WORKING DRAFT

This is a working draft of a Chapter of the Practical Manual on Transfer Pricing for Developing Countries and should not at this stage be regarded as necessarily reflecting finalised views of the UN Committee of Experts on International Cooperation in Tax Matters or its Subcommittee on Transfer Pricing - Practical Issues. Comments

set forth in the Mutual Agreement Procedure ("MAP") under bilateral treaties based upon Article 25 of the UN and OECD Models) have been made more effective due to supplementary domestic regulations and international agreements and practice regarding those procedures.

3. Furthermore, to ensure legal certainty for taxpayers, in TP cases, many countries have implemented advance pricing agreements ("APAs") in their legal or administrative procedures. These APAs are endorsed as an important bilateral resolution mechanism to avoid double taxation. Other countries have introduced an arbitration procedure to give certainty of a resolution (which the MAP as such cannot guarantee).

4. The objective of this chapter is to reflect the legal environmental background of transfer pricing legislation in a global scale and, if possible, identify some important practical issues from the perspectives of developing countries. Of course, there can be no "template" legislation that works in every situation – new legislation has to be appropriate to the needs of a particular developing country, which will often involve substantial adaptation, at least.

2. Domestic Transfer Pricing legislation

2.1 Structural overview

5. Transfer pricing is essentially a neutral concept, meaning the price charged by one segment of an organization for a product or service supplied to another segment of the same organization. However, the term is sometimes used, incorrectly, in a pejorative sense, to mean the shifting of taxable income from one company within a multinational enterprise ("MNE"), located in a high-taxing jurisdiction, to another company of the same group, in a low-taxing jurisdiction, through *incorrect* transfer prices. The aim of the price setting is to reduce the overall tax burden of the group.

6. Thus, to prevent possible tax base erosion, caused by related party pricing, many countries have introduced domestic tax rules to regulate/adjust such incorrect pricing. The current global consensus is that, among related parties, income should be allocated in accordance with the arm's length principle ("ALP"). The ALP is generally accepted as the guiding principle for allocating income not only among related entities (group companies) but also among cross-border units of a single

entity. Under the ALP it is in principle necessary to look to a comparability analysis of third party transactions. However, when the taxpayer fails to provide tax authorities with required data to compute an arm's length price, some countries have adopted a presumptive taxation method which is subject to a rebuttal by a taxpayer by presenting any counter-proof of the arm's length results.

7. Another principle for the TP income allocation is global formulary apportionment ("GFA"). Such systems have been employed by certain countries at domestic level to allocate tax bases of any inter-state business among the relevant State or Provincial authorities. The United States and Canada are examples. However, such a system cannot operate at a global level, in a way avoiding double taxation, without first agreeing on suitable uniform formulas (which is yet to be achieved). This Manual addresses transfer pricing rules based on an arm's length principle, recognizing that that is the most current practical issue facing developing countries. This Manual does not deal with the longer term pros and cons of alternative ways of dealing with transfer pricing, including GFA.

8. As for the domestic legislation of ALP, we can see two different broad approaches which both seek to determine what constitute arm's length prices in a controlled (related party) transaction. One style of statute simply authorises the tax administration to distribute, apportion or allocate gross income, deductions, credits etc. when they determine that such distribution, apportionment, or allocation is necessary in order to prevent tax evasion or clearly to reflect the income of any of such organizations, trades, or businesses.[1]

9. Under this system, there is no reference to the taxpayer's compliance obligation in determining the ALP, while the ALP principle is stipulated not in the general legislative principle but rather, if at all, within regulations supporting the legislation.

10. The second style of statute stipulates that, based upon the self assessment system, any foreign affiliated transaction shall be deemed to have been conducted on an arm's length base for tax purposes.[2] In other words, a non-arm's length transaction is reconstructed as an arm's length transaction for the purposes of

[1] US Internal Revenue Code§482
[2] Japan Special Taxation Measure Act §66-4(1)

calculating taxable income and taxing such income. This type of statute effectively requires taxpayers to conduct their initial tax accounting based on the ALP.

11. But, in any style, a tax law statute itself only identifies the basic structure of tax base allocation among the related parties under the ALP. Detailed practical guidance on the ALP, such as the definition of related parties, transfer pricing methodologies ("TPM"), documentation requirements, penalties and the APA are normally to be found in subordinate legal materials, such as regulations, administrative rules and public notices, etc.

15. Such difficulties suggest that:

1) in certain cases, both taxpayers and tax authorities have to apply the operating profit basis analysis based on the combined profit of entities rather than the price-oriented analysis based on the one-sided information which represents all that is available;
2) in such cases, flexibility in selecting an appropriate methodology based upon the facts and circumstances would be desirable; and
3) rejecting the current hierarchy among TPM is likely to be an efficient policy in reducing excessive compliance cost not only for taxpayers but also for tax authorities. Some countries have already introduced a flexible selection of TPM as their domestic regime.[3]

16. The 2010 OECD TP Revised Guidelines established a new standard, “the most appropriate method rule” in selecting a TPM. If this standard is generally accepted and implemented in domestic legislation, the risk of double taxation, caused by the difference in priority would be reduced substantially. However its impact upon administrations also needs to be considered and until such a global legal environment change has material 827(l)5..5.3(l)71( )-271(Howeve)7.7(r it)n-8.7(m5.6(g)-78t4)5.6(

18. Generally in any methodology, the most critical issue for developing countries will be the lack of third party comparables. The OECD TP Guidelines explore in detail the problem of how to establish comparability analysis in the case of unique intangibles or valuable personnel service provision. However, for developing countries, it can be said that practical guidance in establishing the basic methods without sufficient domestic information on independent comparables should be the primary focus/aim. This area has not been addressed thoroughly in the OECD TP Guidelines. In addition, the standard TP statutes never prescribe in detail on how to address this issue. Therefore, the Manual, as a useful interpretative guideline, is intended to assist in this area.

19. To establish useful and effective guidance, comparability analysis (use of foreign data, adjustment of differences, profit split, etc.) and administrability (availability of data base, documentation, and penalties) should be theoretically

Japanese parent company made a Thai Baht denominated loan to its Thai subsidiary with fixed rates of interest (2.5-3.0%). The National Tax Agency ("NTA") examined the case and adjusted the rate (10.5-19.2%) by the use of certain non-existing (i.e. "hypothetical") transactions as comparables (a quasi Comparable Uncontrolled Transaction ("CUT") method). In this case, they used the short term floating rate of LIBOR (the London Interbank Offered Rate) coupled with an interest swap transaction between fixed interest rate and short term floating rates. This was based on the financial institutions' practice in the market of procuring Thai Baht funds with short term floating interest rates and swapping them with long term fixed interest rates and lending the funds to customers with the long term fixed interest rates to be charged to the customers by adding the swap rates and interest margins for their own profits to the costs of procurement of the funds.

22. While Japan's TP regulations assume actual and existing third party transactions as comparables, the dispute was on whether hypothetical comparables are allowed and, even if allowed, whether such hypothetical transactions lack comparability. The court declared that in case there is no actual comparable transaction, market prices charged by unidentified and unrelated market participants (lending financial institutions) can be used as a comparable, so long as it is possible to assume a hypothetical transaction by basing it on objective and actual index data. Then, it decided that on the facts, the hypothetical transaction met the standard for comparability for purposes of the quasi-CUT method under the Japanese TP regulations.

25. However, there are still some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guidance on the self assessment basis). As discussed in the OECD drafting committee of the 1995 OECD TP Guidelines, non-fault penalties could induce taxpayers to shift their income to low tax jurisdictions. Thus, we should examine the documentation and penalty legislation further. After the evaluation of the efficiency and proportionality, based upon the OECD standard, we should again focus on the early stage of the TP journey by developing countries on this matter.

26. Sometimes the early experience of developed countries some years ago may be more relevant to countries than the latest experiences. As an example, Japanese TP examiners at the initial stage of TP administration (in the early 1990s) experienced trouble in collecting the information about affiliated enterprises that was physically held overseas. At that time, the documentation requirement was very basic under the Japanese domestic legislation; examiners had to exercise their ordinary domestic investigation powers to inquire from taxpayers about the foreign related transactions in general. Soon they identified that not all relevant information was necessarily kept by the Japanese unit, no matter whether that unit was the parent or a subsidiary. Then, Japan started a long journey to adjust the documentation requirement to reflect the actual international business practice of multinational groups by ensuring compliance could be effective but also taking into consideration of the taxpayers' compliance burden. Providing the authorities with legal power to examine the domestic third party transactions and requiring more detailed information in the schedule to be attached to the tax return of a domestic affiliated corporation are examples of outcomes of such a process.

2.3.2 Presumptive taxation methods and the ALP

27. The presumptive taxation method is provided for in the law of some countries. Presumptive taxation provisions, such as that of Japan, give tax authorities the power to "presume" an arm's length price based on information gathered by the authorities, and to reassess the taxpayer's taxable income on that basis. Such provisions are generally only regarded as applicable in case of the

against the manipulation of transfer pricing.

28. This methodology might be common in statutes operating in relation to domestic taxation and TP adjustments. However, TP adjustments generally cause international double taxation whenever tax authorities exercise adjustment on foreign transactions. Thus, most countries structure such statutes carefully in the manner to be accorded with the ALP. However, it seems that some countries lower the threshold for applying this methodology, at least in terms of establishing comparable transactions. Once again Japanese experience can be used as useful guidance.

29. To invoke presumptive taxation in Japan, the statute allows the tax authority to use the "gross profit rate" methods which are very similar to RP or CP, and, if such methods are not available, the profit methods. After the adjustment by presumptive taxation, the burden of proof is shifted to the taxpayers, who have to show that their prices and not the presumed NTA prices are at arm's length.

30. As stated earlier, Japan introduced examiners' authority to inquire into third party transactions at the early stage of its TP journey. The condition to activate this authority is that when examiners request the corporation to provide records, books or copies thereof, which are recognized as necessary for computing the arm's length price, the corporation does not provide those materials in a timely fashion. The meaning of the terms "relevant materials" and "in a timely fashion" caused some disputes, when taxpayers insisted that they had performed all their minimum obligations on the disclosure of basic information to support their methodologies. The focal point of discussions is whether burden of proof is on the tax administration or taxpayers, and whether the presumptive taxation has been properly applied will determine whether the shifting burden of proof has moved from being on the administration to being on the taxpayer. In Japan, in conjunction with the usually "hierarchy" in TPM, this issue still remains decisive on the outcome of lawsuits.

31. Another issue closely related to presumptive taxation is the use of "secret comparables". Once examiners make an inquiry into third party transactions, the acquired data relating to those transactions is generally confidential under the tax laws, because any information is provided by such third parties under the

conditions of confidentiality. Thus, during the dispute procedure, the taxpayers against whom presumptive taxation is applied cannot access any materials which form the basis of the presumptive taxation. In order to secure the opportunity of taxpayers defending their position against such taxation, the OECD guidelines advise that the use of secret comparables would be unfair.[7]

2.3.3 Safe harbor rules

32. Safe harbor rules are rules whereby if a taxpayer's reported profits are within a range or percentage or under a certain amount, or the like, that amount can be relied on by a taxpayer as an alternative to a more complex and burdensome rule, such as applying the transfer price methodologies. A safe harbor cannot normally

improved and they are not needed, or when conditions have changed so that they are no longer appropriate. There is also the possible risk that if the safe harbor rules are too generous, not only is revenue unnecessarily foregone, but there may be a perpetuation of small scale or low profit transactions rather than higher risk/ higher reward transactions to which the safe harbors will not apply, so that

countries we can see a substantial shift of human resources towards APA related issues not only on the taxpayer's side but also on the administration side. The OECD TP guidelines strongly endorsed the APA as a supplement to the traditional administrative, judicial and treaty mechanism for resolving TP issues.[9]

extensively by the OECD guidelines and is dealt with in a later chapter of this Manual. For example, among five fundamental factors for comparability analysis, difference in economic circumstances and business strategies might be a focal point for adjustment, because a similar FDI for developing countries can produce different profit levels due to the differences in the market conditions and different stages of a business cycle, etc. In this context, the effect of "location savings" a mentioned in Chapter 1 should be appropriately addressed or the reference to the multi-year analysis might be necessary.

41. The other problem is capacity building in dealing with APAs. The APA is generally regulated by domestic legislation, such as TP regulations or administrative public notices, depending on the legal character of such arrangement. However, it has become a major inventory for the Competent Authority negotiation in the developed countries, because taxpayers prefer bilateral solutions through the MAP. Thus, to establish any commonly acceptable criteria for the TP purpose is potentially very difficult for local examiners and Competent Authority staff in charge of TP.

42. The following is an example of the practical experience in Japan:
Japan started its TP administration with quite a small sized unit in the late 1980s. Once the NTA identified the rapidly increasing needs for TP management, it (1) expanded a nation-wide training course for international taxation step-by-step, now reaching 100 trainees every year, (2) reorganized and expanded gradually the national and regional examination division, now the headquarters having the TP sections and the MAP office as well as four major regional bureaus having special divisions for TP (including 2 special divisions specializing in APA). Although some essential documentation concerning the TP is required by statute to be interpreted in Japanese, the TP specialists are generally equipped with sufficient language skills to conduct examination on the original accounting books, documents, etc. in English.

3. Dispute resolution

43. As stated earlier, an upward TP adjustment generally causes substantial double taxation for the cross-border business, unless there is a "corresponding adjustment" downward on the other side of the transaction – i.e. by the other country's tax authority. Therefore, every jurisdiction structures carefully domestic

dispute resolution procedures as well as treaty based resolution mechanisms. For

the other country's CA can build a case more easily and, perhaps, effectively. A second problem is the lack of experience for a MAP on TP cases. Perhaps, there should be some trial period for developing countries to skill up their officers and make progress in this area.

47. Here again Japanese experience can be one model: At the initial stage of the MAP, Japan experienced those disadvantages listed above. However, with a good partnership with many treaty partners, a large amount of information was successfully shared; therefore intensive and practical discussions on the TPM or comparability analysis improved the capacity of Japanese CAs rapidly. So far, although there were exceptionally cases with a negotiation period beyond 2 years, the majority of MAP cases have been successfully concluded within the approximately 2 year's period that is a target period with the OECD Model Article 25(5).

48. After stabilizing its own capacity building in the MAP, Japan has made some contribution in this area, bilaterally or multilaterally, for the benefit of new negotiation partners.