preparation of documentation. The decision on the preparation of the documentation on the project basis depends on the volume and complexity of the committed controlled transactions.
9	Implementation and monitoring	In order to ensure the stability of the application of the selected methodology for the controlled transaction and the relevance of the information provided, the documentation should be reviewed on an annual basis, which also implied the initiation of a special process.

Table 4.1. Stages of the preparation of documentation in the Russian Federation

The procedure of tax control in connection with the conclusion of transactions between interdependent persons by tax authorities is regulated by Art. 105.17 of the Tax Code.

As it has already been mentioned above, in Russia an Advance pricing agreement is an agreement between a great tax payer and tax authorities that helps to agree upon the way the transfer price is determined. As well as the transfer pricing method used for tax assessment purposes in cases with particular controlled transactions, comprising the cases before the transactions are carried out. It helps to minimize the number of possible disputable points regarding the price determination for tax assessment purposes. (Article 83, the Tax Code of the Russian Federation, 1998).

There is a list of documents that a taxpayer has to submit in order to have his request for the conclusion of the advance pricing agreements be examined. However, before the submission, a taxpayer can request a prefilling conference with tax authorities (PFC). The PFC helps to analyze the suitability of the request, to decrease the time period of the consideration of the request, to clarify the content of the documents needed. During this conference, a taxpayer in the oral or in the form of presentation can explain:

- 1) the nature and the factual circumstances of the controlled transaction that can become a subject of the agreement;
- 2) the description of the business activities of the parties of the controlled transaction, the tax residents of which states they are, whether the parties are affiliated persons, the nature of the affiliation;
- 3) the assumed methodology for price determination for the tax assessment purposes, sources of information and other data that is considered to be provided by the taxpayer (Recommendations of Federal Tax Service of the Russian Federation, 2012).

Advance pricing agreement can be concluded for one or several transactions that have the same subject for the time that does not exceed three-year period. Though this period can be prolonged with a request (Article 105.21 the Tax Code of the Russian Federation). It is possible to observe, that Russian Transfer pricing rules have a lot in common with the international standards recognized by OECD. However, the illustration of the APAs process provided by Federal Tax Service of the Russian Federation shows that Russian transfer pricing system has its own features that have to be taken into account during the analysis.

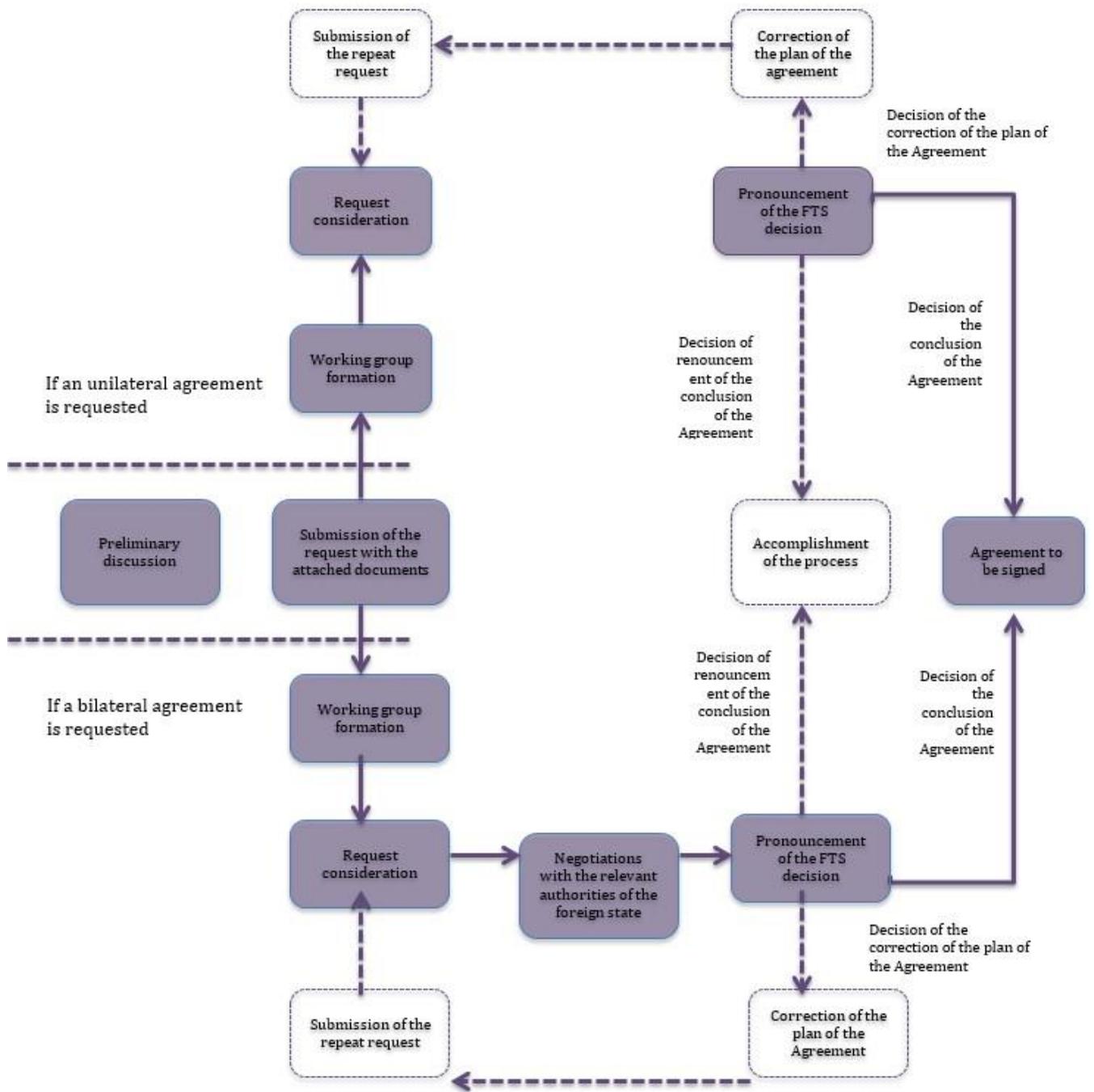


Figure 4.1. The process of consideration of the projects on Advance pricing agreements. (Federal Tax Service of Russia), 2016.

4.2. Consultants' view

As a result of the sending out of questionnaires, 12 answers have been received. Among the respondents there were representatives of the Big 4 that have a sophisticated experience in tax issues, particularly, in transfer pricing. The received answers are supposed to provide external view on the transfer pricing issues in oil and gas sector in Russia. The respondents were informed that all the questioned is related to the Russian oil and gas industry and is to be answered in accordance. The detailed answers are provided in Appendix 3.

The first group of question was about the organizational structure of the company (level of vertical integration, level of diversification, level of centralization).

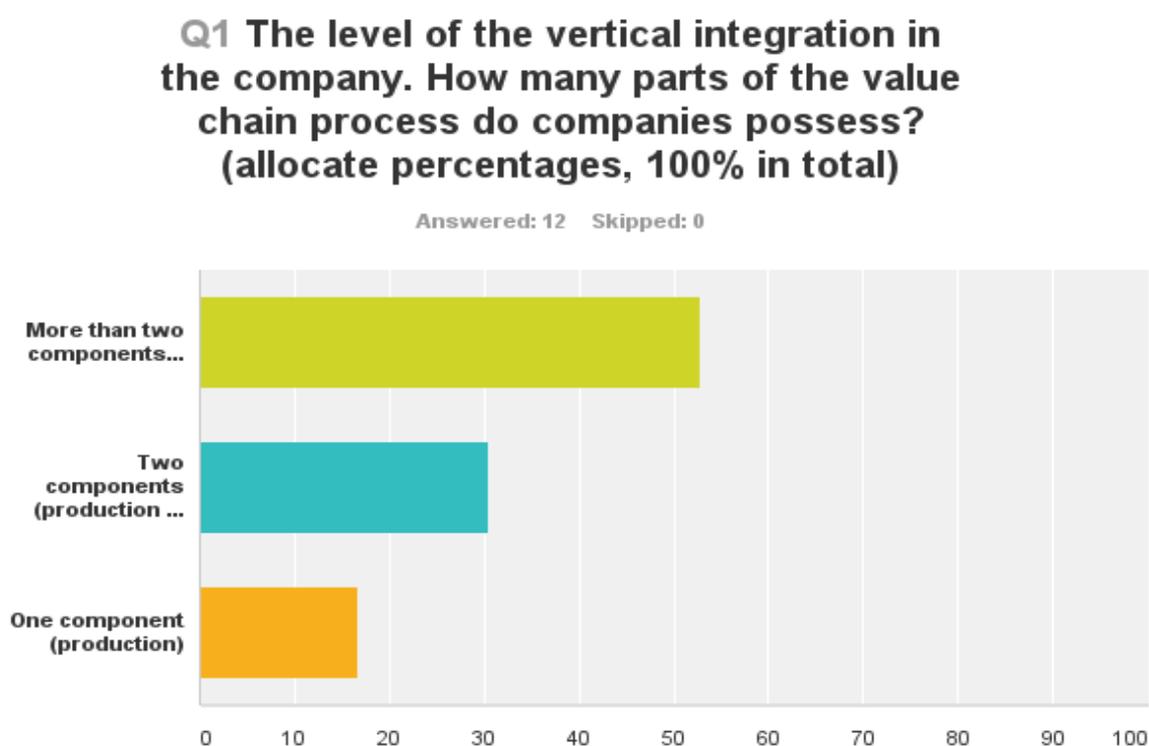


Figure 4.2. The level of the vertical integration in the company.

This chart illustrates how many parts of the value chain process is typical for Russian oil and gas companies. As we can see most corporations possess more than two components (53,8% as average) in other words they can have production, distribution, resale and so on. From the well-head up to the customer (Rosneft, Gazpromneft).

However, the question about the level of diversification showed that most of the companies are present in two industries (43% average allocated to this item) that means that they are highly specified and try to concentrate their business and resources in one sector. On the one hand such a

concentration enables the faster development of the one particular sector, on the other hand such state of affairs can lead to the downturn of the other sectors of Russian economy and to the Dutch disease, where the mis-management of the profits received from the oil industry leads to the under investments in other sectors of economy.

Talking about the level of the centralization of the Russian oil and gas companies, most of the consultants allocated the biggest amount of percentages to the “Operational decisions are made by central management” – 53,8%, “Operational decisions are made both by central and unit management” – 29%, “Operational decisions are made by unit management” – 18%. This means that either they are not aware of the day to day operations made by the unit managements or they consider the Russian oil and gas sector to be highly centralized with the decisions imposed by the top management. If we have a closer look at the allocation of the percentages by each respondent, it is possible to see that half of the respondents allocated 70% and more to the “operational decisions are made by central management”.

The second group of question deals with the transfer pricing methods used by the companies. According to the results, among the yielded from the arm’s length principle, companies use all the listed methods, but the leader is the cost-plus method and comparable uncontrolled price method and transactional net margin method share the second position (31,7% and 28,3% consequently).

About the Arm’s length principle, 75% of the respondents answered that it is often used in relation to transfer pricing, 25% that sometimes and none of the consultants stated that it is seldom used.

In the question about the concluded Advance pricing agreements the opinions of the respondents vary. At average, the equal amount of percentages is allocated to “two-four” and “more than four” oil and gas companies have this type of agreements.

The next section is about the international practices and how they are taken into account.

Q7 Do companies use Transfer Pricing methods in compliance with the OECD standards?

Answered: 12 Skipped: 0

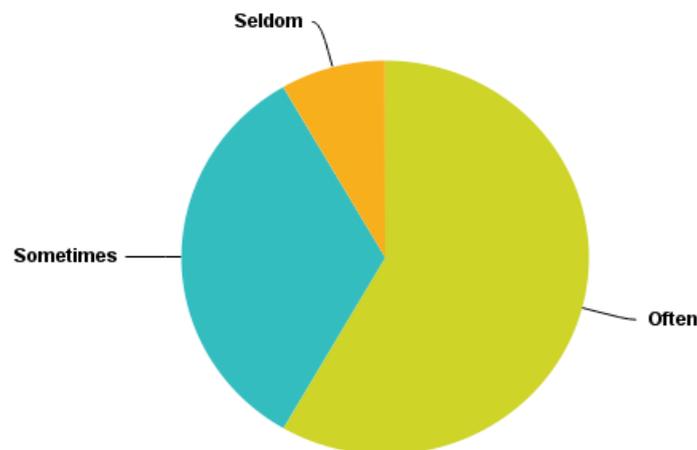


Figure 4.3. The frequency of the use of Transfer pricing methods in compliance with the OECD standards by companies.

Even though companies use the methods in accordance with the OECD recommendations, at first they are bound to the Russian tax legislation what can be proved by the consultants' answers 91,7% of whom pointed Russian legislative system on the first place and only 8,3% noted that oil and gas companies try to keep to the both systems.

If we get deeper into the international practices that oil and gas companies can use as examples while elaborating their transfer pricing system, the respondents named such countries as US, Europe, OECD countries, where US encounters 5 times out of 12, Europe 7 times out of 12 and UK separately 6 times.

Continuing the topic of the OECD guidelines the consultants were asked to say whether they know any OECD guidelines that are still negligible in Russia, but should be introduced in order to improve the transfer price settlement. Some of the respondents pointed out that some "*principals of application of transfer pricing (TP) rules for loan agreements, adjustments*" or "*loan agreements*" can contribute the development of the system, part of the consultants wonder what OECD guidelines can improve the system and others say that any as long as they "*comply with the Russian TP legislation*" or "*Various provisions of OECD TP Guidelines can be introduced by Russian companies, though they would not be able to appeal to them in disputes with tax authorities, since OECD TP Guidelines are not implemented in Russian TP legislation*". So, the problem is that many guidelines can be introduced, but they are to be implemented into the Russian Transfer pricing legislation.

During the analysis of the decisions related to the transfer pricing practices it has been studied that, according to the audit employees the central management that is up to 73,8% is responsible for the choice of the Transfer pricing policy and only 16,7% of the responsibility belongs to the central and unit management. Similar situation is with the settlement of the transfer price 71,7% and 15,4% consequently. However, in the question of transfer price the respondents gave a little bit more powers to the unit management 12,1% and 8,8 % consequently.

It is also necessary to study the motivations for the use of transfer pricing for the oil and gas companies and the purposes of use of advisory assistance.

In accordance with the obtained results the main role of TP advisory concerning transfer pricing issues is to ensure the compliance with tax legislation and minimize tax burden. Where “to ensure the compliance with tax legislation” has been chosen 8 times as of utmost importance and minimize tax burden has been chosen 5 times. And as the least important “to maintain the market position has been chosen” as not important 3 times and “to increase the competitiveness of the company” two times.

It is possible to see the illustration to this question in the figure 4.4 that demonstrated in the chart “What is the main role of the TP advisory concerning transfer pricing?”.

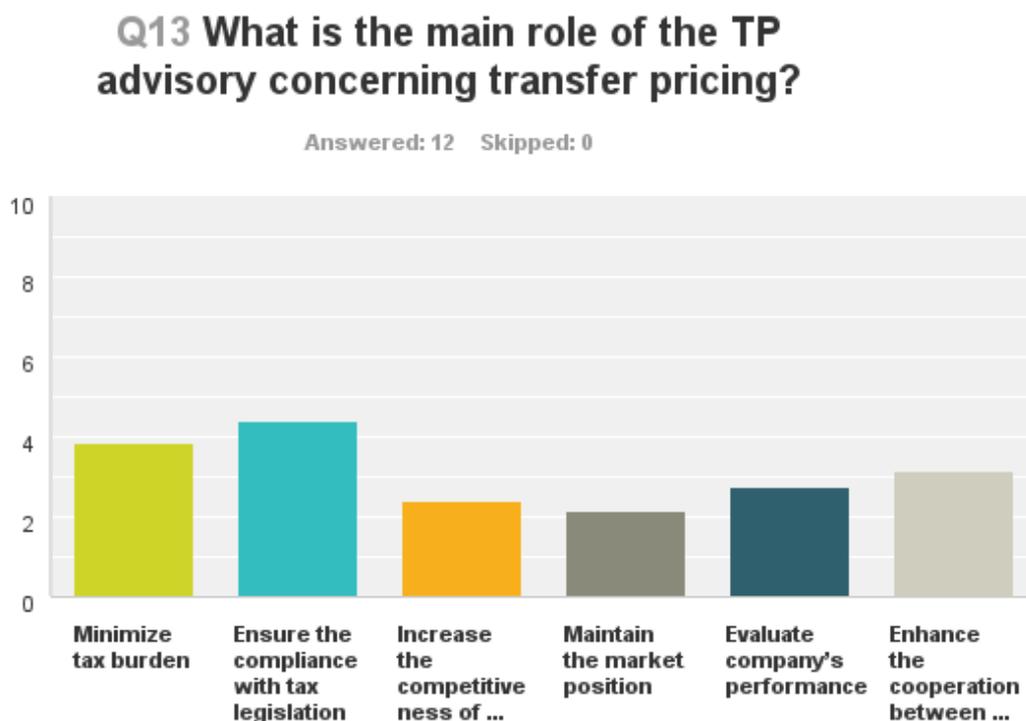


Figure 4.4. The main role of the TP advisory concerning transfer pricing

The answers for the previous questions are supported by the data received from the next question about the company’s (client) main goal in relation to the transfer pricing practices. Respondents have

allocated at average 56,7% to the 'compliance and tax optimization», 20,9% to the «Optimize resource allocation and performance management between the units» and 22,4% to the both position simultaneously.

The next group of questions asked the consultants to estimate the procedure of the documentation. 58,3% of the consultants ascribed the procedure as the medium level of the complexity which requires less experience, but a lot of documentation and 41,7% respondents ascribed high level of complexity, which stands for highly-qualified personnel and a lot of documentation, none of the audit employees consider the procedure to be easy. When the consultants were asked about the development of this process, practically everyone (10 out of 12) stated the integration of the automation and the decrease of the amount of documents as well as *“Simplification of documentation needed to be disclosed”*.

Among the benefits of preparation of transfer pricing study for a company, except being an obligatory procedure *“less problems with tax authorities”*, *“no benefits, it's obligatory”*. The respondents also pointed out that: *“absolutely required with annual update - In order to complete documentation and check compliance with market intervals”*, *“tax legislation compliance, tax burden optimization, effective allocation of resources between companies of the group”*, *“to confuse the tax authorities”*. They also suggested to use it in business *“it can be renewed and it is a substantial study”*, *“an opportunity to optimize business structure and reallocate profit and losses between companies of the group, helps to analyze the company's performance”*.

91,67% of the respondents think that advisor/tax practitioner with a specific designation should prepare a transfer study.

Last group of the question was about the interaction between transfer pricing (TP) advisory and the company. 58,3% of advisors think that clients often ask them for advice concerning transfer pricing issues, 25% that sometimes and 16,7% that seldom. In the question whether the TP advisory assistance influences the organizational structure of the company- 66,7% respondents choose “no” and 33,3% “yes”. Those who choose “yes” were asked how in their opinion the structure is being influenced and among the obtained results there were: *“TP method can influence the organization structure. Consequently, if advisors choose it, they influence the structure”*, *“In order to fit changing TP legislation and at the same time to save existing tax benefits”*, TP advisor can recommend to *“restructure business”*, *“TP is one of the basements of group structuring”*, *“shows possibilities of restructuring the business processes for optimal allocation of resources between units”*.

4.3. Managers' view

Two interviews with top managers of the companies were conducted. Both of these companies are vertically-integrated oil and gas companies. They are on the list of the 10 Russian biggest companies of this sector. The questions to the managers are presented in the interview guide (Appendix 2). The received answers are supposed to provide insider information on the transfer pricing issues in oil and gas sector taking as an example the current situation with transfer pricing system in the selected oil and gas companies.

Organizational structure of the company

The first group of questions was aimed at the organizational structure of the companies. According to the received answers, both of the companies *possess all the parts of the value chain process*:

“yes, we have all the parts of the value chain process from production to retail” (expert A), *“it’s a vertically integrated company, so it has up-stream, down-stream and we are not talking about what sometimes is called mid-stream, which is the supply trading and logistics function, what some other companies call the integrated supply and trading. By virtue of being vertically integrated company we might say that from the well - head to the pump. If I were to list them that would be probably exploration and production, then transportation which is the pipes basically, logistics to the refinery, refining and then re-tail, so these are the traditional”* (an expert B).

However, the companies are not diversified:

“we are not presented in different industries, we extract gas and gas condensate, so it’s diversified only in two ways. However, from the well-head there is only one stream, it is impossible to produce gas without gas condensate” (expert A),

“well, it’s not diversified, it’s mainly presented in one industry and is concentrated on the retail – we sell the oil products” (an expert B).

Operational decisions are taken by the unit management according to one respondent, however the second one pointed out that it depends on the type of the decision that is to be taken:

“it depends on the sort of operational decision. Typically, this will vary from one company to another. So in some companies decisions are very strictly centralized like Rosneft as you probably know very well is famous for delegating very little authority downstairs and having most of the decisions concentrated upstairs, specifically in the hands of the CEO. The company where I work N, there is more delegation of authorities that flows downwards, but you typically have different limits

depending on the scale of the question that needs to be addressed, so if it's a question of everyday operation, typically, the highest it will rise is the head of local subsidiary» (expert B).

Limits become more and more important when it comes to the capital budgeting

«if we look now at the capital budgeting then there is a very clear delegation of authority up to certain limit above which the questions or the initiatives are absolutely have to go to the headquarters and then, perhaps, as high as to the boards of directors».

When the respondent was asked to define more precisely the limits after which the decision is to be taken by the top management, not the management of the unit, he said that

«In N it would be up to 100 million rubles they were thinking of revising it to 500 million rubles, for the lowest level company», «This is standards, for example, in TNK-BP, the projects that would exceed 100 million \$ would go to the boards of directors and they have to be approved by both groups». Also, an investment committee plays not the last role in the decision taking, though this body is not responsible for the decisions itself” (expert B).

And in both companies *the salary of the unit management depends on the unit's profit.*

Transfer pricing methods used in the company

When the managers were asked the questions about the transfer pricing, I found some misunderstanding as one of the managers inadvertently immediately ascribed some negative aspect to the transfer price, meaning that it definitely implies the minimization of the tax base and saying that

“It is too easy to check anything in our business, it is not complicated to check everything in oil and gas sector. Especially when you sell something through the custom. Anything can be seen there” (expert A).

However, expert from company B said that

“if I am refining and produce a certain petrol refines products and these products ultimately are to end up in my retail subsidiary as they have to pass from one segment to another, as you said in the very beginning – the value chain process, from one section to another and this transaction has to happen at a certain price level».

The next question concerning transfer pricing was about the methods used in the companies. Among the applied methods they mention

«the netback price- it is the export price without transportation expenses» (expert A)

and

«they are very different and it very much depends on the managerial agreement to keep the margin in one place or another» (expert B).

An expert B also stated that there is a difference between managerial and financial accounting *«even though you have a formal transfer pricing happening in line with the legislation and legislative and stipulative standards you also have managerial accounting. Management may actually want to see which type of the business gives them more value different from the financial accounting shows them that».*

Sometimes from the point of view of managerial accounting:

«It is more objective to impute to demonstrate more ownership from you than from my ownership even though when I sell it to you at the market to you my margin can be very high formally» (expert B).

The manager was asked to specify this issue to the oil and gas industry, why is it happening there:

«the reason why this is done is, for example, the certain profitability that I need to keep in the refining to make sure refining projects remunerate for themselves, payback for themselves, but I also want to show the bulk of the value created lower down the value chain. This is where I start to play with or manipulate my transfer price I would imagine that the same thing happens with upstream», «in company where I work they use one transfer price for retail and another transfer price for small wholesale» (expert B).

So, according to the experts, the choice of the method depends on

«how management wants to reallocate profits for the packs of accountings inside the company» (expert B).

For the particular downstream department of the company N the transfer pricing method used was *refinery gate price*.

The experts have never heard about the use methods yielded from the arm's length principle, though

“it would be something closer to the cost-plus price” (expert B).

He explained this choice as follows:

“You have a particular product and a price for this product got example in the North European market, you bring this price and deduct from this exportation expenses and so on and then you end up with the price at refinery gate and then you add up once again all the transportation costs and this is the price that you finally get. You don't have a database that would tell you that tis actually the

price, so it's always depends. They all are intended just to create a system that is robust and it can be explained to the regulative” (expert B).

Talking about the *Advance pricing agreements the company A has it but B does not*. That means that even not all the big oil and gas companies have concluded that type of agreements.

Decision-making regarding transfer pricing issues

In both cases, this is *central management that is responsible for the settlement* of transfer price “central management almost without exception” and “top management”. Though the manager A thinks that the management of the units are not inclined to hide any kind of information from the top management, however,

the manager from the company B said that

“yes, that happed in TNK-BP, yes that happens sometimes, it does happen sometimes where the transfer price depends on the lobbying power of any particular group of managers».

External activities concerning Transfer pricing

Both experts stated that it is not difficult to communicate with the regulation authorities. A manager from company A:

“usually such big companies have their own regulation body that controls its operations” Though the manager from the company A said that the procedure of the documentation itself is really complicated.

“No, I don't think so. In big companies a lot of people work on it. Big companies are typically audited by other big companies so before it is being made public, all the books are cleaned and all the books are made available. There were not big deals, people usually hear about them, those that I heard of were the big fines imposed for price read and it was back in TNK-BP. So quite a few oil majors were subject to that case, but transfer pricing – no” (expert B).

About the use audit assistance:

«as any public company uses it» (expert A).

«The audit companies will help to make sure that your accounting reports are presented in the proper manner, they will do that and they will make sure that the profits are shown where they actually belong» (expert B).

The experts were also asked about whether the audit companies are involved into the transfer pricing system within the company.

“So, for example, financial director of downstream decides how we define the transfer price for retail and for small wholesale for the purpose of the next stage period, so of course, no external involvement at this stage. As its basically at the later stage when they come in and help with reporting its perfunctory affair nothing that is concerned to be with TP in particular” (an expert B).

Recommendations

The managers were asked to give their advice on how the transfer pricing system can be developed within the company and if there are any drawbacks.

“Guidelines and people try to work around these guideline, that they show the value they create to the business the best way possible. For example, the small wholesale system was organized in such a way that if you calculate the transfer price in one way it will be strongly negative and if you twiddled your assumptions and looked at the complicated triangulation of the transfer price and add some export channels and weighed them differently you end up with board line but still profitable business, that to me seems bad because this is basically where you open Pandora box, as you basically say it is almost economic relativism, it depends on how we looked at it, what is actually very bad for a company, as the company should have a robust and well-grounded financial decisions. You need to be able to falsify it and with this kind of approach you can not do it. You either make it more profitable or less profitable business just on your assumptions which I think is a very powerful analytical drawback” (expert B).

The experts also were asked to tell how the procedure of the information disclosure can be improved.

“all this principle of the control over the transfer pricing should be annihilated as any regulation body should supervise not one unit of the company but all the group of companies as a whole, not to look at how the transactions are made within the group of companies, but how they are made out of the group. Stop finding the drawbacks where they are not any. As in all developed countries the transactions within the units are not monitored. In general, a group of companies is being audited not every unit separately. The International Financial Reporting Standards were designed for these purposes. We have to follow International Financial Reporting Standards, but legislative base is not in compliance with them. The transactions between the interdependent persons, their definitions do not match the civil legislation that tackles the issues of affiliation. That is why sometimes we have disputes with tax authorities” (expert A).

The expert from company B gave very interesting attitude to *the way the transfer pricing system can be developed* within the company and who should be responsible for decision making. He said that besides the top management there should also be an external stakeholder:

«The projects, the decisions upon this projects need to be made with an objective basis and state may not always be that objective. There needs to be an objective expert, the government can also have some interests and won't be objective, that's why it should be somebody else».

5. Analytical chapter

To begin with, it is necessary to say that results presented in the empirical chapter now will be studied and analyzed that found a reflection in more than one sources of the information: documents, questionnaires and interviews. That organization of the examination will point out if there are different views about how transfer pricing is defined in Russian oil and gas companies.

Aims of the new rules and the reflection of companies

According to the studied documents, the *initial aims of the new rules* were the harmonization and the increase of the efficiency of tax control over the correctness of the calculation. As well as the control over the full payment of taxes in the cases of transfer pricing application, specification of the list of the affiliated parties and improvement of the foundations for the price determination in the controlled transactions. According to the consultants the companies started to use the TP advisory in order “*to ensure the compliance with tax legislation*”.

However, as it has been mentioned in the overview of the current situation regarding transfer pricing in Russia, PWC found that companies found it difficult to keep up with all the new rules. Application of the new transfer pricing rules is associated with certain difficulties:

- lack of clarity in the interpretation of some acts;
- the complexness of the completing the tax notice;
- vagueness of the approaches to the control of market intragroup financial transactions and transactions with intangible assets.

Taking into account the responses of taxpayers, the government tried to ease the burden on taxpayers with a help of:

- postponement of the deadline for the submission of the documentation on the controlled transactions of the year 2012 to November 20th, 2013 (instead of May 20th submission, as set by the Tax Code for the remaining periods);
- postponement of the deadline for the submission of transfer pricing documentation for the year 2012 to December 1st, 2013 (instead of June 1st, 2013 (as determined by the general rule for all other periods);
- exemption from the control of certain financial transactions, the terms of which were agreed upon by the parties prior to the entry into force of the new provisions of the Code and that stood unchanged during 2012;

- provision of clarifications, regarding the possibility of grouping certain types of transactions
- the development of the number of additional initiatives proposed by the business community (for example, cost allocation bill) (PWC, 2016).

Organizational structure of the companies

Talking about the organizational structure of the companies, most of them possess more than two components of the value chain process according to consultants (53,8% as average) and that they have all the parts “*from the well-head up to the customer like Rosneft or Gazpromneft*” according to the experts. Both advisors and managers think that the companies are not diversified, but “*highly specified and try to concentrate their business and resources in one sector*”, “*we are not presented in different industries, we extract gas and gas condensate, so its diversified only in two ways*” or “*present in two industries (43% average allocated to this item)*” (advisors).

However, 53,8% of consultants think that most of the operational decisions in oil and gas sector are made by the central management, though according to the insider information, that is the unit management who is responsible for operational decisions or there are certain limits (usually monetary) up to which the unit management is responsible, still the every-day decisions are in the hands of the head of the local subsidiary.

“*you typically have different limits depending on the scale of the question that needs to be addressed, so if it’s a question of everyday operation, typically, the highest it will rise is the head of local subsidiary*» (expert B).

Limits become more and more important when it comes to the capital budgeting:

«*if we look now at the capital budgeting then there is a very clear delegation of authority up to certain limit above which the questions or the initiatives are absolutely have to go to the headquarters and then, perhaps, as high as to the boards of directors*».

When the respondent was asked to define more precisely the limits after which the decision is to be taken by the top management, not the management of the unit, he said that

«*In N it would be up to 100 million rubles they were thinking of revising it to 500 million rubles, for the lowest level company*», «*This is standards, for example, in TNK-BP, the projects that would exceed 100 million \$ would go to the boards of directors and they have to be approved by both groups*». Also, an investment committee plays not the last role in the decision taking, though this body is not responsible for the decisions itself”.

Transfer pricing methods used

The study of the legislative documents showed that Tax regulation has legally confirmed the use of the transfer pricing methods proposed by the OECD in the transfer pricing regulation process. However, there is no division of these methods into traditional transaction methods and transaction profit methods. Among the most often used methods yielded from the OECD guidelines, consultants named uncontrolled price method and transactional net margin method share the second position (31,7% and 28,3% consequently). However, the managers from the companies are not aware of that types of methods, they called «*the netback price- it is the export price without transportation expenses*».

«*they are very different and it very much depends on the managerial agreement to keep the margin in one place or another*» (expert B).

An expert B also stated that there is a difference between managerial and financial accounting «*even though you have a formal transfer pricing happening in line with the legislation and legislative and stipulative standards you also have managerial accounting. Management may actually want to see which type of the business gives them more value different from the financial accounting shows them that*».

Sometimes from the point of view of managerial accounting:

«*It is more objective to impute to demonstrate more ownership from you than from my ownership even though when I sell it to you at the market to you my margin can be very high formally*» (expert B).

The manager was asked to specify this issue to the oil and gas industry, why is it happening there:

«*the certain profitability that I need to keep in the refining to make sure refining projects remunerate for themselves, payback for themselves, but I also want to show the bulk of the value created lower down the value chain. This is where I start to play with or manipulate my transfer price I would imagine that the same thing happens with upstream*» (expert B).

That is why the choice of the method depends on «*how management wants to reallocate profits for the packs of accountings inside the company*».

Still, after being given an overview of the OECD methods, one of the experts has chosen a cost-plus method. So, among the adjusted external-market price, cost-based price and negotiated price, the one to be applied in Russian oil and gas companies is the cost-based price.

Decision-making regarding transfer pricing issues

The answers of the experts and consultants to this group of questions were pretty much the same. 73,8% of advisors think that it is central management who is responsible for decision making regarding transfer pricing issues and the experts answered “central management almost without exception” and “top management”. Though the experts have different positions on the process of hiding of information from the central management. The manager A thinks that the management of the units are not inclined to hide it, however, the manager B faced that kind of problems in TNK-BP:

“yes, that happed in TNK-BP, yes that happens sometimes, it does happen sometimes where the transfer price depends on the lobbying power of any particular group of managers».

How are international practices, international guidelines incorporated (OECD recommendations and guidelines)?

According to the empirical results, the documents the OECD guidelines are not considered to be normative legislative acts in Russia and are not binding on tax payers. Regulation authorities use these guidelines while choosing the cases and carrying out the analysis of the transactions between the interdependent persons.

For example, some of the statutes of OECD guidelines are implemented in Russian transfer pricing legislation. Federal Tax Service of the Russian Federation tries to incorporate the OECD guidelines. For example, the selection of cases that can be examined is in accordance with the UN Practical Transfer Pricing Manual for Developing Countries. The UN Practical Transfer Pricing Manual for Developing Countries article 4.4.3.4. chapter 4, October 2012 outlines the factors that tax authorities of different countries use while choosing the company for the tax control regarding the question of transfer pricing. In Russia, there is a practice of the risk analysis when the tax authorities choose the outstanding cases for the study.

The Russian Federation being an observer of OECD and a candidate to join the organization, has legally confirmed the use of the transfer pricing methods proposed by the OECD. However, there is no official division of these methods into traditional transaction methods and transaction profit methods.

58,3% of the respondents to the questionnaires stated that the methods yielded from the arm’s length principle are practiced quite often, however, as it has been mentioned in the previous section, the companies’ managers are not aware of them. These are advisors who make the audit of the companies’ books are aware of them. Even though they know them, they are bound to the Russian tax legislation what can be proved by the consultants’ answers 91,7 % of whom pointed Russian

legislative system on the first place and only 8,3% noted that oil and gas companies try to keep to the both systems. However, consultants named several countries, examples of which are taken into account while establishing the successful transfer pricing strategy: US, Europe, UK in particular.

The procedure of the information disclosure

As according to the item 1, Article 105.15 of the Tax Code a taxpayer is required to provide the documentation regarding controlled transactions in a certain form, Federal Tax Service recommends stages of preparation of documentation regarding controlled transactions. There are 9 of them.

On the one hand, 58,3% of the consultants ascribed the medium level of the complexity to this procedure which requires less experience, but a lot of documentation and 41,7% respondents ascribed high level of complexity what stands for highly-qualified personnel and a lot of documentation. They think that the documentation process needs simplification and the decrease in the amounts of the required documents.

On the other hand, they do not find this procedure difficult, they say that there are special departments which work on the preparation of this documentation or that they are being audited. *«Big companies are typically audited by other big companies so before it is being made public, all the books are cleaned and all the books are made available»*. Moreover, sometimes regulation authorities form special bodies that supervise the activities of a particular company, and it is easier to solve the problems with the special body.

What are the Advance pricing agreements in Russia?

Once again, advance pricing agreement is an agreement between a great tax payer and tax authorities that helps to agree upon the way the transfer price is determined and the transfer pricing method used for tax assessment purposes in cases with particular controlled transactions, comprising the cases before the transactions are carried out, to minimize the number of possible disputable points regarding the price determination for tax assessment purposes.

The advisors think that “two-four” or “more than four” companies have advance pricing agreements, however, according to the statistics presented by PWC (2016) there are 15 companies in all the sectors of economy that have that type of agreements in Russia. Thus, an expert A said that their company has it, though the other one doesn't.

External activities concerning Transfer pricing

All the big companies are supposed to be audited. They do it in order to make all their book in compliance with the standards, «clean» and available to the public. Though consultants think that they are asked not just to accomplish that task, but also their advice regarding transfer pricing system

in the companies. The advisors keep in mind that they can influence the organizational structure of the companies through the transfer pricing practices, however, the experts pointed out that the auditors are involved to the process only at the later stages when all the main issues regarding the central questions are sorted out.

«as any public company uses it» (expert A).

«The audit companies will help to make sure that your accounting reports are presented in the proper manner, they will do that and they will make sure that the profits are shown where they actually belong» (expert B).

The experts were also asked about whether the audit companies are involved into the transfer pricing system within the company.

“So, for example, financial director of downstream decides how we define the transfer price for retail and for small wholesale for the purpose of the next stage period, so of course, no external involvement at this stage. As its basically at the later stage when they come in and help with reporting its perfunctory affair nothing that is concerned to be with TP in particular”.

Recommendations

In relation to the new rules, the consultants are not satisfied with the procedure of the information disclosure. Practically everyone (10 out of 12) stated the integration of the automation.

There were some radical suggestions concerning the work of tax authorities. The expert A found the system inefficient and said that the companies are bound to follow International Financial Reporting Standards though the legislative base is not in compliance with them. Moreover, the definition of the transactions between the interdependent persons does not match the civil legislation that provokes disputes with the authorities. Moreover, he thinks that tax authorities are to supervise not only one unit of the company but all the units as an integrative body, not to monitor the transactions within this body, but outside.

The expert B stated that while choosing the transfer pricing system there is a need for robust and well-grounded financial decisions. The decisions that are being made are to be falsified. However, there is not such a system for transfer pricing, there is no a universal database that shows the market price for the controlled transactions. What is more, of course, there are not any guidelines that show how to reallocate profits between the units to make the company more efficient and minimize the tax base within a legal framework.

“You either make one unit more profitable or less profitable business just on your assumption what can be regarded as a very strong analytical drawback” (expert B).

Moreover, one of the experts pointed out that there is need to include an external stakeholder in the decision making process regarding transfer pricing. There is to be an expert that will be able to make objective decisions and neither a person from the company nor from the government can be unbiased.

In general, what has been found with a help of this research project:

- companies mostly use transfer pricing if they want to reallocate profits between the profitability centers;
- according to the consultants their main aim is to minimize tax burden;
- however, they use TP advisory assistance not to minimize tax burden but to make the books be in compliance with the legislation;
- companies use those transfer pricing methods that better suits the situation, in particular a certain part of the value chain process (different transfer pricing methods are used in different departments);
- companies use TP advisory assistance only to a certain level, consultants are mostly involved at the level of “day to day” operations and they do not influence transfer pricing policy or practices;
- companies have to incorporate international guidelines though they do not always match the current legislation that is why they are oriented at the Russian legislation at first, that actually retards the process of the implementation of the successful international practices;
- oil and gas companies are not satisfied with the regulative control that is exercised over the company. They are concerned that authorities supervise the companies of the group separately and do not monitor all the companies of the group at once.

Theory versus practice

Here it is to outline the most important points that found contradictions with theory.

In the theoretical framework it has been studied that there are certain conditions when the vertical integration in the company becomes more favorable than the market. Moreover, the transaction costs examine the mechanism of the vertical integration that diminishes the transaction costs.

The study showed that the companies that operate in oil and gas sector are tend to be highly vertically integrated ones. They expand to the whole value chain process in other words they are present at every stage from the well-head to the distribution to the final customer. By virtue of this a company decreases its transactional costs.

Williamson outline factors when the transactional costs become maximal –

- specificity of the resources involved in the transaction process
- frequency with which a certain transaction occurs;
- the level of uncertainty

All these factors are inherent in the oil and gas sector: hydrocarbon resources are specific, the transactions occur on a constant base at a high rate, and the oil and gas environment possess a certain level of uncertainty even if we consider the current situation with the oil prices. Thus for companies it is more profitable to become a vertically integrated one and to continue the expansion.

Transfer pricing in centralized and decentralized firms

According to the study provided by Pashkus on the transfer price settlement in centralized and decentralized firms that was discussed in the theoretical framework, these types of companies possess several differences while choosing the transfer price.

In decentralized firm – there is a possibility of using external market, freedom of the transfer price settlement, lack of reporting to the top management, this is the manager of the unit who is responsible for decision making, existence of the internal market, multi-functional assets.

The study proved some points that in Russia in decentralized oil and gas companies:

- there is lack of reporting to the top management;
- an internal market does exist

but also some contradictories were found:

- manager of the unit is responsible for decision making but within certain limits that depend on the firm - the higher is the limit up to which the decisions can be made by a unit manager the higher is the possibility that the unit manager will hide the information from the central management;
- managers are not free to use the external market;
- managers of the unit can not settle the transfer price, it is only in powers of top management to do that.

For the centralized companies the theory was confirmed with the evidences from the study.

The aims of transfer pricing

A system of transfer pricing should motivate divisional managers to make effective decisions and provide information for their justification. However, as it has been found out the behavior of the divisional managers in decentralized firms can imply an opportunistic component, they can hide the information from the top manager, by this not contributing to the profit of the company as a whole but to the profits of a particular unit.

Responsibility centers

The division of the company into centers helps to decrease the time needed to make a decision and to react to the customers' requests, to raise the efficiency of the accounting system, to monitor revenues and to evaluate the results of the divisional activities.

In terms of transfer pricing, it comes to the profits centers during the choice of the transfer pricing method that depends on *«how management wants to reallocate profits for the packs of accountings inside the company»*.

Choice of transfer pricing method

Concerning the choice of methods-cost-based price, adjusted external- market price, negotiated price. Companies are more oriented on the cost-based price. The adjusted external-market price where prices on the external market serve as the referent for determining the values of internal transfers (Dan Li. M.P. Ferreira, 2008) are not used as there is lack of information regarding the independent transactions in the external market.

The negotiated price is also not typical for the Russian oil and gas companies, as it is the top management who sets the transfer price and choose the transfer pricing policy, not the managers of the trading profit centers.

Benchmarking

Benchmark in transfer pricing is to analyze the most often used transfer price in the external market.

According to the theory transfer pricing benchmarking review helps company to mitigate the possible risks tied to transfer prices being in compliance with the arm's length principle, to evaluate company's performance in comparison with the independent company in the market and consequently establish appropriate transfer price.

However, the study showed that companies do not possess an open data base that will provide the information on the transactions between the affiliated companies, consequently companies are tend to rely on their own assumption or on the cost-based principle.

6. Conclusions

The aim of this project was to find an answer to the posed in the introduction research question «how is transfer pricing defined in oil and gas sector in Russia».

With the help of the literature study of the international experience of the transfer pricing, the overview of the situation regarding transfer pricing in Russia, Russian oil and gas sector and the robust economic theories I was able to elaborate a proper research design to study the topic. The analysis of the legislative base, the points of view of the consultants and experts from the oil and gas companies made possible to examine the question from a triangle perspective – how is transfer pricing defined in oil and gas sector in Russia?

To sum up, it is possible to name several issues that were outlined during the work:

Firstly, transfer pricing is still new for the Russian economy. People find it not as an effective market mechanism, but as a way to illegally minimize tax burden. Russian companies do not have enough experience to work with transfer pricing rules within the legal base. Moreover, they do not trust the government, they are trying to find different ways to decrease taxes by shifting profits to law-tax jurisdictions, though the new rules are being introduced.

Secondly, despite the fact that the international practices are being incorporated, Russian tax legislation is not always in compliance with them. Although in most cases companies have to follow rules expressed in the Russian legislative acts, sometimes organizations have to implement international practices and at this very moment the disputes of the interpretation of the legislative base occur.

Thirdly, there is not a universal/integral base where companies can find information upon the controlled transactions and the transfer pricing benchmarking review is viewed as a rather complicated process. Thus, it is hard to settle the market price for the controlled transactions between the units and the companies mostly used cost-based price as a transfer price.

Fourthly, not all the companies are aware of the OECD guidelines being introduced and applied by Russian tax authorities to supervise their controlled transactions.

Fifthly, the new law introduced by the Russian government took legal effect only in 2012, consequently, the new rules have not shown the impact that they have made as the publication of the first statistics is intended only to the year 2016.

All in all, transfer pricing in oil and gas sector in Russia can be characterized as a young phenomenon that is still to inherit the successful international practices:

- not all the introduced rules are in compliance with the tax legislation;
- there is still lack of trust to the governmental bodies and lack of the highly-qualified information regarding the transfer pricing questions.

However, there is a potential for the development of the transfer pricing system in oil and gas sector in Russia. The government is interested in the maximization of the tax base of the companies that work with natural resources, consequently, with those whose profits are the biggest in the Russian economy, companies are also intend to make their transactions be subjected to the legal framework.

There is a need to integrate an automation component to the process of the communication with the tax authorities. It will facilitate the process of the information disclosure and increase the level of trust to the tax authorities. The automation of the process of the documentation submission will allow to eliminate or at least decrease a human factor. Consequently, the system will become more transparent that will grow the trust.

Still while the automation is not on the raw, companies should make use of the prefilling conference with tax authorities which makes clear the number and the nature of documents to be submitted as well as fasten the procedure of the conclusion of the advance pricing agreement, taking into account peculiarities of a particular case.

Moreover, there is a need to make the international guidelines that are to be used by the Russian companies to be in compliance with the Russian legislative base. For example, companies have to follow International Financial Reporting Standards, but legislative base is not in compliance with them. The transactions between the interdependent persons, their definitions do not match the civil legislation that tackles the issues of affiliation.

Another point is an external stakeholder that can help to develop the transfer pricing system by bringing an objective component to the decision making process. Government can not be an external stakeholder as it wants to maximize the tax base consequently has its own interests. An external stakeholder could be an expert from the relative sphere.

The government has not only to provide the clarification letter on the use of the new rules but also to organize more dialogues with the representatives of the audit firms and companies'. The consultants can give an external overview of the situation, as they work with different organizations and can sum up the questions that are typical for the sector, and the experts from the companies can provide the information concerning the insider problems regarding the implementation of the new rule.

Further research

It can be worth to consider to increase in the number of the respondents to the questionnaires that will help to give more robust picture of the current situation – about 10 consultants from each Big 4 company. As well to increase the number of the experts from the oil and gas companies - for example, experts from Russian major oil and gas companies.

Moreover, the research can be repeated after the first statistics regarding the implementation of the new rules are to be published. These statistics will show the impact of the amendments to the legislative base, its strong and weak points.

Furthermore, a new research can analyze not only the legislative base but the view of the representatives of the tax authorities, how they find the system itself, how they see the implementation process, its drawbacks and strengths from the governmental point of view, what it means from the point of view of a supervisor.

Also, it would be interesting to find out what international successful practices could suit Russian business environment but have not been introduced yet.

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Appendices

Appendix 1

All the questions are related to the companies that operate in the oil and gas sector

1. The organization structure of the companies

1.1. The level of the vertical integration in the company. How many parts (components) of the value chain process do companies possess?

- More than two components (production, distribution, retail)
- Two components
- One component

1.2. The level of the diversification.

- Present in more than two industries
- Present in two industries
- Present in one industry

1.3. The level of the centralization

- Operational decisions are made by central management
- Operational decisions are made both by central and unit management
- Operational decisions are made by unit management

2. Transfer pricing methods used

2.1 What are the transfer pricing methods used by your clients?

- Traditional transaction methods (comparable uncontrolled price method, resale price method, cost-plus method)
- Transactional profit methods (profit split method, transactional net margin method)
- Others (if those that they use are not mentioned, please specify)

2.2 How often is the Arm's length principle used in relation to the Transfer Pricing?

- Often
- Sometimes
- Seldom

2.3 Do any of the companies use APAs (Advance Pricing Agreements)?

- More than four companies
- Few of them (two-four)
- Less than two

3. How are international practices taken into account

3.1 Do companies use Transfer Pricing methods in compliance with OECD standards?

- Often
- Sometimes
- Seldom

3.2 Companies are trying to keep to the:

- Russian tax legislation
- OECD principles
- Both

3.3 Which countries experience is taken as an example during the transfer price settlement in companies?

3.4 Which OECD guidelines are still negligible in Russia, but can be introduced in order to improve the settlement of the transfer price?

4. Decisions related to the transfer pricing practices

4.1 What organizational structure does choose the TP method?

- Central management (CEO, CFO, etc.)
- Unit management (business unit, division)
- Both central and unit management
- If others, please, specify

4.2. Who is responsible for the settlement of the transfer price?

- Central management (CEO, CFO, etc.)
- Unit management (business unit, division)
- Cooperation between central and unit management
- Others (if others, please, specify)

5. Motivations for the use of transfer pricing for the oil and gas companies.

5.1 What is the main role of the TP advisory concerning transfer pricing?

- Minimize tax burden
- Ensure the compliance with tax legislation
- Increase the competitiveness of the company
- Maintain the market position
- Evaluate company's performance
- Enhance the cooperation between the units

Respondents are asked to ascribe level of importance:

- Not important
- Of low importance
- Of medium importance
- Very important
- Of utmost importance

5.2 What is the company's (client) main goal in relation to the transfer pricing practices? (allocate percentages)

- Compliance and tax optimization
- Optimize resource allocation and performance management between the units
- Both of the stated

6. Preparation of the transfer pricing documentation

6.1 How complicated do you find the procedure of preparation and submission of the disclosure?

- High (Highly-qualified personnel and a lot of documentation)
- Medium (less experience but a lot of documentation)
- Low (little experience and little documentation)

6.2 How can it be developed?

6.3 What are the benefits of preparation of a transfer pricing study for a company?

6.4 Should a transfer pricing study be prepared by advisor/tax practitioner with a specific designation?

- Yes
- No

7. Interaction between TP advisory and the company

7.1 How often do the clients ask for the TP advice?

- Often (most of the issues concerning TP)
- Sometimes (important issues)
- Seldom (only critical issues)

7.2. Does the TP advisory assistance influence the organizational structure of the company?

- If yes, then how? (open question)

Appendix 2

Interview guide

I conduct a survey for my Master Thesis as a part of the dual Energy Management program in the University of Nordland/MGIMO. I am interested in how is transfer pricing defined in the oil and gas sector?

I would like to get your opinion on this topic and would be really pleased if you agree to answer the questions. I should notify you that our conversation will be recorded or, if possible, some notes will be taken. And the interview will take about 30 minutes. So can I record our conversation?

Questions about the organisational structure

1. How many parts of the value chain process do companies possess?
2. How deversified is the company?
3. What do you think about the level of diversification? Can it be more/less diversified?
4. How are most operational decisions made? By central management or by the unit management (both)?
5. Does the salary of the unit management depend on the unit's profit?

Questions about the transfer pricing methods used in the company

6. Is the transfer pricing system popular within the company?
7. Which transfer pricing methods are more popular within the company?
8. Is Arm's length principle always in relation to the Transfer Pricing?
9. Does the of the company use APAs (Advance Pricing Agreements)?
10. Does the company use Transfer Pricing methods in compliance with OECD standards?

Decision-making

11. Who is responsible for the settlement of the transfer price?
12. Does the transfer pricing system influence the informational flows within the organization?
13. What do you think whether the units hide any information from the central management?

Intra activities concerning Transfer pricing?

14. Does a company use an advisory assistance?
15. Does it help? In what way
16. How difficult is it to communicate with the regulation authorities?
17. What are the benefits of preparation of a transfer pricing study for a company?
18. How do you find the procedure of the information disclosure?
19. How can it be developed?

Recommendations

20. Why do the company use Transfer Pricing?
21. What does the company want to achieve?
22. How can Transfer Pricing be developed within the company (which methods to choose)?
23. Who should be responsible for the decision-making?

Appendix 3

Survey results

Question / respondent	1	2	3	4	5	6	7	8	9	10	11	12	Average
Q1. The level of the vertical integration in the company. How many parts of the value chain process do companies possess? (allocate percentages, 100% in total)													
More than two components (production, distribution, retail)	60	25	60	70	40	60	50	80	40	70	10	80	53,8
Two components (production and distribution)	20	70	20	20	40	35	30	20	40	25	15	20	29,6
One component (production)	20	5	20	10	20	5	20	0	20	5	75	0	16,7
Q2. The level of the diversification in the companies (allocate percentages, 100% in total)													
Present in more than two industries	20	25	30	30	60	50	20	40	60	10	5	30	31,7

Present in two industries	60	25	40	40	30	20	60	60	30	30	55	70	43,3
Present in one industry	20	50	30	30	10	30	20	0	10	60	40	0	25,0
Q3. The level of the centralization in the companies (allocate percentages, 100% in total)													
Operational decisions are made by central management	30	80	40	25	60	20	40	20	70	80	80	90	52,9
Operational decisions are made both by central and unit management	60	15	30	50	20	20	30	60	20	15	15	10	28,8
Operational decisions are made by unit management	10	5	30	25	20	60	30	20	10	5	5	0	18,3
Q4. What are the transfer pricing methods used by your clients? (distribute percentages, 100% in total)													
Comparable uncontrolled price method (CUP-method)	5	30	50	25	30	50	25	20	30	25	30	20	28,3
Resale price method	8	0	0	15	0	0	20	0	0	10	5	0	4,8
Cost-plus method	60	30	10	25	30	0	15	40	40	65	65	0	31,7

Profit split method	2	10	0	0	30	0	0	0	30	0	0	0	6,0
Transactional net margin method (TNMM)	25	30	40	35	10	50	30	40	0	0	0	80	28,3
Other (if other, please specify)	0	0	0	0	0	0	0	0	0	0	0	0	
Q5. How often is the Arm's length principle used in relation to the Transfer Pricing?													
often	+	+	+	+	+		+		+	+	+		
sometimes						+		+				+	
seldom													
Q6. Do any of the companies use APAs (Advance Pricing Agreements)?													
More than four companies		+	+	+		+				+			
Few of them (two-four)	+				+		+	+	+				
Less than two											+	+	
Q7. Do companies use Transfer Pricing methods in compliance with the OECD standards?													
Often	+		+	+				+		+	+	+	

Sometimes					+	+	+		+				
Seldom		+											
Q8. Companies are trying to keep to the:													
Russian tax legislation	+	+	+	+	+	+	+	+	+	+		+	
OECD principles													
Both											+		
Q9.Experience of which countries is taken as an example during the transfer price settlement in companies?	US	OECD countries	US	Europe	UK, US	there were some UK examples	EU, ES	UK, EU	UK, US	Europe	European companies	Depends, I have seen UK experience	
Q10. Which OECD guidelines are still negligible in Russia, but can be introduced in order to improve the settlement of the transfer price?	n/a	All OECD TP Guidelines can be used, as soon as they comply with Russian TP legislation	don't know	not sure	n/a	the distinguish between different types of methods	loan agreements	don't know	sure there are some, but can't name them exactly	Various provisions of OECD TP Guidelines can be introduced by Russian companies, though they would not be able to appeal to them in disputes with tax authorities, since OECD TP Guidelines are not implemented in Russian TP	Principals of application of TP rules for loan agreements; adjustments	Please research	

											legislation			
Q11. What organizational structure does choose the TP method?(allocate percentages, 100% in total)														
Central management (CEO, CFO, etc.)	85	80	100	90	40	100	80	100	20	80	10	100	73,8	
Unit management (business unit, division)	5	0	0	0	20	0	20	0	40	15	5	0	8,8	
Both central and unit management	15	20	0	10	40	0	0	0	40	5	70	0	16,7	
Other (if other, please, specify)	0	0	0	0	0	0	0	0	0	0	0	0	0,0	
Q12. Who is responsible for the settlement of the transfer price (allocate percentages, 100% in total)													0,0	
Central management (CEO, CFO, etc.)	80	80	100	90	20	100	80	100	20	80	10	100	71,7	
Unit management (business unit, division)	5	0	0	0	50	0	20	0	50	15	5	0	12,1	
Cooperation between central and unit management	15	20	0	10	30	0	0	0	30	5	75	0	15,4	

Other (if other, please, specify)	0	0	0	0	0	0	0	0	0	0	0	0	0,0
Q13: What is the main role of the TP advisory concerning transfer pricing?													
Minimize tax burden	of utmost importance	of utmost importance	of medium importance	of low importance	of low importance	of utmost importance	of utmost importance	of utmost importance	of low importance	very important	very important	very important	
Ensure the compliance with tax legislation	of utmost importance	very important	of utmost importance	very important	of utmost importance	of utmost importance	of utmost importance	of medium importance	of utmost importance	of utmost importance	of utmost importance	of low importance	
Increase the competitiveness of the company	of low importance	of utmost importance	of low importance	of low importance	of medium importance	of medium importance	not important	of low importance	of medium importance	of medium importance	not important	of low importance	
Maintain the market position	of medium importance	very important	of low importance	of low importance	of low importance	not important	not important	not important	of medium importance	of medium importance	of low importance	of low importance	
Evaluate company's performance	very important	of low importance	very important	of low importance	of low importance	very important	very important	of low importance	of medium importance	not important	of low importance	of medium importance	
Enhance the cooperation between the units	of medium importance	of medium importance	of low importance	of medium importance	of utmost importance	of medium importance	very important	of medium importance	of utmost importance	of low importance	of low importance	of medium importance	
Q14. What is the company's (client) main goal in relation to the transfer pricing practices? (allocate percentages, 100% in total)													

Compliance and tax optimization	100	80	25	50	50	60	35	30	50	90	70	40	56,7
Optimize resource allocation and performance management between the units	0	20	25	25	50	20	15	20	50	1	15	10	20,9
Both of the stated	0	0	50	25	0	20	50	50	0	9	15	50	22,4
Other (if other, please specify)	0	0	0	0	0	0	0	0	0	0	0	0	0,0
Q15. How complicated do you find the procedure of preparation and submission of the disclosure?													
High (Highly-qualified personnel and a lot of documentation)		+	+	+			+			+			
Medium (less experience but a lot of documentation)	+					+	+		+	+		+	+
Low (little experience and little documentation)													
Q16. How can it be developed?	it can be decreased	Simplification of documentation needed to be disclosed	more optimization, fewer documents	optimization of the tax system	fewer documents, more optimization	to decrease the amounts of documents needed	automatization	more automatization	less documents, more digital	By carrying out consultations between tax authorities and taxpayers.	It can be developed with more automatization	Can be partly automated	

Q17. What are the benefits of preparation of a transfer pricing study for a company?	it's obligatory	An opportunity to optimize business structure and reallocate profit and losses between companies of the group	find out	helps to analyze the company's performance	fewer documents, more optimization	it is needed to complete the information disclosure	less problems with tax authorities	no benefits, it's obligatory	it can be renewed and it is a substantial study	tax legislation compliance, tax burden optimization, effective allocation of resources between companies of the group	to confuse the tax authorities	Absolutely required with annual update - In order to complete documentation and check compliance with market intervals	
Q18. Should a transfer pricing study be prepared by advisor/tax practitioner with a specific designation?	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	no	yes	
Q19. How often do the clients ask for the TP advice?													
Often (most of the issues concerning TP)		+	+		+				+	+	+	+	
Sometimes (important issues)	+			+			+						
Seldom (only critical issues)						+		+					
Q20. Does the TP advisory assistance influence the organizational structure of the company?	no	yes	no	yes	no	no	no	no	no	yes	no	yes	

<p>Q21. If yes, then how?</p>		<p>Shows possibilities of restructuring the business processes for optimal allocation of resources between units</p>		<p>tp method can influence the organization structure. Consequently, if advisors choose it, they influence the structure</p>						<p>In order to fit changing TP legislation and at the same time to save existing tax benefits, TP advisor can recommend to restructure business</p>		<p>TP is on of the basements of group structuring</p>	
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