

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 in writing are sought and should be sent to the Secretariat to the UN Tax Committee at taxffdoffice@un.org by 8 November 2010 at the latest. The Secretariat particularly notes the contribution of Professors Aoyama and Miyatake and of Mr. Kyung Geun Lee in preparing this draft.

Chapter [2A] – The General Legal Environment

1. Outline of this Chapter

1. Transfer Pricing (“TP”) in domestic legislation was introduced by the United Kingdom in 1915 and shortly thereafter by the United States in 1917. The aim of the legislation was to secure government revenues needed at the time of World War I. However, TP was not an issue of great concern until late 1960s when international commercial transactions expanded greatly in volume. The development of TP legislation has mainly been led by developed countries in the context of a rapid growth of international trade and investment. Although different legislative traditions apply, the content of domestic TP regulations have gradually found some harmonisation, especially in its theory, in accordance with the “arm’s length Principle”. The arm’s length principle is reflected in Article 9 and its commentaries of both the UN and OECD Models. Now, it can be said that TP legislation has become almost identical in many tax jurisdictions, regardless of origin, even if the application is not always so closely aligned.

2. With the increase of cases where tax authorities have made adjustments to transfer prices set by the related entities, taxpayers increasingly require more practical dispute resolution mechanisms to address double taxation cases caused by such TP adjustments. As a result, the Competent Authority (CA) negotiations (as 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 (th), in a low-taxing jurisdiction, through *incorrect* transfer prices. The aim of the price setting is to reduce the overall tax burden of the ifp.

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.

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 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.

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12. Thus, there is still a great deal of room for double taxation to occur. For example where specific guidance on the implementation of common ALP is different from one country to another and relevant tax treaties, as well as other materials such as the commentaries on the UN or OECD Models, do not bridge this gap with any specific understanding or interpretative guidance.

13. In the following we will demonstrate potential significant differences in domestic law which may result in major differences in how the countries interpret or apply the ALP.

2.2 Priority of TPM: Best Method rule vs. Priority on the traditional methods

14. Under previous OECD TP Guidelines (i.e. under the 1995 and 2009 versions), traditional transactional methods (i.e., CUP, RP, CP) take priority over other methods (i.e. TNMM, PS). Many countries have followed the OECD TP Guidelines in their domestic legislation. However, as current transactions conducted by affiliated group companies often involve high valued intangibles or tailor-made expensive personal services, traditional transactional methods are

rarely able to finally determine the arm's length price in practice. Further, there are significant difficulties in collecting comparable data, especially for many developing countries, in view of the cost of relevant databases and the fact that they normally will not have data drawn from relevant countries. This means that

there may not be comparables or they will at least need significant adjustment – both issues are discussed later in this Manual.

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.

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 materialized, it would be expected that at least an agreement on the most appropriate method rule by any tax treaty could attain that objective on MAP cases.

2.3 *Practical Guidance for cases without sufficient comparables*

17. During the initial stage of foreign direct investment (FDI), the important functions and risks are generally performed or assumed directly by the parent company located abroad. When

manufacturer or a fee-base distributor, then, the traditional transactional methods are most likely to be workable in practice. As the role of the domestic subsidiary becomes more complex over time, TNMM and PS (i.e. “non-traditional” methods) are likely to play a much bigger role in reaching an arm’s length price or range. Thus, in developing countries, the most appropriate method principle, if applicable, would be activated mainly for the later stage of the FDI.

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

in-depth adjustment on them. The legitimacy of such procedures heavily depends on the accuracy of comparability analysis as a whole.

21. In clarifying the procedures, we need some examples of the TP adjustment conducted by developing countries which have used different country or different industry sector's data base. One simple example is a Japanese case on the interest receipt on the foreign currency lending to the Thailand subsidiary. A 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.

23. The NTA has issued the revised TP Guidelines (Public Notice) in 2007 which identifies the comparability analysis of inter-company loans denominated in foreign currency by following this decision.

| 24. In India, Transfer Pricing officers have noticed several cases where Indian subsidiaries

39. In other words, safe harbors may be useful in relieving small and medium sized enterprises of compliance burdens that disproportionately affect them as compared with MNEs (and may affect their ability to compete) or relieving MNEs of similar burdens in relation to small transactions, for a better investment climate. Of course, there are possible down-sides to safe harbors, including possible abuse (such as appearing to make a large transaction into several smaller ones) and the risk that lobbying will make it hard to remove safe harbors when capabilities have 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 compliance burdens will be higher, and there may even be a discouragement of investment in high margin activity as compared to low margin activities.

40. The OECD TP guidelines, however, also discuss substantial other potential disadvantages with the safe harbor rule, such as the high risk of double taxation and mutual agreement procedure difficulties. Following this analysis, the OECD guidelines, instead of safe harbor rules, recommends administrative flexibility in dealing with small-size cases.

41. On this issue, Korean experience represents a relevant example. Before joining the OECD, Korea's national tax authority employed a so-called "standard offer-commission rate" for import and export business taxation. Under this scheme, the NTA used a standard offer commission rate, which was based upon a survey on actual commission rates, as a last resort under its ruling only in case other methods for identifying the arm's length rate were inapplicable in determining commission rates received from a foreign party. The NTA finally repealed this ruling as it considered the ruling contrary to the ALP, at the same moment as it repealed a global formulary apportionment method which was designed to determine the profit level within its jurisdiction. These developments were accompanied by targeted training projects for international examiners within the NTA, to make the necessary adjustments to practice. Safe harbors are discussed in

42. In India, the Safe Harbor Rules are yet to be formalized. However, the committee formed for recommending Safe Harbor Rules examined the implementation of these Rules in the light of above mentioned constraints and has submitted its report to the Government.

2.4 Advance pricing arrangements (APAs)

43. In many countries, APAs has been introduced to confirm the arm's length result in advance by agreement between taxpayers and tax authorities on the certain sets of criteria (TPM,

they tend to be sought by companies in broad conformity with ALP 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 pros and cons of APAs at different stages of a country's transfer pricing journey are discussed in more detail in a later chapter.

46. Under the existing legislation, India does not have any regulation dealing with APA. However, India proposes to introduce APA from 01-04-2012.

47. In any case, the possible advantages of APAs are not always available in practice, because of some legal and administrative issues. One threshold for the developing countries to refer to or apply the existing APA is the adjustment of differences. This is related to the comparability analysis, which is now explored 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" mentioned in Chapter 1 should be appropriately addressed or the reference to the multi-year analysis might be necessary.

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48. 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.

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49. 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.

50. In India, capacity building has taken place mainly through on job training. The Directorate of Transfer Pricing has expanded with number of cases being referred for audit increasing every year since 2004, when the Directorate was setup. The National Academy of Direct Taxes, the Apex body responsible for training, has been conducting specialized training for officers in collaboration with OECD. The Government has also been sending officers for trainings and

taxation but also in relation to past taxation. The roll-back system for APA is generally accepted by many countries, where the tax authority decides that the agreed TPM is also appropriate as a TPM for the past open years, considering all facts and circumstances. Thus, dispute resolution based upon the treaty has become one of the most important procedures for taxpayers.

| 52. In India, an alternate dispute resolution mechanism has been adopted in the past one year, being the Dispute Resolution Panel (DRP). Consisting of three Commissioners of Income Tax, the Panel hears the objections of the taxpayer after the passing of the order by the transfer pricing officer but before it becomes final. For taxpayers who choose to approach the DRP, the tax demand does not become final until the Panel passes its orders. The Panel has nine months to

56. One disadvantage with developing countries is that there is insufficient current experience in negotiation with other Competent Authorities on TP matters. At the first stage of the TP journey, the CAs in developing countries have to face some difficult conditions. The biggest problem may be the difference in accessibility of information on TPM. While at the local unit there may be limited information, its related party may have access to more and better data, with which 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.

57. 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