Chapter 3 – The General Legal Environment

3.1. Introduction

3.1.1. Transfer pricing in domestic legislation was introduced by the United Kingdom in 1915 and shortly thereafter by the United States in 1917. However, transfer pricing was not an issue of great concern 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 the context of a rapid growth of international trade and investment, but in recent years (especially with the growth and complexity of international "transfers" within groups) a wider group of countries, both developed and developing, are introducing legislation to address transfer pricing issues. See further Chapter 1, para 3 for evolution of transfer pricing rules.

3.1.2. Domestic transfer pricing regulations in effect worldwide show some harmonization, especially in the theory, in accordance with the "arm's length" principle, even if the application is not always so closely aligned. These developments have taken place within different legislative traditions of countries, and the sovereign right for countries to address taxation matters. Reasons for this include:

- the broad acceptance of the arm's G

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 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 the rules therein. Those reasons and the "environment" of the legislation should be compared with those in the reader's country. This analysis will help indicate what adaptation, if any, of the legislation is needed for it to work effectively in the conditions of the reader's country.

3.2. Domestic Transfer Pricing legislation Structural overview

3.2.1. As already noted in Chapter 1, transfer pricing is essentially a neutral concept. However the term is sometimes used, incorrectly, in a pejorative sense, to mean the shifting of taxable income from one company within a multinational enterprise ("MNE") located in a high taxing jurisdiction to another company of the same group, in a low taxing jurisdiction, through incorrect transfer prices. The aim of such price setting is to reduce the overall tax burden of the group. This involves a transfer price of course, but is more accurately referred to in this manual as one type of transfer *mis*pricing since 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 Chapter 1, para 1.1.7. for examples.

3.2.2. Many countries have introduced specific domestic tax rules to prevent possible tax base erosion through incorrect related party pricing. 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 look to 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. This is normally subject to a rebuttal by a taxpayer who may present counter evidence to justify the arm's length results.

3.2.3. Another principle for transfer pricing income allocation is global formulary apportionment ("GFA") as noted in the introduction; see chapter 1, para 4.13. 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 Korea used to apply the GFA on the grounds that this method provided more certainty and also reduced compliance costs for taxpayers. However, around the mid 1990s, the Korean tax authorities revoked some of their own guidelines based upon the GFA acknowledging that the 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 longer term pros and cons of any possible alternative ways of dealing with transfer pricing, including GFA.

3.2.4. 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:

3.2.4.1. 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,

3.2.7. There remains substantial risk of double taxation even when two countries are following the same general arm's length principle approach. E.g. such double taxation may occur where specific guidance on the implementation of the arm's length principle is different from one country to another or in relevant tax treaties, 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.
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3.3. Associated enterprises

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3.3.1. The definition of which companies, and therefore transactions, are covered by transfer pricing legislation is aus s i h

3.4. Coverage of transactions and Availability/Priority of Transfer Pricing Methods

3.4.1. Transfer pricing generally covers all cross border transactions involving a country,

sector databases. Such examples may be drawn from actual cases in other countries; such examples for specific areas are provided in the relevant Chapters of this Manual.

3.5.3. Ease of administration is another important issue in the design of legal frameworks. Documentation requirements backed up by penalties for non compliance are the main instruments for 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 multinationals, especially if

3.6.3. 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 case may be formulated in more detail through those precedents, depending on the general status of precedent03Tj/TT6 1 Tf56i1Tf56i1Tf56iTf.229d460Tcransfer

3.6.14. Tax administrations and taxpayers may encounter several challenges in meeting their respective burdens of proof. As a practical matter, associated enterprises normally establish the Ō

domestic confidentiality requirements,

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.[8]

3.8.4. Safe harbour rules may also 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). In the case of MNEs, such rules can relievend

last resort under its ruling only

endorse the APA as a supplement to the traditional administrative, judicial and treaty mechanisms for resolving Transfer Pricing issues.[14]

3.10.2. One of the key advantages of adopting

the treaty partner making a corresponding adjustment in its jurisdiction. In addition, the bilateral APA not only plays a big role in the confirmation of future taxation but also in 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 as a transfer pricing method for past open years, considering all facts and circumstances. Thus, dispute resolution based upon tax treaties has become one of the most important procedures for taxpayers.

3.11.2. The OECD Model Treaty Article 25 was revised in 2008 to introduce the possibility of arbitration of unresolved Mutual Agreement Procedure 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 9; 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.

3.11.3. For most developing countries arbitration is a new issue to be addressed, and the reality in any case 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 with a developing country party. However, 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.

3.11.4. 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 of the transfer pricing regime. There may be differences in the accessibility of information on transfer pricing methods; also there may be limited information. In 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 (EOI). A second problem is the lack of experience in conducting a MAP on transfer pricing cases. 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 APAs as an important part of capacity building on transfer pricing issues. Matching capability with the transfer pricing regime is thus an important factor in the design of the domestic legal environment.

3.11.5. Japanese experience can be considered a reference point. At the initial stage of engaging in MAPs, Japan experienced the disadvantages listed above. However, after developing a good partnership with many treaty partners, a large amount of information was successfully shared. Therefore intensive and practical discussions on the transfer pricing methods or comparability analysis rapidly improved the capacity of Japanese CAs. So far, although there were exceptional cases with a negotiation period beyond two years, the majority of MAP cases have been successfully concluded within the

approximately two year period that is a target in the OECD Model Article 25(5). After