Chapter B.8

GENERAL LEGAL ENVIRONMENT

B.8.1. Introduction

B.8.1.1. Transfer pricing rules were introduced in domestic legislation by the United Kingdom in 1915 and by the United States in 1917. Transfer pricing was not an issue of great concern, however, until the late 1960s when international commercial transactions expanded greatly in volume. The development of transfer pricing legislation was historically led by developed countries; in recent years, however, with the growth and complexity of international "transfers" within MNEs, both developed and developing countries are introducing legislation to address transfer pricing issues. See Chapter B.1, Paragraph B.1.3 for more on the evolution of transfer pricing rules.

B.8.1.2. Domestic transfer pricing legislation worldwide shows some harmonization in basic principles, in accordance with the arm's length standard, even if the application is not identical across jurisdictions. The introduction of transfer pricing rules has taken place within different legislative traditions, and in the context of the sovereign right of countries to address taxation matters. The reasons why there has been a great deal of consistency in approach include:

- The broad acceptance of the arm's length principle as the best current alternative for dealing with transfer pricing issues;
- Many countries have adopted the UN or OECD forms of Article 9 in their bilateral tax treaties, and have therefore already committed to it; and
- The benefits of similar approaches between countries in terms of avoiding double taxation or double non-taxation.

B.8.1.3. With the increase in cases where tax authorities have made adjustments to transfer prices set by related entities, taxpayers increasingly seek practical dispute resolution mechanisms to avoid double taxation. As a result, mutual agreement procedure (MAP) discussions as set out in bilateral treaties[31] have been made more effective through supplementary domestic regulations, as well as practice regarding the conduct of the MAP.

B.8.1.4. Many countries have implemented advance pricing agreements (APAs) in their legal or administrative procedures as a bilateral resolution mechanism to avoid double taxation. Other countries have introduced an arbitration procedure to give certainty that a dispute will be resolved. The advantages and disadvantages of these solutions are dealt with in Chapter C.4; however, the application of these solutions will be influenced by the legal environment of each country, and thus will take place in a variety of ways.

B.8.1.5. This chapter reviews the legal environment of transfer pricing legislation in a global context and seeks to identify the key practical issues from the perspective of developing countries. It should be emphasized that there is no "template" or model legislation that works in every situation. New legislation has to be appropriate to the needs of a particular developing country. This means that any legislation of another country which is examined as a source of ideas should be considered closely as to why it has worked or has not worked in its original context, including ease of practical administration of and compliance with the rules it contains. Those reasons and the "environment" of the legislation should be compared with those in the country developing transfer pricing rules. This analysis will help indicate what adaptation, if any, of the legislation is needed for it to work effectively in the conditions of a particular country.

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[31] Based upon Article 25 of both the UN and OECD Model Conventions.

B.8.1.6. It is important that drafters of transfer pricing legislation take into account the outcomes of the BEPS Project, especially regarding Actions 8, 9, 10 and 13 (8 – Intangibles; 9 - Risks and capital; 10 - Other high-risk transactions, and 13 - Transfer pricing documentation).[32] These issues tend to have a more harmonized legal approach in a post-BEPS Project era.

B.8.2. Domestic Transfer Pricing Legislation: Structural Overview

B.8.2.1. As already noted in Chapter B.1 "transfer pricing" is essentially a neutral concept. However, the term is sometimes used, incorrectly and in a pejorative sense, to mean the shifting of taxable income from one company within an MNE, located in a high-tax jurisdiction, to another company of the same group, in a low-tax jurisdiction, through incorrect transfer prices. The aim of such practices is to reduce the overall tax burden of the group. This involves a transfer price, but is more accurately referred to in this Manual as a type of transfer mispricing; the issue is not that there has been a "transfer price" set (as there must be in such a transaction, however legitimate) but that the price set is not an arm's length price. See B.1.1.7 for examples.

B.8.2.2. Many countries have introduced specific domestic tax rules to prevent possible tax base erosion through mispricing of transactions between related parties. As noted above, this legislation is almost invariably proposed as being in accordance with the arm's length principle. The arm's length principle 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 arm's length principle, it is in principle necessary to conduct a comparability analysis of third party transactions. However, when the taxpayer fails to provide the tax authorities with the required data to compute an arm's length price in particular circumstances some countries have adopted a presumptive taxation method (discussed at Paragraph B.8.7 below). This is normally subject to rebuttal by a taxpayer, who may present counter-evidence to show the results as being at arm's length.

B.8.2.3. Another principle for transfer pricing income allocation is global formulary apportionment (GFA), see Chapter B.1, Paragraph B.1.4.14. for further information. However, such a system cannot operate at a global level, in a way that fully avoids double taxation, without prior agreement on a suitable uniform formula, which is yet to be achieved. Before joining the OECD, the Republic of Korea used to apply the GFA method on the grounds that this method provided more certainty and also reduced compliance costs for taxpayers. However, around the mid-1990s, the tax authorities of the Republic of Korea revoked some of their own guidelines based upon GFA acknowledging that GFA is not consistent with the arm's length principle. This Manual addresses transfer pricing rules based on the arm's length principle; developing countries almost invariably accept the arm's length principle as the basis of their bilateral tax treaty provisions on related party dealings and in their domestic legislation addressing the same issues.

This Manual does not deal with the advantages and disadvantages in the longer term of any possible alternative ways of dealing with transfer pricing, including GFA.

B.8.2.4. Two different broad approaches may be seen in domestic legislation relating to transfer pricing. Both of these seek to implement an arm's length approach in relation to controlled transactions:

B.8.2.4.1. The first possible legislative approach simply authorizes 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 avoidance or clearly reflect the income of any organizations, trades, or businesses.[33] Under this system there is no reference to the taxpayer's compliance obligation in determining the arm's length principle, while the arm's length principle may be stipulated in either the general legislative principle or within regulations or secondary legislation supporting the primary legislation.

[32] Reports available at http://www.oecd.org/tax/beps/beps-actions.htm

[33] E.g., US Internal Revenue Code §482.

B.8.2.4.2. The second legislative approach stipulates that, based on the self-assessment system, any foreign affiliated transaction shall be deemed to have been conducted on an arm's length basis for tax purposes if that transaction is not in fact conducted at arm's length.[34] In other words, a non-arm's length transaction is reconstructed as an arm's length transaction for the purposes of calculating taxable income and taxing such income. This legislative approach effectively requires taxpayers to conduct their initial tax accounting based on the arm's length principle.

B.8.2.5. A country's choice between the two above alternatives will depend on the basic principles of domestic tax law in that country. This will, for example, include issues such as the form of anti-avoidance legislation and where to place the burden of proof. However, the choice of styles of domestic legislation has made no substantial difference in the legal procedure of structuring the arm's length principle. The manner in which arm's length methodologies are stipulated in each country's legislation differs to some extent, as described below.

B.8.2.6. Depending on the legal system of the country concerned, tax laws may set out in great detail issues such as the definition of related parties, transfer pricing methodologies, documentation, penalties and the procedures for Advance Pricing Agreements/Arrangements (APAs). Other countries might opt only to identify the basic structure of tax base allocation among the related parties under the arm's length principle. In the latter case, detailed practical guidance should normally be available in subordinate legal materials, such as regulations, administrative rules and public notices. Therefore, even if such matters are defined in great detail in the primary tax law, there is a need to provide clear operational guidance. Users of this Manual should consider the level of guidance available in their countries, and determine if further detail is needed.

B.8.2.7. There remains substantial risk of double taxation even when two countries follow the same general arm's length principle approach. For example, such double taxation may occur where specific guidance on the implementation of the arm's length principle is different from one country to another, and countries do not bridge this gap with any specific understanding or interpretative guidance. The following paragraphs demonstrate potential significant differences in domestic law which may result in major differences in how countries interpret or apply the arm's length principle.

B.8.3. Associated Enterprises

B.8.3.1. The definition of which entities (companies, trusts, individuals and other persons) and therefore transactions are covered by transfer pricing legislation is a key issue since the arm's length principle applies to transactions between related parties. Article 9 of both the UN and OECD Models considers enterprises to be "associated" (i.e. "related parties") if one of the enterprises meets the conditions of Article 9, Subparagraph 1(a) or 1(b) with respect to the other enterprise. These subparagraphs cover so-called parent-subsidiary relationships and brother-sister relationships as relevant situations.

B.8.3.2 The requirement of control in each subparagraph is defined as being to "participate directly or indirectly in the management, control or capital of an enterprise". There is no specific common guidance on this matter either in the Commentaries on Article 9 in the UN and OECD Models, or in the OECD Transfer Pricing Guidelines. This is mainly because transfer pricing issues are relevant only if special conditions have been made or imposed between two parties. Thus, the degree of control as a threshold for triggering transfer pricing legislation has in effect been left to domestic legislation.

B.8.3.3. Some countries apply a 50 per cent shareholding threshold as the degree of participation required for "associated" status; some countries employ a lower threshold. However, countries with higher thresholds usually employ substantive rules on control as a fall-back, or subsidiary, test. These may focus on elements other_than shareholding, such as dependency of input materials, distribution networks, voting rights, entities included in consolidated financial statements,_financial resources and

[34] E.g. Japan Special Taxation Measure Act §66-4(1).

human resources in relation to other group members. There is thus no significant difference among countries on this matter.

B.8.3.4. Differing threshold criteria can result in disputes in certain circumstances. For example, in Japan, domestic law stipulates that a shareholding of 50 per cent or more is the threshold for an "associated enterprise", which is generally a possible target of transfer pricing examination by tax authorities. This may bring into the examination "net" a 50/50 joint venture project organized by two independent parties.[35]

B.8.3.5.. In South Africa transfer pricing rules are applied to cross border transactions between related persons, i.e. connected persons. A connected person is defined in relation to natural persons, trusts, members of partnerships and companies. Companies could be connected persons if one of the companies holds at least 20 per cent of the equity shares or can exercise at least 20 per cent of the voting rights in the other company. As an additional example, in Brazil the threshold of ownership is 10 per cent of the company´s equity, and this also applies when a person (individual or company) owns at least 10% of the equity of the two companies involved in the transaction (the Brazilian company and the foreign company), as the TP legislation also applies the concepts of the Company Law. Brazilian TP legislation is very broad regarding the concept of "related persons", e.g. it also considers the kinship of the individual resident in the foreign country performing commercial relations with companies in Brazil that are controlled or managed by his or her relatives (depending on the kinship grade); and all transactions performed with listed jurisdictions (low tax and non cooperative jurisdictions) are subject to TP adjustments.

B.8.3.6. For developing countries, analysis of control might be an important challenge in ensuring that their transfer pricing legislation can be administered effectively. In addition, factors for identifying control should be carefully examined because evaluation of those factors requires complicated fact-finding procedures which might differ depending on industry sector, geographic characteristics, product cycle, etc.

B.8.4. Coverage of Transactions and Availability/Priority of Transfer Pricing Methods

B.8.4.1. Transfer pricing generally covers all cross-border transactions involving a country, regardless of whether participants are residents or non-residents. Thus, transactions conducted between a permanent establishment (PE) of a foreign company located in a jurisdiction and its affiliate company located in another jurisdiction are also taxable events under the domestic law of that jurisdiction. On the other hand, a transaction between a foreign company with a domestic PE and its affiliated company located domestically may be categorized as a non-taxable event in certain jurisdictions, such as Japan, because there is no substantial risk of income shifting beyond their borders.

B.8.4.2. However, transactions between local branch offices and their headquarters are regulated by other legislation, such as non-resident/foreign company taxation rules, and may be affected by Article 7 of bilateral tax treaties (usually based upon the UN or OECD Models). Although under such circumstances the arm's length principle generally prevails in an equivalent manner, the legal framework of taxation should be differentiated. For example, the dispute resolution mechanism might be different depending on each country's domestic law and the relevant treaty. Nevertheless, in general, the same domestic transfer pricing legislation may be applicable both to transactions between a local branch (PE) and its headquarters (see Article 7 of the UN and OECD Models), and to transactions between associated enterprises (see Article 9 of the UN and OECD Models), despite the fact that a tax treaty between the countries involved in the transaction may be applicable.

B.8.4.3. The choice of method, availability of different types of methods and the priority to be given to various different transfer pricing methods are matters often covered by domestic legislative frameworks. Availability and priority of the transfer pricing methods is one of the most important elements for domestic legislation. This is often done through administrative guidance or other subsidiary materials

[35] An equal-footing arrangement is generally not understood to pose a high risk of income-shifting, although there could still be some room for non-arm's length pricing.

rather than taxation laws. Many countries have followed the OECD Transfer Pricing Guidelines in developing their domestic legislative frameworks, and have preferred the traditional transaction methods over transactional profit methods as a means of establishing whether a transfer price was at arm's length. See further a detailed discussion of the methods in Chapter B.3, including that there is no longer considered to be a "hierarchy" of methods and that the most appropriate method should be applied.

B.8.5. Practical Guidance for Cases Without Sufficient Comparables

B.8.5.1. The most critical issue for developing countries as well as developed countries when applying any methodology will often be the lack of third party comparables. Practical guidance in establishing the basic methods without sufficient domestic information on independent comparables should be a key focus in domestic legislative frameworks. This area has not been addressed thoroughly in the OECD Transfer Pricing Guidelines and many of the transfer pricing regimes seen worldwide do not prescribe in detail how to address this issue. This Manual as a whole is intended to assist especially in this area; users should refer to Chapter B.2 on Comparability Analysis in particular. Domestic legislative frameworks and administrative guidelines should generally address the analysis of comparables as a benchmark of the arm's length principle. Such frameworks should seek to establish useful and effective guidance on matters such as comparability analysis (use of foreign data, adjustment of differences, profit split, etc), access to data, safe harbour rules, if any, and burden of proof. It is worth paying attention to the new paragraphs 2.16A to 2.16E that were added to Chapter II (Methods) of the OECD Transfer Pricing Guidelines as a result of the BEPS Project dealing with the CUP method for commodities when there is a quoted price, e.g.: "-Under the CUP method, the arm's length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price."[36] See the chapter on Methods (Chapter B.3 of this Manual) for more details.

B.8.5.2. Ease of administration is another important issue in the design of legal frameworks. Documentation requirements supported by penalties for non-compliance are the main instruments used by tax authorities for collection of sufficient information to test whether or not taxpayers have established an arm's length result. Preparing documentation is one of the most expensive compliance costs for MNEs, especially if there are differences in countries' requirements. There is value in seeking to align documentation requirements with those of other countries, especially in the same region, unless there are good reasons in terms of reducing compliance and collection costs, or specific features of local legislation, that require differences. The OECD/G20 BEPS Project specifically focused on transfer pricing documentation and country by country reporting. In October 2015 a report providing guidance on the implementation of these measures under action 13 was published.[37]

B.8.5.3. Some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guidance on self-assessment) will remain. It is therefore appropriate to continuously evaluate documentation and penalty legislation for efficiency and proportionality. The experience of countries that have introduced transfer pricing rules may be relevant to developing countries just starting to develop capability in transfer pricing. For example, at the initial stage of transfer pricing administration in the early 1990s, Japanese transfer pricing examiners experienced difficulties in collecting information about affiliated enterprises that was physically held overseas. Documentation

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[36] OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 53. Available at http://dx.doi.org/10.1787/9789264241244-en

[37] See OECD (2015): OECD/G20 Base Erosion and Profit Shifting Project: Transfer Pricing Documentation and Country-by-Country Reporting: Action 13: 2015 Final Report available at: http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en#.V-N2wfCa0dU; further guidance was issued in 2016, available at http://www.oecd.org/tax/beps/beps-actions.htm

requirements were very basic under Japanese domestic legislation at that time; examiners had to exercise their ordinary domestic investigation powers to inquire from taxpayers about international related party transactions. They soon identified that not all relevant information was necessarily kept by the Japanese unit. Japan therefore started a process of adjusting documentation requirements to reflect the actual international business practice of multinational groups by ensuring effective compliance but also taking into consideration the taxpayers' compliance burden. See Chapter C.2 on documentation for specific country practices.

B.8.6. Burden of Proof

B.8.6.1. The burden of proof in tax litigation refers to the necessity of affirmatively proving the truth of facts alleged by a litigant on a preponderance of evidence. It is also sometimes referred to as "the risk of non-persuasion" or the "burden of persuasion". A party meets this burden by convincing the fact-finder to view the facts in a way that favours that party. The party with this burden stands to lose if its evidence fails to convince the judge during a trial. A concept that precedes, but is different from, the burden of proof is "the burden of allegation", which means a party's duty to plead a matter in order for that matter to be heard in the lawsuit. A litigant needs to satisfy both the burden of allegation and the burden of proof to win a lawsuit.

B.8.6.2. The burden of proof operates in litigation. However, it is important to be able to identify the party with the burden of proof when a tax audit is conducted or when the transfer pricing assessment is made; because when a transfer pricing assessment is disputed it may ultimately end up in court.

B.8.6.3. The burden of proof for transfer pricing litigation may be determined in accordance with the burden of proof rules of civil procedure or tax litigation in general. If there are many court decisions on transfer pricing, the burden of proof for transfer pricing cases may be formulated in more detail through those precedents, depending on the general status of precedent in that jurisdiction. The burden of proof rules for transfer pricing cases differ among countries. The position that the taxpayer bears the burden of proof is taken, for example, by the Australia, Brazil, Canada, India, South Africa and the United States.

B.8.6.4. In the United States the taxpayer bears a two-fold burden of proof in order to win transfer pricing cases. The taxpayer must establish that (i) the Internal Revenue Service's (IRS's) allocation of income is arbitrary, capricious and unreasonable and (ii) the prices, royalties or other compensation in question are at arm's length. The burden of proof is shifted to the IRS or can be removed if the IRS has raised a "new matter" not previously addressed in the notice of deficiency or has attempted to increase the deficiency amount relating to transfer pricing after the issuance of the notice of deficiency.

B.8.6.5. In Canada the burden of proof rests on the taxpayer because it is the rule in any litigation.

B.8.6.6. In Australia the burden of proof is on the taxpayer, as documentation demonstrating that the terms and conditions of its transactions with related parties are consistent with arm's length terms and conditions must be prepared and maintained by the taxpayer. Division 13 of the Income Tax Assessment Act 1936 gives the Commissioner the authority to determine the arm's length price where it cannot otherwise be determined.

B.8.6.7. In India the burden of proof to establish the arm's length nature of international transactions is generally with the taxpayer. Once the taxpayer discharges this burden, the burden shifts to the tax authorities to establish that the arm's length price has not been determined in accordance with the provisions of the law or that the information or data used in the computation is not reliable or correct.

B.8.6.8. In Brazil the burden of proof is on the taxpayer, who has the right to choose the method, but has the obligation to keep the appropriate documentation, and to provide additional documentation and information in the case of a tax audit. However the burden of proof shifts to the Tax Administration if it challenges the taxpayer's TP adjustments (or the lack of adjustments).

B.8.6.9. In South Africa section 102 of the Tax Administration Act of 2011 provides that the burden

of proof that: (1) an amount, transaction, event or item is exempt or otherwise not taxable, (2) an amount or item is deductible or may be set-off, (3) an amount qualifies as a reduction of tax payable, or (4) a valuation is correct, rests with the taxpayer. Upon the hearing of any appeal to the tax court by a taxpayer against a decision by the South African Revenue Service (SARS) to disallow an objection against an assessment by SARS, the assessment may not be reversed or altered unless it is shown by the taxpayer that the basis upon which the assessment was raised is wrong. Section 129 of the Tax Administration Act requires the tax court to decide matters before it on the basis that the burden of proof as described in section 102 is upon the taxpayer.

B.8.6.10. The position that the tax authorities bear the burden of proof is taken, e.g. by France, Germany, the Netherlands and Japan.

B.8.6.11. In France the tax authorities bear the burden of proof. However, if the tax authorities resort to an assessment where no tax returns have been filed the burden is reversed so as to rest with the taxpayer.

B.8.6.12. In Germany the tax authorities bear the burden of proof with regard to the details and circumstances that establish or increase a tax claim. An exception to this rule applies if tax-relevant facts and circumstances cannot be assessed completely, even though the tax office has utilized all available and appropriate reasonable measures, and the taxpayer has failed to comply with its obligations to cooperate. Further, where the tax authorities are entitled to estimate the taxpayer's income the taxpayer has the burden of proof to show that the tax auditor's estimate is based on false or wrongfully selected assumptions.

B.8.6.13. In the Netherlands the burden of proof in transfer pricing cases generally rests with the tax authorities, provided that the taxpayer presents documentation to support the company's transfer pricing policy and demonstrates that the application of its policy is consistent with the arm's length principle. If the information supplied constitutes sufficient proof, the burden falls on the tax authorities to provide reasonable proof of suspected prices contravening the arm's length standard and thereby to cause the burden of proof to shift to the taxpayer. The tax authorities must generally prove the correctness of the adjustment when making a transfer pricing adjustment. Owing to the introduction of documentation requirements in the Netherlands, effective from 1 January 2002, the burden of proof for the arm's length nature of transfer pricing shifts to the taxpayer if a taxpayer does not supply sufficient information. The taxpayer then has to provide reasonable proof that the prices are at arm's length. As a result, not only is the burden of proof shifted but it also becomes more difficult for the taxpayer to establish its position. The State Secretary for Finance has further observed that the taxpayer is not required to complete a survey or study concerning transfer prices in comparable situations between unrelated parties. The lack of a study will not lead to a reversal of the burden of proof.

B.8.6.14. In Japan the government has the burden of proof when a taxpayer seeks to overturn an assessment of the government through litigation, including a transfer pricing adjustment, which restricts the constitutional freedom of, or imposes an obligation on, the taxpayer. In principle the government bears the burden of proof with respect to the existence of revenues and the non-existence of necessary expenses in tax litigation, provided that the court may exercise discretion in making factual assumptions when it believes that those assumptions are warranted by the facts. The burden of proof may be reversed when the taxpayer fails to produce records to enable the tax administration to undertake its examination of whether the arm's length requirements are complied with. The tax administration is then empowered to estimate the taxpayer's income in accordance with the apparent arm's length principle. The burden of proof rules in Japan have been developed in more detail through several court decisions on transfer pricing taxation. For example, in its judgment of 30 October 2008 on the *Adobe* case the Tokyo High Court held that the tax authorities bore the burden of proof for showing that they had applied the Resale Price Method correctly.[38]

[38] In this case the tax authorities compared the personal services function of the tested party (the Japanese subsidiary that was paid by its foreign parent company for performing personal services to assist the parent company's unrelated distributor in Japan) with the resale function of comparable enterprises in the same industry.

B.8.6.15. Tax administrations and taxpayers may encounter several challenges in meeting their respective burdens of proof. As a practical matter, associated enterprises normally establish the conditions for a transaction at the time the transaction is undertaken. In auditing these transactions the tax administration may have to engage in a verification process perhaps some years after the transactions have taken place. Moreover, at some point the associated enterprises may be required to prove that these transactions are consistent with the arm's length principle. As a part of the due diligence process, the arm's length principle may result in a compliance_burden for the taxpayer and an administrative burden for_the tax administration in evaluating significant numbers and types of cross-border transactions. The tax administration would review any supporting documentation prepared by the taxpayer to show that its transactions are consistent with the arm's length principle. The tax administration may also need to gather information on the comparable uncontrolled transactions and the market conditions at the time the transactions took place, for numerous and varied transactions. Such an undertaking usually becomes more difficult with the passage of time. Both taxpayers and tax administrations therefore often have difficulty in obtaining adequate information to apply the arm's length principle.

B.8.6.16. The divergent rules on the burden of proof between two countries engaged in a MAP may cause difficulty in reaching a MAP agreement. In such event, neither the treaty partner countries nor the taxpayers should misuse the burden of proof. Tax administrations as well as taxpayers should exercise good faith in showing that their determination of the transfer price is consistent with the arm's length principle regardless of which party bears the formal burden of proof.

B.8.6.17. It should be noted that in practice the burden of proof is not always a deciding factor. The burden of proof requirement nevertheless plays an important role in deciding who should disclose what. Since burden of proof is a general issue stipulated in the law of each country, the issue of whether the taxpayer or tax administration has the initial burden to prove that the pricing is in accordance with the arm's length principle should be handled within the domestic legal framework.

B.8.7. Presumptive Taxation Approaches and the Arm's Length Principle

B.8.7.1. A "presumptive taxation" approach is provided for in the law of some countries. Presumptive taxation provisions, such as those 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 taxpayer's failure to provide documentation on the arm's length price within a reasonable time (such as when information is requested of a taxpayer during an audit). Presumptive taxation is usually provided for as a last resort.

B.8.7.2. This methodology may be common in legislation operating in relation to domestic taxation and transfer pricing adjustments. However, transfer pricing adjustments in relation to foreign transactions generally create a risk of international double taxation. Most countries therefore structure such legislation carefully in a manner consistent with the arm's length principle. However, it seems that some countries lower the threshold for applying this methodology, at least in terms of establishing comparable transactions. Once again the Japanese experience can be useful.

B.8.7.3. To invoke presumptive taxation in Japan, the statute allows the tax authority to use the Resale Price Method or the Cost Plus Method by utilizing the gross profit ratio found in a company in the same industry. 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 National Tax Agency's presumed prices are at arm's length.

B.8.7.4. As stated earlier, Japan introduced the examiners' authority to inquire into third party transactions at an early stage of its transfer pricing journey. The condition to make use of this authority is that when examiners request a taxpayer to provide records, books or copies thereof, which are

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The court, however, was not persuaded by the tax administration's presentation of such comparables for the reason that the offered comparables lacked proper comparability because sales activities are different from service activities.

recognized as necessary for computing the arm's length price, the taxpayer does not provide those materials in a timely fashion. The meaning of the terms "relevant materials" and "in a timely fashion" has caused some disputes, when taxpayers have insisted that they have performed all their minimum obligations on the disclosure of basic information to support their methodologies. The focal point of discussions has been whether the burden of proof is on the tax administration or on taxpayers. The question of whether presumptive taxation has been properly applied will determine whether the burden of proof has shifted from being on the administration to being on the taxpayer.

B.8.7.5. The utility of presumptive taxation methods depends on which structure of the two choices noted above (assessment by the authorities/tax administration or self-assessment) the country concerned employs. Under a self-assessment system such as in Japan, where the tax authorities always have the burden of proof whenever they propose an adjustment, presumptive taxation may appear more attractive. On the other hand, in an anti-avoidance focused system where taxpayers have an initial burden of proof on the authorities' adjustments, a penalty system may play a more effective role than presumptive taxation. This type of presumptive taxation is not the same as the fixed margins methodology of the Brazilian legislation, which is a simplification of the arm´s length principle for the Resale Price and Cost Plus methods (see Chapter D.2).

B.8.7.6. Another issue closely related to presumptive taxation, but relevant to other systems also, 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 conditions of confidentiality. Therefore during the dispute procedure the taxpayers in relation to whom presumptive taxation is applied cannot access any materials which form the basis of the presumptive taxation. In order to secure an opportunity for taxpayers to defend their position against such taxation the OECD Guidelines advise that it would be unfair to apply a transfer pricing method on the basis of such secret comparables unless the tax administration is able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer. Disclosure of the data would provide an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.[39]

B.8.7.7. In some systems, information is called for from comparable companies to ascertain the correct factual position regarding their financial transactions or functional profile. This information may be in addition to information already publicly available with respect to the company. However if such information is used against a taxpayer for determination of the arm's length price in a particular case, this is invariably notified to the taxpayer and an opportunity is granted to the taxpayer to offer a rebuttal against the use of such information.

B.8.8. Safe Harbour Rules

B.8.8.1. Safe harbour rules are rules that apply to a category of transactions, allow a defined category of taxpayers to follow a simple set of prescribed transfer pricing rules, or exempt taxpayers from the application of the general transfer pricing rules. These rules could be limited to taxpayers with reported profits below a threshold amount, expressed as a percentage or in absolute terms. This simpler mechanism to establish tax obligations can be relied upon by a taxpayer as an alternative to a more complex and burdensome rule, such as applying the transfer pricing methodologies. There are other types of simplified mechanism for transfer pricing that the countries concerned also categorize as safe harbours. For example, another simplified mechanism sometimes used enables a company to avoid making a transfer pricing adjustment where the ratio between international transactions and the overall transactions of a given company is smaller than a percentage stipulated in the law or regulation. A safe harbour cannot normally be used to the disadvantage of a taxpayer — it is generally regarded as applicable only at the election of the taxpayer.

B.8.8.2. Safe harbour rules can be an attractive option for developing countries, mainly because they

[39] OECD Transfer Pricing Guidelines at Paragraph 3.36.

can provide predictability and ease of administration of the transfer pricing regime by a simplified method of establishing taxable profit. Supporters of this type of rule point to the advantages of simplifying compliance, lowering compliance costs and providing certainty for taxpayers, as well as administrative simplicity for tax authorities.

B.8.8.3. It is often stated that safe harbours allow tax administrations (especially when they are just beginning to administer transfer pricing laws) to focus their limited resources, including audit resources, on the more complex and higher risk cases of non-arm's length transfer pricing, especially high-margin transactions. Given the difficulties of information collection and analysis of data many developing countries might consider that at least for smaller taxpayers or less complicated transactions safe harbour rules contribute to minimizing the complexity of establishing an arm's length price, which requires collection and analysis of data. The complexity might be disproportionate to the size of the taxpayer or its level of controlled transactions.[40]

B.8.8.4. Safe harbour rules may also be useful in relieving SMEs of compliance burdens that disproportionately affect them as compared to MNEs (and may affect their ability to compete). In the case of MNEs, such rules can relieve similar compliance burdens in relation to small transactions, creating a better investment climate. For example, safe harbours can decrease the MNEs' compliance burdens to some extent by their application to a certain class of transactions within a certain defined threshold, such as low value-added services[41] and interest rates in respect of short-term inter-company "plain vanilla" (i.e. on standard terms) loans of moderate value.

B.8.8.5. There are possible down-sides to safe harbours, including the possibility of abuse. An example of such abuse is breaking down what is in reality a large transaction into several smaller ones. There is also a risk that taxpayer lobbying efforts will make it difficult to remove safe harbours when capabilities have improved and they are no longer needed, or when conditions have changed so that they are no longer appropriate. There is also the possible risk that safe harbour rules are too generous; this can possibly result in revenue unnecessarily foregone. This will also be the case if transactions that would otherwise have been concluded at lower prices are priced at the limit of the safe harbour. Or there may be a distortionary impact in that such a regime may encourage and perpetuate an economy based on small-scale or low profit transactions rather than higher risk/higher reward transactions to which the safe harbours will not apply. Safe harbours may thus even discourage investment in high-margin activity as compared to low-margin activities.

B.8.8.6. The section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines, updated in May 2013, discusses some potential disadvantages of safe harbour rules, such as the reporting of taxable income that is not in accordance with the arm's length principle, increased risk of double taxation or double non-taxation when adopted unilaterally, potential for creating inappropriate tax planning opportunities, and equity and uniformity issues due to the creation of two sets of rules in the transfer pricing area. In conclusion it is recommended that where safe harbours can be negotiated on a bilateral or multilateral basis, they may provide significant relief from compliance burdens and administrative complexity without creating problems of double taxation or double non-taxation. It is also stated that country tax administrations should carefully weigh the benefits of and concerns regarding safe harbours, making use of such provisions where they deem it appropriate.[42]

B.8.8.7. On the issue of the practical application of safe harbour regimes, the experience of the

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[40] OECD Transfer Pricing Guidelines at Paragraph 4.94 to 4.101.

[41] See the Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 and related proposals: (1) Guidelines on low value adding intra-group services and (2) Potential approaches to non-EU triangular cases available from http://www.transferpricing.com/pdf/EU_Communication01252011.pdf

[42] OECD: Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines http://www.oecd.org/ctp/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf See paragraphs E.4. Concerns over safe harbours and E.5. Recommendations on the use of safe harbours

Republic of Korea represents a relevant example. Before joining the OECD the Republic of Korea's national tax authority, the National Tax Service (NTS), employed a so-called "standard offer-commission rate" for import and export business taxation. Under this scheme, the NTS used a standard offer commission rate based on a survey of actual commission rates. This was available as a last resort under its ruling only in cases where other methods for identifying the arm's length rate were inapplicable in determining commission rates charged by a foreign party. The NTS finally repealed this ruling as it considered the ruling to be contrary to the arm's length principle.

B.8.8.8. In India safe harbour provisions were introduced in the Indian Income Tax Act with effect from 1st April 2009. The relevant rules were notified on 18 September 2013 after detailed consultation with all the stakeholders. These provisions were applicable to all eligible taxpayers and eleven categories of eligible international transactions on the basis of an option exercised by such taxpayers. The sectors covered under the safe harbour rules are: software development services; information technology enabled services; knowledge process outsourcing services; advancing intragroup loans; provision of corporate guarantees; contract research and development services relating to software development; contract research and development services relating to generic pharmaceutical drugs; and manufacturing and export of core and non-core auto components. The option of a safe harbour validly exercised by the taxpayer is expected to be in force for a specified period as opted for by the taxpayer or for a period of five years whichever is less.

B.8.9. Adjustments

B.8.9.1. A taxpayer may seek, on examination, a reduction in a transfer pricing adjustment based on an unintentional over-reporting of taxable income. However, no clear guidance in this regard is found in the OECD Transfer Pricing Guidelines. The only guidance available indicates that tax administrations may or may not grant the request for downward adjustment at their own discretion.[43] It adds that tax administrations may also consider such requests in the context of MAPs and corresponding adjustments. This is an issue which developing countries should also consider when designing their domestic legal environment for transfer pricing.

B.8.9.2. The Republic of Korea's experience may be considered as an example in this regard. In 2010, the Republic of Korea clarified in its tax law that a downward adjustment should be applied in cases where a tax adjustment is made under a transfer pricing method using multiple year data. Therefore, tax officials are no longer given any discretion to make the adjustment only for years with a deficient profit, and to disregard years with excess profits, when they adjust the taxpayer's profit level under a transfer pricing method using multiple year data.

B.8.9.3. In South Africa the legislative provision that requires that terms and conditions should be adjusted to those that would have existed had the parties been independent persons dealing at arm's length is limited to situations where the taxpayer derives a tax benefit. The over-reporting of taxable income would not fall within the meaning of a tax benefit.

B.8.10. Advance Pricing Agreements/Arrangements

B.8.10.1. APAs have been introduced in many countries to confirm the arm's length result in advance by agreement between taxpayers and tax authorities on certain sets of criteria (transfer pricing methods, comparables and appropriate adjustment thereto, critical assumptions as to future events, etc). To a great extent, APAs have reduced transfer pricing adjustment risks for multinationals, especially under bilateral APAs involving two countries, and therefore the number of applications for APAs has reached almost the number of adjustment cases in some developed countries.[44] On the other hand, although unilateral APAs are categorized as partial solutions for double taxation, they are also considered useful in specific

[43] OECD Transfer Pricing Guidelines at Paragraph 3.17.

[44] From July 1, 2015 to June 30, 2016, Japan received 149 applications for APAs, whereas it adjusted 240 cases after examination for the same period.

cases depending on all the facts and circumstances.

The OECD Transfer Pricing Guidelines strongly endorse APAs as a supplement to the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues.[45]

B.8.10.2. One of the key advantages of adopting an APA system is that uncertainty can be eliminated through enhancement of predictability of the taxation of international transactions. Developing countries thus have a good opportunity to obtain access to the existing documentation which is relevant to their local operations. A second advantage is that APAs can provide an opportunity for both tax administrations and taxpayers to consult and cooperate in a non-adversarial spirit and environment. As a third advantage an APA may prevent costly and time-consuming examinations and litigation of major transfer pricing issues for taxpayers and tax administrations. Fourthly, the disclosure and information aspects of an APA programme as well as the cooperative attitude under which an APA can be negotiated may assist tax administrations in gaining insight into complex international transactions undertaken by MNEs.[46]

B.8.10.3. Some consider adequate levels of experience to be necessary before the appropriate type of APA can be achieved, while others see the experience gained in concluding APAs as an important part of capacity building on transfer pricing issues. Matching operational capability to offer APAs with operational capability of the transfer pricing regime is thus an important factor in the design of the domestic legal environment.

B.8.10.4. Some countries choose not to have APAs, at least for some time after their transfer pricing regime is put in place. For example, they may feel that they need to develop capacity and skills before they can properly evaluate what is an appropriate APA system for them.[47] Other countries are concerned that APAs are not useful in a transfer pricing regime because they tend to be sought by companies that are in broad conformity with the arm's length principle and may divert scarce resources from achieving compliance in the worst cases of avoidance. As with any such mechanism, checks and balances must be provided to ensure that the APA process is applied consistently between taxpayers and is not subject to abuse or integrity issues. The advantages and disadvantages of APAs are discussed in more detail in Chapter C.4 on Dispute Resolution and Avoidance: it may however be noted that consideration must be given to the inclusion of an APA programme at different stages of the design of a legal framework for transfer pricing.

B.8.11. Dispute Resolution

B.8.11.1. As stated earlier, an upward transfer pricing adjustment generally causes substantial double taxation for the cross-border business, unless there is a "corresponding adjustment" downward by the other party to the transaction — i.e. by the other country's tax authority. For this purpose, countries should take into consideration domestic dispute resolution procedures as well as treaty-based dispute resolution mechanisms when designing a transfer pricing regime. Domestic remedies are expected to work effectively for transfer pricing cases, if a transfer pricing adjustment lacks a domestic legal basis. However, even when a taxpayer partially wins the case, the double taxation arising from an adjustment is still not recovered unless the MAP works successfully to reach agreement on the arm's length result between the treaty partners, with one treaty partner making a corresponding adjustment in its jurisdiction. In addition, a bilateral APA not only plays a major role in the confirmation of future taxation but also in

[45] OECD Transfer Pricing Guidelines at Paragraph 4.123 to 4.165. In addition, see the Annex to Chapter 6 on "Guidelines for conducting APA under the MAP".

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[46] OECD Transfer Pricing Guidelines at Paragraph F.3 Advantages of advance pricing arrangements

[47] After almost a decade of experience of implementation of transfer pricing regulations in the country, India introduced APAs with effect from 1st July 2012 in the Income Tax Act. Financial Year 2013-14 was the first year that APAs came into effect. Since then India has signed more than 100 unilateral and bilateral APAs.

relation to past taxation. The roll-back system for APAs is accepted by many countries, where the tax authority decides that the agreed transfer pricing method is also appropriate for past open years, considering all the facts and circumstances. Thus, dispute resolution based upon the MAP provision in tax treaties (usually based upon Article 25 of either the UN or OECD Model) has become one of the most important procedures for taxpayers.

B.8.11.2. Article 25 of the OECD Model Tax Convention was revised in 2008 to introduce the possibility of arbitration of unresolved MAP issues. In addition to guidance on how to reach a conclusion when dealing with these issues, it ensures that the Competent Authorities seek to resolve issues within a reasonable period of time, something which has not always happened in practice. Some issues for developing countries, when considering the possible use of arbitration or when asked to consider it by a potential treaty partner, are addressed in the Commentary to Article 25 of the UN Model. Alternative versions of the Article, with or without arbitration, are included for consideration depending on the preferences of treaty partners. The substantive issues regarding MAP are discussed in Chapter 4 of Part C; however, for the purposes of the present chapter, the need to accommodate treaty obligations and processes should be taken into account in the design of the legal environment.

B.8.11.3. For most developing countries, arbitration is a new issue to be addressed. The reality is that for a long time only a very small number of cases will be covered by a bilateral treaty with an arbitration provision, especially in the case of treaties where the other party is a developing country. Moreover, even when an arbitration clause exists in the Article related to MAP, it is essential that the MAP itself is operating as efficiently and effectively as possible.

B.8.11.4. One issue experienced by some developing countries is that there is insufficient current experience in negotiation with other competent authorities on transfer pricing matters. Competent Authorities in developing countries have to face some difficult conditions at the initial stage of the design and implementation of the transfer pricing regime. There may be differences between the two Competent Authorities' abilities to access information on transfer pricing methods; and there may also be limited information available to the local entity while the related party may have access to more and better data. However, this may be resolved through effective exchange of information. A further problem is the lack of experience in conducting a MAP in transfer pricing cases.

B.8.11.5. The Japanese experience can be considered as one reference point. At the initial stage of engaging in MAPs Japan experienced the disadvantages listed above. However, after developing effective partnerships with many treaty partners a large amount of information was successfully shared. Intensive and practical discussions on the transfer pricing methods or comparability analysis thus improved the capacity of Japan's Competent Authority. So far, although there were exceptional cases with a negotiation period beyond two years, the majority of MAP cases have been successfully concluded approximately within the two year period which is now included as a target period in Article 25(5) of the OECD Model Convention. After stabilizing its own capacity building for MAP, Japan has made some contributions in this area, bilaterally or multilaterally, for the benefit of new negotiating partners.

B.8.11.6. The Indian experience in this regard has been somewhat similar. The Indian Competent Authority has been successfully negotiating with treaty partners for the settlement of cases under MAP. After years of experience gained from negotiations with treaty partners and improvements with regard to the exchange of information, the Indian Competent Authority has been successful in concluding settlements of large cases.