

## TRANSFER PRICING REGULATIONS IN ARMENIA

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2020 June



**IOTA**

Intra-European Organisation  
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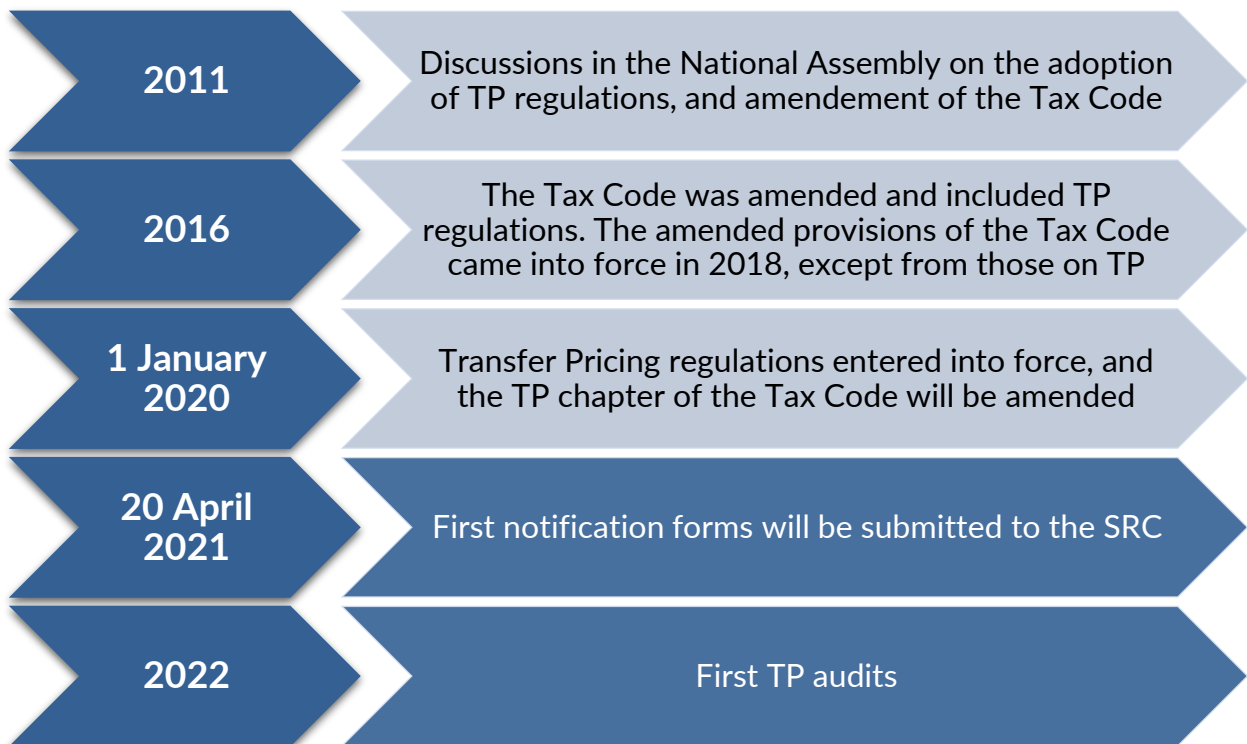
## BACKGROUND

Back in 2011, the adoption of transfer pricing (TP) regulations as a separate law was discussed in the National Assembly of Armenia (the Parliament). Also, discussions were held to adopt a new Tax Code. Hence, it was decided to include the transfer pricing regulations in the upcoming Tax Code, which was adopted in 2016. The provisions of 2016 Tax Code came into force starting from 2018, but the implementation field of the TP regulations was incomplete, thus, it was decided that the transfer pricing regulations would start to be effective starting from 1 January 2020. In 2019, the Armenian Tax Authority (the State Revenue Committee, or the SRC) proposed three supplementary legal acts, in particular, Government decrees regarding the TP regulations. These decrees were on: 1) “Determining the arm’s length range”, 2) “Transfer pricing methods and their application”, and 3) “Mutual administrative assistance and its application”. In late 2019, the Chairman of the SRC adopted an order on “Filling the notification form on controlled transactions”, which is already effective. On 20 April 2021, the first notification form on controlled transactions will be submitted to the SRC, and in 2022 the first TP audits will be conducted. The figure on the next page (Figure 1) shows the process of development of transfer pricing regulations in Armenia.

The legal area of the TP regulations and their implementation is difficult, as these regulations are new for Armenia. Like in all other countries, in Armenia also, implementation of transfer pricing regulations is complex, particularly from the viewpoint of SRC’s administrative capacities. For this reason, it is of high importance that the SRC intensively cooperates with the international experts from international organizations in the framework of various bilateral projects, through which the transfer pricing tax auditors gain valuable knowledge on TP audits.

This paper will speak about the transfer pricing regulations of Armenia, the provisions, application of which seemed to be/could be problematic for the taxpayers, and the amendments and additions in the TP chapter of the Tax Code. For each Article that the paper covered, a table is provided, which includes information on the problems with the Article and the reasons, i.e. what kind of issues could result from that specific problem. At the end, the paper will conclude the covered regulations.

FIGURE 1



## PROBLEMATIC PROVISIONS AND THE AMENDMENTS IN THE TRANSFER PRICING REGULATIONS

Although, Armenia's current regulations on transfer pricing are mainly in accordance with the OECD standards, in order to implement the TP regulations, the current provisions on TP regulations in the Tax Code need to be amended, as there are specific parts and points that need to be clarified, defined, changed, or even deleted. On the other hand, for the taxpayers, some provisions are not always clearly written, others are controversial and need clarification. Moreover, there are concepts and regulations that are missing in the Tax Code and need to be added for the regulations to be complete and more effective. In this regard, the SRC is currently amending the Chapter 73 (from Article 360 to Article 378) of the Tax Code.

Regarding the amendment, the first article that needs to be amended from the Chapter 73 is the Article 360. According to the 2018 version of the Tax Code, it states that the following taxes and fees shall be compliant to the arm's length principle when conducting a transfer pricing audit:

- Profit tax,
- VAT,
- Royalty (natural resources utilization fee).

Moreover, the idea that the VAT should also be included in a transfer pricing audit, is concerning. The VAT will be removed from the upcoming amended TP chapter of the Tax Code, due to several factors. Firstly, the international practice of most of the countries of not including it in their TP regulations, as the inclusion of it will cause difficulties regarding tax administration. Secondly, taking into account some peculiarities of the Armenian Tax Code concerning VAT exemptions, possible difficulties may appear during TP audits, e.g. an NGO, which has a VAT exemption, receives a grant from its non-resident party in an amount of 200 million AMD in a

reporting period. This transaction may be controversial whether to include in a TP audit or not.

The next concerning provision is the part 3 of the Article 360. It states: “Where for the purpose of calculation and payment of taxes and/or fees prescribed by the Code, the Code provides other regulations for determination of tax bases for supply of goods, alienation of intangible assets, performance of works and/or provision of services, then said regulations shall apply instead of transfer pricing regulations prescribed by this Chapter when determining the tax bases of controlled transactions.”. This part may cause misunderstandings regarding TP regulations and other provisions of the Tax Code. Thus, this part should be edited and clarified. This provision will refer to those regulations that are included in ratified international treaties, or agreements, and which differ from the transfer pricing regulations. Also, to those transactions, calculation of which includes international prices agreed by the parties of international treaties, or agreements.

Main problems with the article	Reasons
1. Inclusion of the VAT in TP regulations	1. Possible difficulties in case of transactions having VAT exemptions
2. Part 3 of the Article 360	2. May cause misunderstandings regarding TP regulations and other provisions of the Tax Code.

## ARTICLE 362

### (RELATED TAXPAYERS)

This article is one of the most important articles of the TP chapter of the Armenian Tax Code. Within the meaning of the Chapter, two and more taxpayers shall be considered as related where:

1. One of the taxpayers is directly or indirectly involved in the management, supervision of the other taxpayer or has a participation (stock, share, unit) in the authorized or share capital of the other taxpayer;
2. The same taxpayer is directly or indirectly involved in the management, supervision of two or more taxpayers or has a participation (stock, share, unit) in the authorized or share capital thereof.

Within the meaning of part 1 of this Article, it shall be considered that a taxpayer is directly or indirectly involved in the management, supervision of another taxpayer or has a participation (stock, share, unit) in the authorized or share capital of another taxpayer where:

1. 20 and more percent of the stocks, share, units of the authorized or share capital of the other taxpayer directly or indirectly belongs to the taxpayer;
2. The taxpayer practically controls the business decisions of the other taxpayer.

Moreover, there are also other criteria, which can cause the parties to be related. In particular, according to the part 3 of the Article 362, a taxpayer shall be considered as practically controlling the business decisions of the other taxpayer irrespective of participation in the authorized or share capital of that taxpayer where any of the following conditions is met:

1. The taxpayer directly or indirectly owns or controls 20 and more percent of the voting equity securities of the other taxpayer;

2. The taxpayer directly or indirectly controls the process of formation (election) of the executive board or the board of directors of the other taxpayer;
3. The sum total of the loans directly or indirectly provided and/or secured by the taxpayer to the other taxpayer exceeds 51 percent of the book value of the total assets of the latter;
4. More than 80 percent of the entrepreneurial income of the taxpayer during a given tax year was derived from the transactions on supply of goods to, performance of works for and/or provision of services to the other taxpayer, except for incomes and interests drawn from transactions on lease and/or gratuitous use of property, alienation of intangible assets;
5. More than 80 percent of the expenditures of the taxpayer during a given tax year was made on transactions on acquisition of goods, acceptance of works and/or services, except for the expenditures arising from transactions on lease and/or gratuitous use of property, acquisition of intangible assets and interest payment;
6. The taxpayers have concluded a contract on joint activity prescribed by Article 31 of the Code under which the taxpayer has invested more than 50 percent of his or her assets in the joint activity;
7. The taxpayers have concluded a contract on gratuitous use of property under which the taxpayer (borrower) uses the property of the other taxpayer (lender) by the right of gratuitous use for a period of more than one year and the value of said property exceeds 51 percent of the book value of the total assets of the borrower. This point shall apply also to contracts on lease and financial lease of property.

The provisions of this article are based on the OECD standards, i.e. participation in the management, control, or capital of another enterprise, same directors, sole supplier/customer. But, as the OECD standards are not binding for other countries, and leave the country's legislation to adopt certain criteria and thresholds, and based on the analysis of the behavior of Armenian taxpayers, the SRC added two other criteria for determining related taxpayers. The two "additional" criteria are deviating from the OECD standards, but are important for the SRC to consider that kind of transactions as



subject for TP regulations, in particular, providing a free of charge right to use an asset, and provision of loans.

Another problematic issue of the Article 362 is that it refers to the parties of a transaction as “taxpayers”. According to the point 11 of the part 1 of the Article 4 of the Tax Code, the taxpayers is an organization or a natural person (including an individual entrepreneur, notary), who has or may have an obligation to pay a tax or make a payment in the cases prescribed by the Code or laws of the Republic of Armenia on fees. This definition appears to be broad, considering the scope of the Transfer Pricing legislation, which is limited to transaction between enterprises. Furthermore, the use of the word “taxpayer” could be non-appropriate to define foreign entities that are not taxpayers of the Republic of Armenia. Hence, instead of the term “taxpayers”, should be used the terms “resident enterprises”, and “non-resident enterprises”, and in some parts should be also mentioned “resident natural persons”, and “non-resident natural persons”.

Regarding transactions between resident and non-resident enterprises there is another issue, which can be unclear for the taxpayers regarding the implementation of transfer pricing regulations. The matter concerns the relations between the headquarter company and daughter company and headquarter company and its branch. The standpoint of the SRC will be that, although, based on the two relationships they can be regarded as related, the TP regulations will be applied in the first case, while the headquarter and branch company relationship will be regulated based on the existing double taxation treaty provisions (particularly, Article 7 “Business Profits”) between the headquarter company’s country and the country of the branch company.

Furthermore, another issue with this article is the point 3 of part 3, which states, that a taxpayer shall be considered as practically controlling the business decisions of the other taxpayer irrespective of participation in the authorized or share capital of that taxpayer, where the sum total of the loans directly or indirectly provided and/or secured by the taxpayer to the other taxpayer exceeds 51 percent of the book value of the total assets of the latter. This provision will be clarified for cases when contract of a transaction was signed before 1 January 2020 (the date when the TP legislation will



be in force in Armenia), but the loan provided in 2020. Also, how the book value of total assets should be calculated after signing the contract of transaction before 2020, and as of which date. Another issue with this provision is that there was a technical problem with this point. The 51% threshold in the Armenian version of the Tax Code refers to the borrowings, while in the English version it was translated as “loans”. If this point would not be changed, in case of banks, most of their transactions with their customers may be considered as controlled.

Main problems with the article	Reasons
1. The term “taxpayers”	2. The definition of “taxpayer” is broad and also includes the natural persons, who are not covered by the transfer pricing regulations.
2. Percentage threshold for book value of the assets in order to be considered as related parties	3. The issue relates to the calculation of the book value in cases when the transaction was signed before 2020 (when the TP chapter came into effect) and the 51% threshold was met in 2020. Also, the possible problem in case of banks, which may be considered as related to the most of their customers, due to this provision.
3. Regulations on headquarter-daughter and headquarter-branch relationships	Uncertainty for the taxpayers regarding the regulations on these type of relationships

## ARTICLE 363

### (CONTROLLED TRANSACTIONS)

As mentioned earlier, the Armenian TP legislation has some peculiarities, and one of them relates to the Armenian resident-resident transactions that may be concerned as controlled. In particular, according to the part 2 of the Article 363 of the Tax Code: “A transaction on supply of goods, alienation of intangible assets, performance of works and/or provision of services carried out between related taxpayers considered as residents of the Republic of Armenia shall be considered as controlled in the following cases:

1. One of the parties to the transaction is considered as a royalty payer in accordance with part 2 of Article 198 of the Code; (i.e. natural resources utilization payment)
2. One of the parties to the transaction enjoys tax benefits prescribed by the Code regarding profit tax, VAT and/or royalty;
3. One of the parties to the transaction is considered as an operator of a free economic zone prescribed by point 4 of Article 3 of the Law of the Republic of Armenia “On free economic zones”.

Also, according to the part 3 of this Article, the transaction carried out between a resident taxpayer and taxpayers registered in countries (geographical areas) having specific liberal tax systems shall be considered as controlled, whether or not the taxpayers are related persons.

Due to this Article, the metal mining industry and also, taxpayers, who are exempted from profit tax will be “targeted” by the TP tax inspectors. For instance, based on the Armenian Tax Code, agricultural product producers are exempted from profit tax. This means that in case of related parties in this sphere, the whole sector would be subject for transfer pricing regulations, which could be very costly for these producers, i.e. finding comparables and filling the documentation for their controlled transactions.

On the other hand, the effectiveness of inclusion of resident-resident transactions under the TP regulations is hard to estimate, yet. The real impact will be obvious in the upcoming years.

## ARTICLE 364

(THE ARM'S LENGTH PRINCIPLE)

## ARTICLE 371

(ARM'S LENGTH RANGE)

Generally, the provisions under the Article 364 and Article 371 are correspondent to the OECD standards. The SRC elaborated three Government decrees on transfer pricing regulations on: 1) Arm's length principle, 2) Transfer pricing methods, and 3) MAP. A range between a lowest value and a highest value of a financial indicator is applied as an arm's length range in the following cases:

- All used values of a financial indicator result from uncontrolled transactions that are comparable to a controlled transaction as defined in subpoint 1) of point 1) of Article 365 of the Tax Code, including a situation where relevant comparability adjustments pursuant to Article 366 of the Tax Code have been made achieving the condition defined by subpoint 2) of point 1) of Article 365 of the Tax Code.

To put it more clearly, according to the Government decree on the Arm's length principle, there are two cases when the full range can be applied:

- The results of financial indicators are derived from uncontrolled transactions, and:
  1. No differences between the transactions that could materially affect the financial indicator being examined under the methodology (e.g. price or margin) exists,

2. The reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

In cases, where there are less reliable comparables, taxpayers should take the interquartile range (25-75%) from the whole arm's length range. There might be cases when a taxpayer while searching for comparables and determining the arm's length range, would not select a comparable that is not/less reliable and hence, would not determine the interquartile range. When the SRC will find out that the comparables are not reliable and the arm's length range was not calculated properly, the SRC will make adjustments, and will calculate the median point from the interquartile range as the arm's length financial indicator.

The definition of the arm's length principle in the Armenian Tax Code is slightly different from the OECD's definition, as it focuses on the comparison between financial indicators of the controlled transaction and the ones of the uncontrolled transaction.

## ARTICLE 375

### (NOTIFICATION OF CONTROLLED TRANSACTIONS)

In late 2019, came into force the order of the SRC Chairman on "Filling the notification form on controlled transactions". For the tax authority the notification form is considered as an initial information source on risk assessment. The notification form is simple to fill and is totally electronic. Though many countries do not have threshold for providing the notification form and documentation, for Armenia it is for the taxpayers whose sum total of controlled transactions exceeds 200 million AMD (about 377.000 €). Although many taxpayers are concerned that this threshold is too low, it will remain for the upcoming years, and may be raised in the future.

In the notification form a taxpayer should fill the following information: 1) its company details and profile, 2) information on non-resident related parties and transactions with

them, 3) applied TP methods on each transaction, 4) the amount of transaction, 5) applicability of APA, 6) availability of free of charge controlled transactions, 7) controlled transactions with resident parties, and 8) information on uncontrolled transactions.

For searching the comparables the taxpayers should use the information sources prescribed by the Tax Code. But the information sources mentioned in the relevant article (Article 367) are incomplete and may not contain reliable comparables. According to the point 3 of Article 367, the following, in particular, may be used as other sources of information on uncontrolled transactions:

1. Information submitted to the tax authority as prescribed by the legal acts regulating tax relations, where it does not constitute a tax secret;
2. Databases containing financial and other information that are included in the list of databases approved by the Government;
3. Published customs statistics on foreign trade;
4. Information published in official sources of information of state administration bodies, local self-government bodies;
5. Physical volumes of production and turnover, as well as actual sales prices (including average sales prices) of mineral resources and mineral resource products and goods included in the list prescribed by the Government;
6. Information published by the National Statistical Service of the Republic of Armenia;
7. Value of immovable property determined as prescribed by law.

Another peculiarity that can result issues regarding tax compliance is that the current TP chapter of the Tax Code there are no fines and penalties for not providing the notification form. So, the filling and providing the notification form is based on self-compliance of a taxpayer. For this reason, it would be reasonable to adopt the system of fines and penalties for not providing the notification form, as it is the case in many countries. Moreover, the fines should be high, so that it would not be preferable for large taxpayers to pay the fine and not to submit the notification form.

Main problems with the article	Reasons
1. The threshold on annual controlled transactions	1. May be low, comparing to the international best practice
2. Absence of fines and penalties for not providing the Notification form on controlled transactions	2. Can result possible non-compliance issues

## ARTICLE 376

### (TRANSFER PRICING DOCUMENTATION)

The current transfer pricing legislation of Armenia does not cover the three types of documentations that are regarded as international standards regarding TP, i.e. the Master file, Local file, and Country-by-country reporting (CbCr). After the amendment, the Tax Code should include provisions on these concepts, their definition, and their regulations based on international standards.

As in February 2019, Armenia joined the OECD Inclusive framework on Base Erosion and Profit Shifting project (the BEPS), and the country-by-country reporting (CbCr) is one of the BEPS minimum standards (mandatory regulation for all the BEPS members to implement), Armenia must have the CbCr until 2022.

The implementation of regulations on CbC reporting, contains some challenges for Armenia. Although, the CbCr is being provided by the ultimate parent company of an MNE, and includes essential information for transfer pricing auditors on MNE's global operations, this type of documentation is filled by MNE's having more than €750 million turnover, and in this case Armenia will be a "receiver" of CbCr, as there are no such huge companies in Armenia, which will be the ultimate parent of an MNE and with such a large annual turnover. The problem with being a "receiver" of CbCr is that in case of

developing countries it requires a large capacity, and this could be an issue for the SRC, because one thing is to receive such large information, and another thing is to be capable to use that information properly.

Also, as the CbC reporting is transmitted through the Common Transition System (CTS), which has an annual cost of €20.000, and this cost may also be concerning for the SRC. Moreover, the SRC should manage to do on time the corresponding requirements of the Information Security Management before the deadline on the implementation of CbCr regulations. Currently, the SRC is working on these requirements based on the technical assistance of the OECD Global Forum experts.

Notwithstanding the concerning issues on the implementation of regulations on transfer pricing documentation, the SRC is committed to include in the Tax Code relevant provisions on TP documentation, and also, provisions on fines and penalties. The fines and penalties should be for incomplete documentation, for not providing the documentation, and for not meeting the deadline for documentation filling (30 working days after the SRC’s request is sent to the taxpayer). Without having provision on penalties and fines regarding TP documentation, the transfer pricing regulations may not “work” effectively in Armenia, as most of the taxpayers may prefer not to provide any documentation to the SRC.

Main problems with the article	Reasons
1. The absence of the regulations on “master file”, “local file”, “country-by-country reporting”	1. Previously, Armenian Tax Code did not include any provisions on three-tiered transfer pricing documentation.
2. The annual cost of CTS	2. The cost may be concerning for the SRC



3. The absence of fines and penalties regarding TP documentation

3. Without fines and penalties, most of the taxpayers may prefer not to provide any documentation to the SRC, and the transfer pricing regulations may not “work” effectively in Armenia

## CONCLUSION

To conclude, the current Armenian transfer pricing regulations are partly based on the OECD standards, but still are incomplete and sometimes deviate from international those standards, i.e. there are still provisions that need to be added or changed in order to be in accordance with the OECD standards. On the contrast, some provisions deviate from the OECD standards and are not yet subject to be amended, e.g. the threshold of annual controlled transactions, which in many countries is higher, or the participation in management, control or capital threshold in order to be considered as related parties, which in many countries is 50%.

Currently, the transfer pricing chapter of the Armenian Tax Code is under the process of being amended, after which it will almost completely be based on the OECD standards and international best practice. As this year is the first year when the transfer pricing regulations came into effect (1 January 2020), the first audits will be in 2022, during which the transfer pricing regulations will be “tested” in practice, and maybe in the upcoming years some provisions will be amended again.