C.1. Establishing and Updating Transfer Pricing Regimes

Contents

C.1.1 Introduction

C.1.1.1. Overview of Part C

C.1.1.1.1. Part C of this Manual addresses the practical implementation of transfer pricing rules in a particular jurisdiction guided by the legislative design principles outlined in B.8. This Chapter, C.1., provides guidance on

- How the principles and the substantive issues raised in Part B can be implemented in a national transfer pricing regime through laws and subsidiary regulations.
- How that national transfer pricing regimes relates to domestic tax laws
- The position of transfer pricing rules within the overall framework of international tax rules within that domestic regime
- How to keep the newly implemented transfer pricing regime updated, and to administer it on a daily basis

C.1.1.1.2. The Chapters that follow in Part C then deal in depth with specific areas of implementation and administration. Chapter C.2. covers the documentation requirements central to a transfer pricing regime, transparency issues and exchange of information, in an increasingly complex business environment discussed in detail at Part A. Chapter C.3. discusses transfer pricing audits and provides guidance on approaches to managing audit programmes and capacity. Chapter C.4. provides detail and approaches to dispute resolution techniques, including how to access dispute resolution systems.

C.1.1.1.3. Chapter C.5 then brings together these issues for a tax administration in a developing country to provide approaches to build capacity within the tax administration. Part C thus aims to provide a set of approaches by which a tax administration in a developing country can introduce and sustain a transfer pricing regime that meets international standards.

C.1.1.2. Key considerations in the design of the transfer pricing regime

C.1.1.2.1. Two different approaches are broadly discussed at B.8.2.4, to implement the arm's length standard with respect to related party transactions, namely:

- Incorporate the arm's length principle, as well as other guiding transfer pricing principles into the income tax legislation, with the detailed transfer pricing guidelines expressed as Regulations, Rules or other subsidiary legislation.
- Incorporate the full transfer pricing regime into the income tax system. A typical approach may see the transfer pricing regime being incorporated in a Supplementary law, regulated in Law and further explained in an Administrative ordinance. All features of the regime are thus legal in nature.

Irrespective of which approach is taken in policy design, the measures need have full force of domestic tax law.

C.1.1.2.2. As a policy choice, governments should decide when, how and in what format they want to receive transfer pricing information. The form should be the most convenient format for the tax administration to process and respond to the information received, if required.

C.1.1.2.3. Disclosure requirements included in legislation may be voluntary, as part of the regular submission of annual returns, at the end of accounting/assessment periods, or be required as a result of the conclusion of a transaction. In these cases, taxpayers are required to voluntarily inform the tax administration of the existence of a related party transaction, and to provide the details of that transaction.

C.1.1.2.4. On the other hand, the legislation may require the taxpayer to retain the information and provide it upon request In that case the taxpayer has the responsibility to have adequate documentation to prove that the transaction was effected at arm's length if asked by the tax administration to demonstrate that.

C.1.1.2.5. An example of voluntary information requirements on transfer pricing in filing the annual income-tax return is the related party transactions reporting form. A specific example is the Australian International Dealings Schedule that has to be filed with the annual corporate income tax return. Another example is the Brazilian Corporate Income Tax Return (Declaração de Informações Econômico-Fiscais da Pessoa Jurídica, (DIPJ)) where the taxpayer is required to voluntarily report all transfer pricing transactions taking place within a period or annual basis (depending on the taxpayer's reporting schedule). Taxpayers are required to report certain transactions with non-residents as they arise through these forms. The South Africa transfer pricing questionnaire, required to be submitted with the annual corporate tax return, is a good non-OECD example.

C.1.1.2.6. The voluntary disclosure of information is the most suitable option for tax administrations with capacity constraints – it may, as a result, be the preferred option for a developing country with limited resources to gather taxpayer information. Under this option, it is important for the regulation in force to make disclosure of information a function of the transfer pricing legislation so that the obligation to report derives directly from the main legislation (without any additional administrative requirements). That will provide tax administrations with taxpayer information which would allow them to better target audit procedures. Tax administrations should make sure they have human and technological resources in place to be able to audit the information, if required.

C.1.1.3. Balance to be struck between statute and subsidiary regulations

C.1.1.3.1. As mentioned in C.1.1.1, above, some tax systems contain a general recognition of the basic aspects of a tax obligation, and then issue extensive regulations explaining how the rules would apply in practice. This essentially means recognising the arm's length principle and the basic principles applicable to transfer pricing through the primary legislation.

C.1.1.3.2. This is the case in the United States, for example, where the substantive provisions are included in the Internal Revenue Code (IRC) Section 482, and then extensively regulated in the Treasury Regulation Section 1.482–1 through Section 1.482–9. Legislative and procedural regulations have the weight of law in the United States, and are binding on the taxpayer. Therefore, even though the IRC only provides the foundation to the transfer pricing principle, the obligation to observe transfer pricing rules and the determination on how to observe it is mandated by the regulations.

C.1.1.3.3. Sometimes domestic tax systems are not able to confer the appropriate weight of authority to the accompanying regulation (as a result of the way the domestic tax system is organized or the legal system), but the bulk of the regulatory provision is, nevertheless, only included in regulation. That is the case in Belgium, and in several other European countries. The arm's length principle was formally introduced into Belgian tax law by adding a second paragraph to section 185 of the Income Tax Code in the second half of 2004. As in the USA, only the founding principle is foreseen in statute. The bulk of the regulation is contained in administrative guidelines (circular letters). Administrative guidelines are binding for the Belgian tax authorities, but not on the taxpayers who, in theory, can tax plan around those rules. Therefore the taxpayer can rely on those rules but is not bound by them.

C.1.1.3.4. India has applied a more balanced approach where Sections 92 to 92F of the Income Tax Act, 1961 outlines the statutory principles that are then amplified in Rules 10A to 10E of Income-tax Rules,1962. E.g. Sec. 92C cover determination of arm's length price while Rule 10B amplifies the principles to be followed.

C.1.1.3.5. On the opposite side of the spectrum is Brazil, where all of the transfer pricing system is regulated through primary legislation (Supplementary Laws, Ordinary Laws, Normative Ordinances and Administrative Acts, and therefore it is binding on the taxpayer and the tax administration.

C.1.1.3.6. Developing countries should assess which system is most suitable considering their own domestic tax legislation and the level of complexity they want to assume through the application of the transfer pricing legislation. Objective statutory provisions tend to provide greater certainty because they are binding on taxpayers and the tax administration. They are also likely to provide fewer margins for dispute, making the system simpler, which in turn puts less pressure on already limited human resources from the tax administration. Consideration should also be given on the status of rulings; e.g. Australia are administratively binding on the tax administration, but not on the taxpayer.

C.1.1.4. Transfer pricing organization in tax administration

C.1.1.4.1. An important part of implementing a transfer pricing regime is determining which part of the tax administration should undertake transfer pricing work. The typical options are:

- Creating a transfer pricing department or division, tasked with the responsibility to handle all transfer pricing work arising from the application of the rules;
- Placing the transfer pricing work within an international operations group within the tax administration.

Consider compliance with the transfer pricing regime a part of the compliance responsibility of all taxpayers subject to these rules, and seek to train all officers who are likely to face transfer pricing issuesC.1.1.4.2. In addition to one of the three above options, tax administrations also have the option of creating specially designated departments within other departments, to deal with high profile cases, special cases, or with certain groups of taxpayers. In this case, countries might consider also creating the following sub-departments:

- Placing the work within a LTU/LTO (Large Taxpayers Unit/Office) and to build up capacity of officials working within that office in transfer pricing.
- Developing transfer pricing capacity in specific industry focused units which the tax administration considers to be particularly susceptible to transfer mispricing – e.g. pharmaceuticals, oil and gas, automotive, etc.

C.1.1.4.3. The choice to be made by a particular country will depend on its particular circumstances and capacity available. The choice may be also be dynamic, i.e. as capacity is developed along the lines suggested at C.5. E.g. at the early stages of the regime being implemented, the transfer pricing work can be concentrated in the part of the tax administration that deals with international tax issues. As capacity is built and more cases seen, a new section can be created within the LTU/LTO where the most high profile cases may be expected to emerge. Over time, more specialist knowledge can be built up and spread wider across the tax administration. See further C.3.2. for a detailed discussion on audit capability.

C.1.1.4.4. LTU/LTOs have been implemented across the world, and allow the tax administration to create centres of competence dealing with separate taxpayer types. Such units are often part of a reformed administration that include structuring the administration along functional lines, focusing on the taxpayer as the administration's 'customer' the minimization of whose compliance cost has to be the main objective of the administration. It is quite common to allocate the transfer pricing inspection division to the LTU/LTO which is then considered the central repository of experience.

C.1.1.4.5. Such an allocation of responsibilities can foster evolutionary, learning approaches. A good example is Brazil where the transfer pricing programme in the LTO (known as the DEMAC) focused its audits mainly at specific sectors such as pharmaceuticals and automobiles. However, as the audit teams grew in sophistication in their approaches and as they grow in number and experience, the focus became wider.

C.1.1.4.6. Finally, the design of a good tax administration must include an effective audit program capable of detecting and penalizing non-compliant taxpayers. Such an audit programme could grow out of a larger compliance team, and could include industry and/or issues oriented audits, comprehensive regular audits of specific businesses that fall within risk criteria and, fully fledged tax fraud investigations. Joint investigation programmes for corporate income tax and GST non-compliance can also be planned by more sophisticated tax administrations. See further Chapter C.3.

C.1.1.4.7. Open consultation with business and stakeholders prior to implementation or modification of a particular piece of legislation may also help create more common understanding between the taxpayer and the tax administration. This will help avoid potential future disputes by allowing time for taxpayers to foretell the issues that might cause greatest concern in the legislation about to be implemented. C.1.1.4.8. Use of information and communication technology (ICT) in tax administration is now a central part of capacity development. Tax administrations should consider use of ICT to increase transparency in the tax system and to automate processes. Increase in transparency means making information more readily available, without the need for personal contact, and automated communications which might include online access to templates, case studies, step-by-step guidelines (even if informal guidelines of no legal status), explanation of legislative changes, publication of pre-selected information geared towards specific industries, or types of taxpayers (i.e. leaflets reporting on information pertinent to small and medium enterprises, a separate information leaflet for large taxpayers, one for car makers, pharmaceuticals, etc). Automation of processes would include introduction or extension of electronic filing of transfer pricing related compliance obligations, and possibly the use of trusted third party platforms. These measures have the potential to significantly reduce business compliance costs, improve taxpayer confidence and increase simplicity; they may also support anti-corruption initiatives and improve perceptions.

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C.1.2. Transfer pricing rules in national tax regime

C.1.2.1. Domestic rules

C.1.2.1.1. The Associated Enterprises article (Article 9) of tax treaties sets out the basic conditions for transfer pricing adjustments and for corresponding adjustments where there is a risk of double taxation. Although Article 9 advises the application of the arm's length principle it does not set out detailed transfer pricing rules. The Article is not considered to create a domestic transfer pricing regime if this does not already exist in a particular country. Countries must therefore formulate detailed domestic legislation to implement transfer pricing rules. Often countries apply their domestic transfer pricing rules only to cross-border transactions. See B.1.7. for an exhaustive discussion of the substantive principles in this regard.

C.1.2.1.2. There are variations between countries in the definition of an "associated enterprise" based on factors such as the domestic legal system and circumstances of the country. The definition often uses a number of factors such as a minimum shareholding level or effective control of financial, personnel, trading conditions or other factors. There may also be a de minimis criterion under which related party transactions only come within the transfer pricing rules if they reach a certain amount. Although international consistency in the definition of associated persons and application of the arm's length principle is beneficial each country must design its transfer pricing legislation in a way that is consistent with its legal and administrative framework, treaty obligations and resources. This can also be an evolutionary process; as the country develops its transfer pricing regime, it will also need to ensure that the administrative rules in, e.g. a Taxes Management Act, is simultaneously kept up to date.

C.1.2.1.3. Some countries may include safe harbour rules to exempt taxpayers meeting certain defined criteria from the need to comply with specific aspects of the transfer pricing rules. This reduces taxpayer compliance costs, increases certainty and also reduces costs of tax collection. The tax administration can focus audit resources on higher risk cases in terms of revenue at stake and risk of non-compliance. Safe harbours may however encourage tax planning and avoidance and are incompatible with the arm's length principle. There is also a risk of double taxation where rules differ between countries. For further discussion see section B.1.7.5. Some key points to be considered in this regard are outlined below. These are not exhaustive features of a developing country regime, but they tend to be the most problematic issues faced by a tax administration.

- The application of safe harbours for juridical certainty
- The documentation requirements, which can also make or break a transfer pricing system
- The time limits for application of the legislation.

C.1.2.2. Interaction of transfer pricing provisions with other cross-border rules

C.1.2.2.1. In designing a domestic tax system consideration must be given to the interaction of transfer pricing rules with Controlled Foreign Corporation (CFC) rules. CFC rules are designed to prevent tax being deferred or avoided by taxpayers using foreign corporations in which they hold a controlling shareholding in low-tax jurisdictions. Without CFC rules income could be left in low tax jurisdictions and remain outside the scope of domestic tax rules. CFC rules treat this income as though it has been repatriated and it is therefore taxable on the resident shareholders. It is widely considered that the transfer pricing rules should have priority and the CFC rules should apply to the profits remaining in controlled foreign companies after application of the arm's length principle (see section B.1.7.7).

C.1.2.2.2. It may sometimes be more advantageous for tax purposes to finance a company by way of debt than of equity as the interest paid on debt may be deducted for tax purposes while dividends on equity may not be tax deductible. In many countries thin capitalization provisions have been introduced to deny a deduction for excessive interest payments. This is done by prescribing a maximum debt to equity ratio and disallowing a proportion of interest payments if debt exceeds this maximum level (see section B.1.7.8). These rules protect the tax base by discouraging cross-border shifting of profits through excessive interest payments on debt. If transfer pricing rules also apply to interest on related party financing the arm's length principle may be applied to intragroup financing before the application of thin capitalization rules.

C.1.2.2.3. Some countries that do not have very detailed transfer pricing rules in place may deal with abusive forms of transfer pricing through the use of a general anti-avoidance rule (GAAR). Abusive non-arm's length transactions may come within the scope of the GAAR. This may be useful in the early stages of introducing a transfer pricing regime, however use of the GAAR in transfer pricing issues may create uncertainty for business which may therefore prefer detailed transfer pricing legislation, regulations or guidance.

C.1.3. Keeping transfer pricing regimes updated

C.1.3.1 Gathering Information

C.1.3.1.1. This section provides information to developing countries about resources available to follow the latest developments in international tax rules and initiatives. It also provides guidance on the mechanisms available for developing countries to obtain training, information updates and to engage in international tax dialogue after it has implemented transfer pricing rules. Such resources will assist countries in keeping abreast of developments, exchange peer experiences and keep their transfer pricing regimes updated.

Regional Coordination through the existing intergovernmental agencies

C.1.3.1.2. One of the suggested approaches to keep up to date with developments in international transfer pricing legislation is to engage with regional intergovernmental agencies such as CREDAF, International Organization of Tax Administrations (IOTA), Inter-American Centre of Tax Administrations (CIAT), the African Tax Administration Forum (ATAF), Study Group on Asian Tax Administration and Research (SGATAR), and the Commonwealth Association of Tax Administrators (CATA).

C.1.3.1.3. These are non-profit international public organizations that can provide specialized technical assistance for the modernization and strengthening of tax administrations in different regions of the world, through conferences, targeted field missions, exchange of information, and sometimes even targeted training. As their names indicate, they tend to cater for a specific geographic region, or a particular group of countries grouped through similar characteristics. Some countries are members to more than one regional organisation.[1]

(i) CIAT's predominant membership is from the Americas,[2]
(ii) ATAF's membership is primarily of African countries,
(iii) SGATAR's membership is located in the Asia-Pacific region and is currently composed of 17 member tax administrations.
(iv) CATA's membership currently includes forty-six Commonwealth countries spread over all geographic regions of the world.

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[1] For example Australia, is a member of both SGATAR and CATA.

[2] There is a special category of associate member. CIAT's General Assembly may accept as Associate Members countries from regions other than the Americas that apply for accession and have the approval of the Executive Council. There are currently 5 European countries, 2 African countries and 1 Asian country in CIAT's membership.

Engage with Institutional Stakeholders

C.1.3.1.4. The United Nations, OECD, World Bank and the IMF are all agencies who consistently engage with countries providing capacity development. Countries generally need to apply to those agencies, seeking training which may be specific to the requesting country, or may be provided regionally, as part of a larger group of tax administrators. Following the work of the United Nations and the OECD is key to keeping domestic transfer pricing regimes updated. Engaging in international tax dialogues is also a means to obtaining updated information with respect to the latest developments in transfer pricing.

C.1.3.1.5. Some national and regional tax administrations also provide very good guidance in the field of international taxation in general, and transfer pricing in specific, in areas where they themselves face difficulties in compliance and policy formulation. The United Kingdom's HMRC, South Africa's SARS, the Brazilian Receita Federal, the United States' IRS, and the European Commission (within the European Union) are all very sophisticated bodies which provide guidance on policy and on their own interpretation of certain international tax provisions.[3] These national tax administrations and others could be followed and even consulted by developing nations wishing to resolve perhaps similar problems arising as a result of the application of their own transfer pricing rules.

C.1.3.1.6. Finally, some academic institutions, research centres and think tanks have funds to invest in capacity development in developing countries, and encourage their experts to provide such assistance.

Create a clearing House for information and capacity development with like-minded countries

C.1.3.1.7. Like-minded tax administrations should come together to share experiences and tax information which they consider useful for other tax administrations. That is particularly relevant for countries who share borders, or who have similar legal backgrounds, or may be part of a regional economic group.

C.1.3.1.8. By acting within an organised group, tax administrations can share training expenses while promoting capacity development, disseminate knowledge, organise joint seminars, share the contents of training received from intergovernmental institutions such as the World Bank, the UN, OECD and the IMF, and also bid for capacity development money from donor agencies, foundations and agencies.

Participate in the South-South Dialogue for capacity development

C.1.3.1.9. In general, tax authorities in developing countries lack sufficient qualified and experienced resources to understand the concerns of MNEs and to deal with controversial transfer pricing issues,

[3] Some of them are not available in English.

especially in view of global developments around new fast developing topics such as BEPS. Regular training and experience sharing is necessary for capacity development. A knowledge sharing platform with other tax authorities (a regional institution, or a clearing house institution) could be an important step in this regard . International secondments to gain more practical experience at the United Nations, the OECD or in another tax administration should be considered if possible. An independent external consultancy body might also be an option, as explained below. Other capacity development issues are covered in detail at Chapter C.5.

C.1.3.1.10. A higher risk of unnecessary miscommunications between taxpayers and revenue authorities on some less important points is one of the main challenges in countries where transfer pricing regulations are relatively new. A greater pool of transfer pricing experts would be helpful to revenue authorities and taxpayers who are trying to address complex transfer pricing issues in such countries. These experts could assist, e.g. revenue authorities and taxpayers in advanced dispute resolution processes to provide expert perspectives. This could be a short term solution to help to reduce the number of protracted enquiries where taxpayers have tried to apply approaches that are consistent with international principles.

C.1.3.1.11. A pool of experts might be found from engagement with regional intergovernmental organizations, neighbouring countries, countries sharing the same language or from active participation in a South-South Dialogue.

C.1.3.2. Updating national tax legislation

C.1.3.2.1. This section seeks to provide advice on the instruments that exist for tax administrations to introduce unilateral policies that draw upon the current international discussions, without having to go through the whole legislative process in modifying tax legislation that might at times be controversial or suit purposes other than transfer pricing.

Advanced Pricing Agreements

C.1.3.2.2. As previously mentioned in Chapter B.8.10.1., unilateral APAs tend to be tailored agreements between the tax authority and one taxpayer. It is an instrument through which countries can pre-determine, in agreement with the taxpayer, the result of the application of the arm's length standard to a particular transaction or sets of transactions, based on certain sets of criteria (transfer pricing methods, comparables and appropriate adjustment thereto, critical assumptions as to future events, etc).

C.1.3.2.3. Many countries have introduced APA procedures in their domestic laws through different legal forms. For example, in certain countries an APA may be a legally binding engagement between taxpayers and tax authorities, while in other countries it may be a more informal arrangement between the tax authorities and the taxpayer. The possible advantages and disadvantages of APAs for developing country administrations and taxpayers, including some implementation issues, are addressed in Chapter C.4.

C.1.3.2.3. APAs have, to some extent, 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. This, however, is not true for developing countries. There are only a few APAs signed, often unilateral and often for outbound, developing country headquartered companies. Developing country tax administrations tend to be less comfortable signing APAs on cross-border transactions, due to the increased risk and complexity inherent to those transactions. Bilateral APAs are seldom negotiated; it thought that limitation of resources and the lack of practical experience are the main reasons for this.

C.1.3.2.4. Developing countries could use unilateral, as well as bilateral, APAs as an instrument to be able to adapt existing transfer pricing legislation to specific, unique cases. It is a useful instrument to

(i) avoid disputes involving an extemporaneous tax adjustment;
(ii) reduce the manpower employed towards tax auditing procedures
(iii)) be able to forecast how much tax revenue can be collected as a result of the application of transfer pricing rules in any given year; and
(iv) improve the relationship between the taxpayer and tax administration.

Tax Rulings

C.1.3.2.5. Tax rulings work very similarly to APAs. The difference between them is that a tax ruling can be granted on any tax issue, and an APA relates only to the application of transfer pricing regulations. As under the APA, tax rulings tend to grant greater legal certainty to the tax system by establishing, a priori, a tax rate, or a modified tax base, or by recognising a taxpayer's unique circumstances. A ruling may also be used to attract foreign direct investment, assuming that the tax administration uses the tax ruling to grant a more favourable tax treatment to a specific taxpayer.

C.1.3.2.6. Tax rulings also help create an active tax dialogue between taxpayer and tax administration and stimulates greater cooperation to the extent both parties fix an understanding to pay or not to pay certain taxes. Since tax rulings are tailored towards a specific taxpayer or a group of taxpayer, it can also have the effect of modifying the domestic tax legislation of a country through a "special proceeding," suitable only for a particular situation or taxpayer, without having to modify the entire legal tax system of a country. To that extent, and because the legislative process runs a lot more slowly than the conferral of an administrative decision, it might be helpful in allowing countries to follow the trends set in the international scene. A country wishing to grant tax rulings needs to have the legal basis for it in its domestic tax legislation.

Establish an International Consultancy Body

C.1.3.2.7. Developing countries might benefit from establishing a third party organisation (an expert body, composed of academics, industry experts, and/or government officials) to advise them on the ways through which they might be able to fine tune or update their legislation. A third party advisory group could suggest updates, or point out to controversial issues in the country's legislation, suggest action in certain transfer pricing areas, and even audit the country’s tax legislation for improvement.

By contributing to regional and global dialogues, developing countries might be able to benefit from the use of existing consultancy bodies, used by countries with similar legislation, or countries located within the same geographic region. This may help manage costs if countries opt to be evaluated contemporaneously with each other. The effort could be hosted in an existing cooperation organization, as mentioned above, or within an UN specialized organization to further manage costs.