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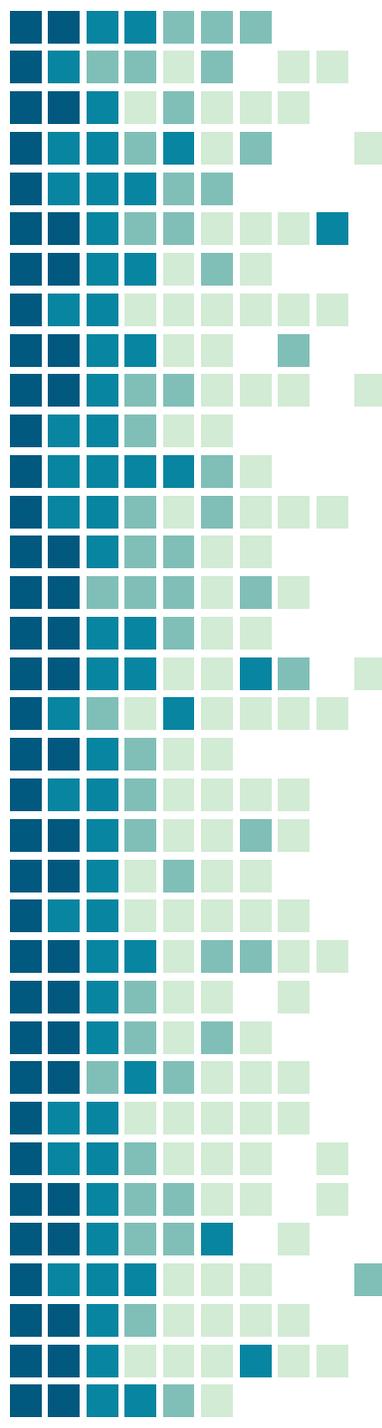
# Chapter C.1 of UN TP Manual: General Legal Environment for Updating Transfer Pricing Regimes

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# Research Credits



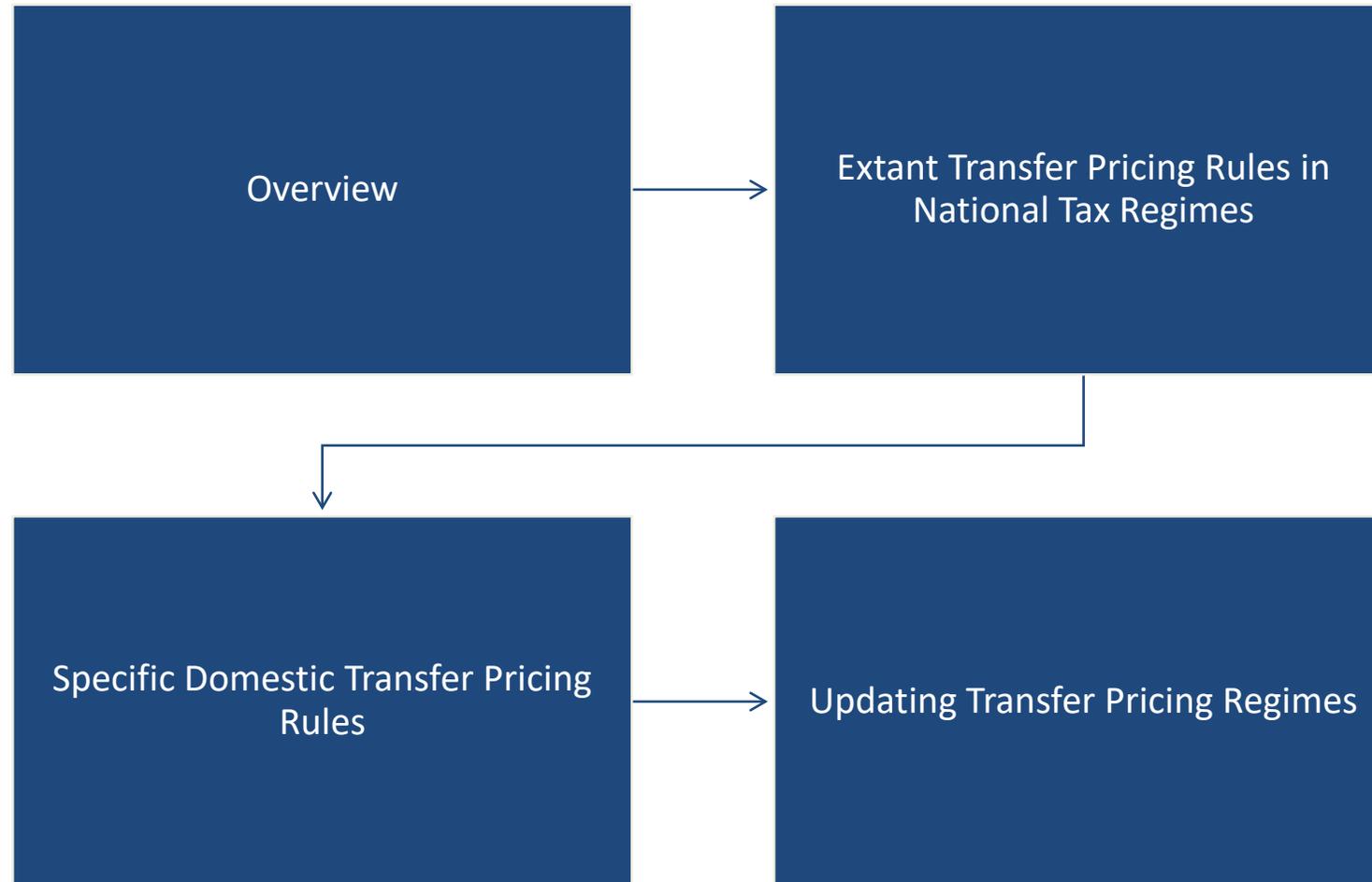
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# Legends used in the Presentation

ALP	Arm's Length Principle
APA	Advance Pricing Agreements/Arrangements
APAs	Advance Pricing Agreements
ATAF	African Tax Administration Forum
CATA	Commonwealth Association of Tax Administrators
CFC	Controlled Foreign Corporation Rules
CIAT	Inter-American Center of Tax Administrations
CREDAF	Cercle de Reflexion et d'Echange des Dirigeants des Administrations Fiscales
GAAR	General Anti-avoidance Rule

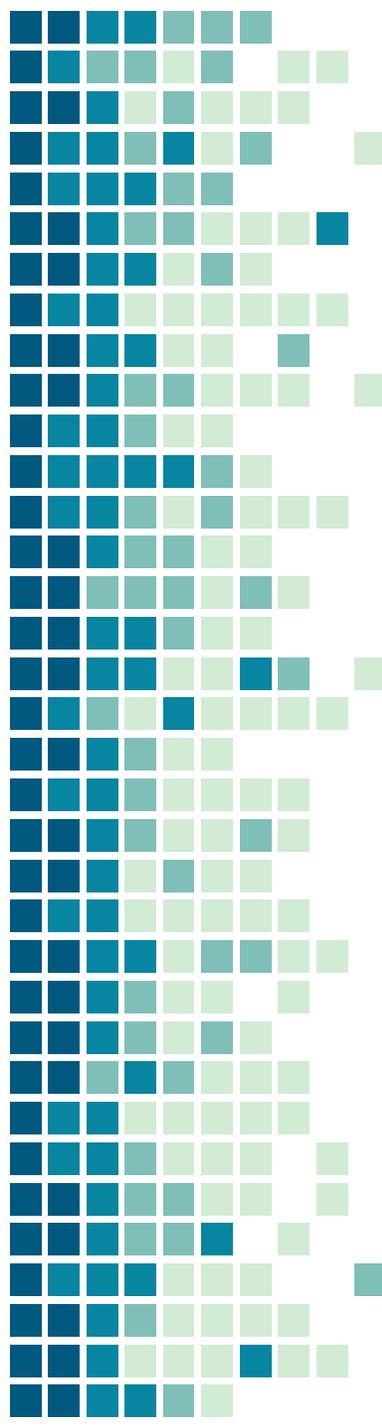
IOTA	Intra-European Organisation of Tax Administrations
LVAS	Low Value adding Services
MAP	Mutual Agreement Procedures
MNE	Multi National Enterprise
OECD	Organisation for Economic Cooperation and Development
SGATAR	Study Group on Asian Tax Administration and Research
SME	Small and Medium Enterprise
TP	Transfer Pricing
UN	United Nations

# Presentation Schema



# Introduction

# Overview

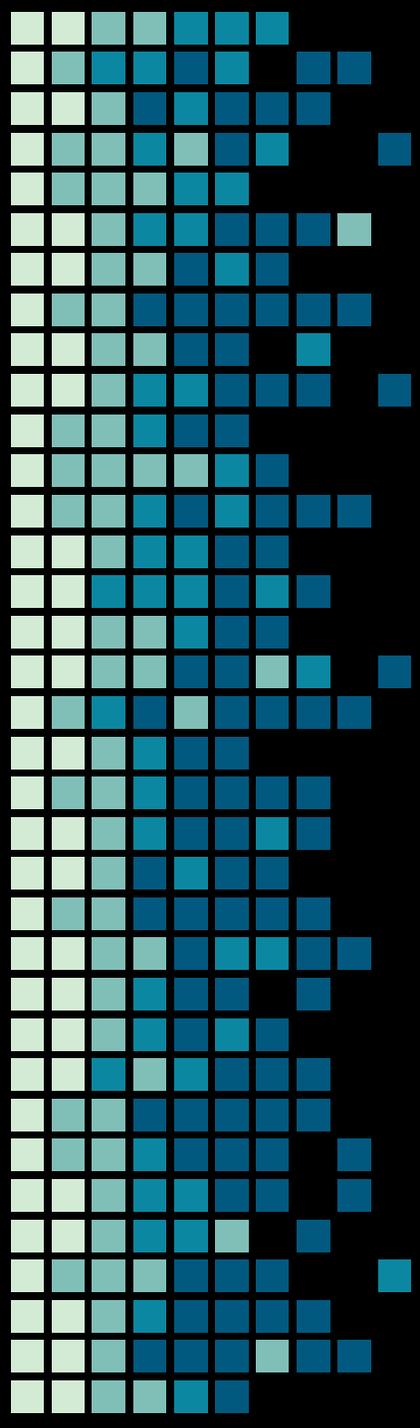


Transfer pricing was not an issue of great concern until the late 1960s when international commercial transactions expanded greatly in volume

With the **increase in controversy regarding adjustments** by tax authorities to transfer prices, taxpayers increasingly seek **practical dispute resolution mechanisms** to avoid double taxation (such as MAP, APAs and arbitration proceedings)

**Domestic transfer pricing legislation worldwide shows some harmonization in basic principles**, in accordance with the arm's length standard, though, its application is not identical and poses complexities across jurisdictions

Chapter C.1. of UN TP Manual reviews the **legal environment of TP legislation in a global context** and seeks to identify the key practical issues from the perspective of developing countries



# Extant Transfer Pricing Rules in National Tax Regimes

# Background and Key Considerations

Many countries have introduced **specific domestic tax rules to prevent possible tax base erosion** through mis-pricing of transactions between related parties (including **presumptive taxation**)

Another approach to transfer pricing income allocation is the **Global Formulary apportionment** (though it has not been practical yet at the global level)

TP legislations have **to be developed in accordance with the need of every country** as there are no fixed Models/Template.

This includes **analysis of any legislation of another country** but not limited to Practical Administration, Burden of Compliance, Environment of Legislation and “Why it has worked/Not worked in Original Context”

Two different Approaches may be seen in domestic legislation relating to transfer pricing

1

This involves **allocation of income/deductions/credits** by tax authorities to prevent tax avoidance

2

Based on self assessment system, **foreign affiliated transaction shall be priced for tax purposes** as if it had been conducted at arm’s length, thereby requiring the taxpayers to transact in arm’s length principle.

# Domestic Rules

- OECD/UN Model sets out the basic condition for TP adjustments and corresponding adjustments to prevent double taxation.
- Generally, countries apply their domestic transfer pricing rules to cross-border transactions, but **some countries opt to apply transfer pricing rules also to domestic transactions** (considering the risk of domestic tax erosion through RPT when there are different tax regimes in a jurisdiction)
- Upon introduction/ updating the domestic TP rules, **time lag between initiative of the legislation and approval by the legislative bodies** should also be considered.
- With respect to the **definition of AE and application of arm's length principle**, it might be beneficial to **have international consistency**, but each country must **design its TP legislation in a way consistent with legal and administrative framework, treaty obligations and resources**.
- Countries might also introduce **safe harbour rules** to reduce tax collection and enhanced certainty

# Concept of “Associated Enterprise”

**Article 9** of both the UN and OECD Models considers enterprises to be “associated” if one of the enterprises meets the conditions of Article 9, Subparagraph 1(a) or 1(b) with respect to the other enterprise. (Eg. Parent Subsidiary relationship)

One enterprise is said to have **control** over the other if it could

Participate directly or indirectly

- Management
- Control
- Capital of another enterprise

There are **no specific guidance as such on what is control in OECD/UN models** and is at the discretion of domestic legislation

**Countries generally apply criteria for determining control** (differing thresholds result in disputes in certain circumstances)

Which include

- 50% Shareholding
- Even above 50% or less than 50% shareholding
- Also elements other than shareholding, like dependency on inputs, financial/ human resources etc.

- *For developing countries, the term control has to be analyzed carefully for effective administration of TP legislation*
- *In addition, factors for identifying control should be carefully examined depending on industry sector, geographic characteristics, product cycle, etc.*

# Other Aspects of Domestic Legislation

## Coverage

- TP generally **covers all cross border transactions** between AEs
- In contrast, **transactions between domestic PE of a foreign company and its affiliated company located domestically may not be subject TP regulations** owing to less risk of income shifted beyond borders (Eg. Japan)
- However, **transactions between local branch office and their head quarters** may be regulated by specific legislation, **consequently affected by Article 7** of (OECD/UN model).

## Methods and Compliances

- Types of TP methods, choice of methods and availability of method depends upon domestic legislation which is **based on the administrative guidance or other subsidiary material instead of tax laws**
- Upon design of legal framework, **ease of administration, documentation, penalties for non-compliance** should also be considered.
- Forms for receiving TP information should be convenient to process and respond (**mandatory disclosure of information** is the best option)

## Burden of Proof

- The burden of proof for TP litigation may be determined in accordance with the **burden of proof rules of civil procedure or tax litigation in general.**
- In several countries the **burden of proof rests originally on the taxpayer** (Eg: Australia, Brazil, Canada, India, South Africa and the United States)
- Once the taxpayer discharges this burden, then it **shifts to the tax authorities** to evaluate and prove if the controlled prices have been determined in accordance with the ALP or if the information or data used in the computation is reliable or correct

# Issues and Challenges in Domestic TP Regulations

## 1. Presumptive Taxation methods

The **effectiveness** of presumptive taxation **depends on the approach adopted** by the country concerned (i.e. Self Assessment vs Assessment by tax authorities).

In such cases **disclosures of data would provide opportunity to tax payers to defend its position**

### Issues

#### Mispricing of RPT

In an anti avoidance focused system, a **penalty system may play a more effective** role than presumptive taxation to **avoid mispricing of RPT**.

#### Use of Secret Comparables

Third party information are made available to tax authorities subject to confidentiality, therefore during the course of dispute taxpayer wont have access to comparable.

## 2. Burden of proof

Since this involves **review of various documents**, gathering information on comparable uncontrolled transaction and market condition becomes a **difficult exercise with passage of time**.

Countries should **keep in mind the interest of the revenue and taxpayer (financial risks)** and set a **time period during which adjustments could be made**

## 3. Balance to be Struck between Statute and Subsidiary Regulations

This essentially means recognizing the arm's length principle and the basic principles applicable to TP through the primary legislation

**Objective statutory provisions** tend to provide greater certainty because they are binding on taxpayers and the tax administration.

# Specific Domestic Transfer Pricing Rules

# Safe Harbour Rules

- They are a form of **simplified TP rules** that applies to specific transactions which **approximates outcomes under arm's length principle** to avoid double taxation

## What are safe harbour rules?

### Significance

- An attractive option for developing countries with limited access to resources and data.
- A **relief to SME** from compliance burden and also to MNE from small or risky transactions

- **Information sourced from tax returns of tax payers can support the design of safe harbour rules.**
- Upon design of Safe harbour, **flexibility in opt in and opt out** should be considered.
- Safe Harbour rules should consider at least 3 concepts namely: **Category of eligible transaction, TP methods and Corresponding range or results to be used.**

### Considerations

### Issues

- May result in **unnecessary revenue forgone** and may encourage **tax planning and avoidance.**
- Could **discourage investments in high margin activity** compared to low margin activity

# Safe Harbour Practical issues

OECD has proposed **fixed margin (5% mark up on cost) in dealing with Low-value added services (LVAS)**

- LVAS are services of a supportive nature, not forming part of the core business of the enterprise, and that does not use any intangibles or assume significant risks

These **fixed margins could be perceived as being too high.**

- The **other state may not accept such fixed margin as arm's length**, thereby denying to make corresponding adjustment resulting in double taxation.

For **all other transactions exceeding the safe harbour limits**, taxpayers could be **required to comply with all transfer pricing rules** and the burden of proof remains with the taxpayer

The safe harbour regime may include provisions and regulations of the procedure for applying for MAP.

- As an option for the safe harbour, tax authorities may also allow taxpayers to apply for APAs to comply with the transfer pricing regime.

# Downward Adjustment

- Generally TP rules may result in increase in the amount of tax payable.
- However, there could be a need for downward adjustments resulting from unintentional over reporting of taxable income.
- Tax authorities would not generally consider this at their own discretion.
- **Hence, developing countries should consider this when designing domestic legal environment for TP**

## Examples

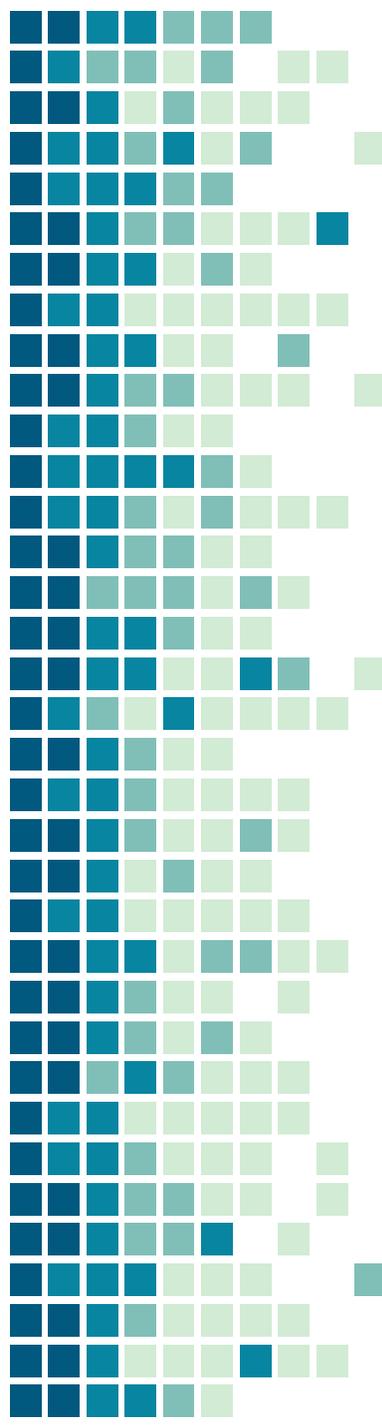
### Republic of Korea

It has clarified that a downward adjustment should be applied in cases **where a tax adjustment is made under a transfer pricing method using multiple year data.**

### South Africa

TP adjustments are **limited** to situations where the taxpayer will **always make adjustments that favour tax administrations**

# Advance Pricing Agreements/Arrangements



- Consideration must be given to the **inclusion of an APA programme at different stages** of the design of a legal framework for transfer pricing.



- As APAs are for serving the taxpayers, **adequate capacities must be installed to respond to tax payers demand.**



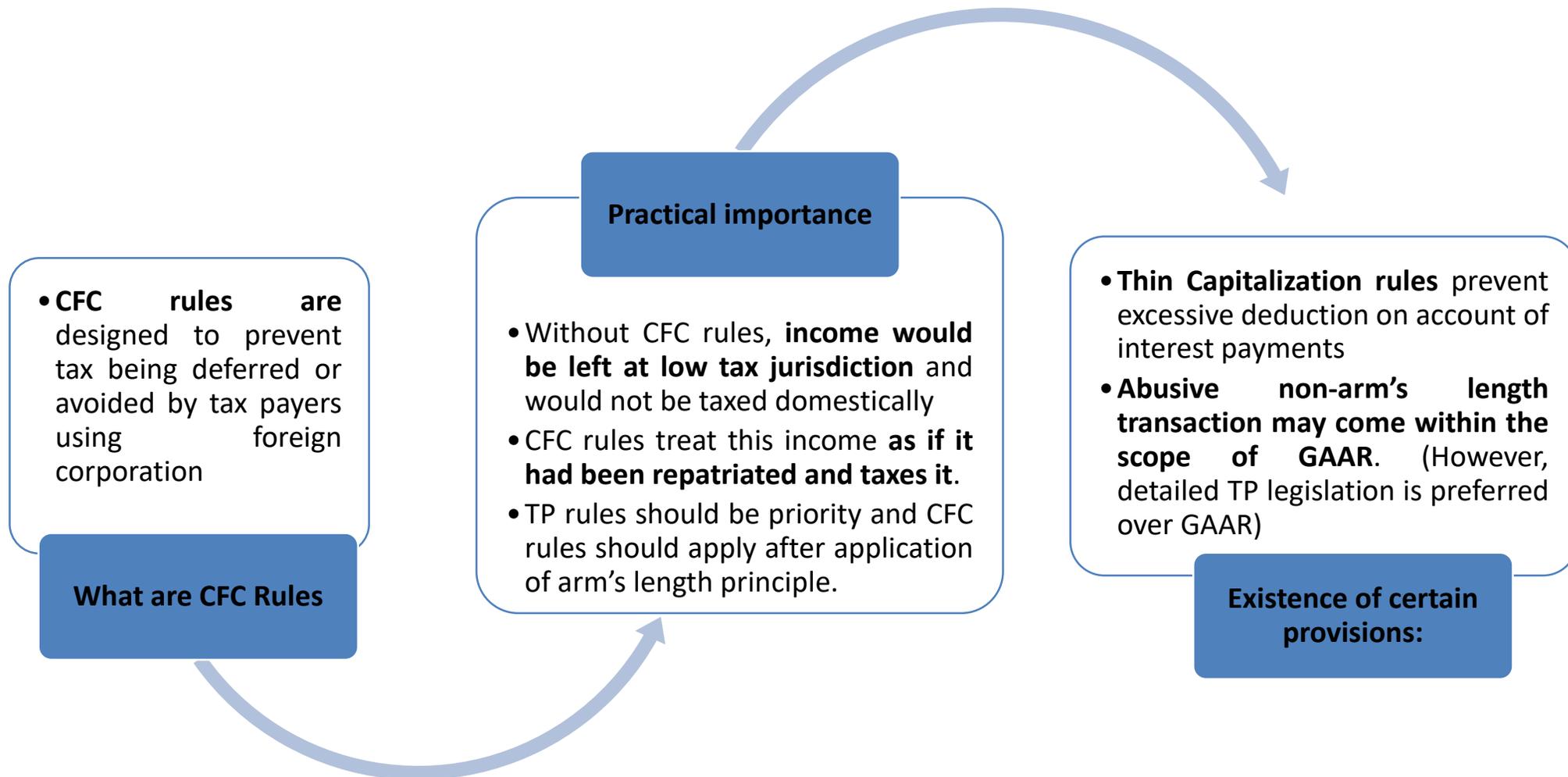
- In addition, **tax payers would also be required to pay fees when filing APA** to cover cost of processing



- **Matching operational capability to offer APAs with operational capability of the TP regime** is thus an important factor in the design of the domestic legal environment.

# Interaction of Transfer Pricing Provisions with Other Cross-border Rules

In designing a domestic tax system, **countries should consider interaction of TP rules with CFC, Thin Capitalisation and GAAR**



# Updating Transfer Pricing Regimes

# Gathering Information

Countries should keep abreast of developments, exchange peer experiences and keep their transfer pricing regimes updated

## **Regional coordination through existing intergovernmental agencies such as CREDAF, IOTA, CIAT, ATAF, etc.**

- To keep up to date with developments in international TP

## **Engagement with institutional stakeholders** such as the with United Nations, OECD, World Bank, IMF

- These organisations can provide capacity development assistance and also help resolve issues

## **Create a clearing house for information and capacity development with like-minded countries**

- Like-minded tax administrations should come together to share experiences and tax information.
- By acting within an organized group, tax administrations can share training expenses

## **Participate in the South-South dialogue for capacity development**

- A **knowledge sharing platform** with other tax authorities
- **International secondments** to gain more experience at the United Nations, the OECD or in another tax administration should be considered
- A greater pool of TP experts to assist revenue authorities and taxpayers

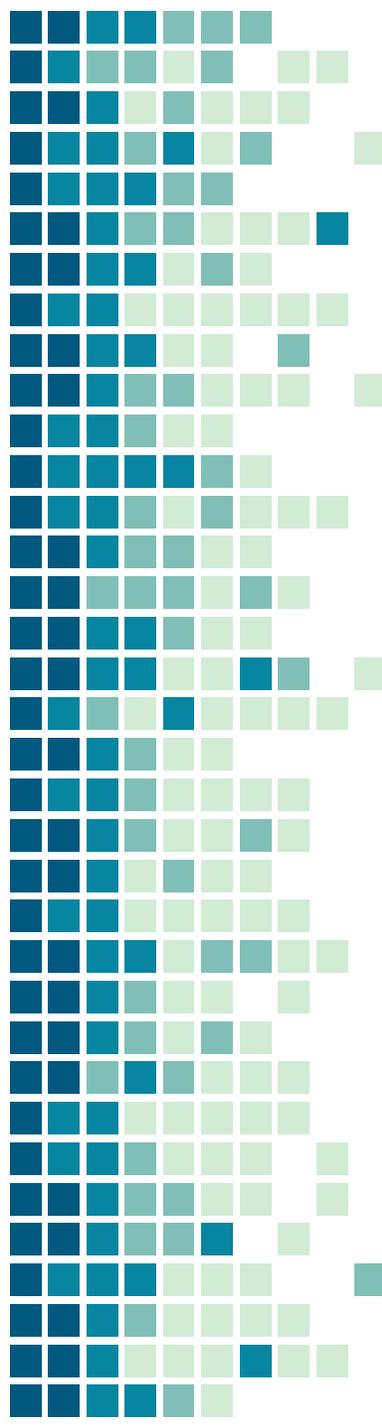
# Examples of Measures to Update Transfer Pricing Regimes

## Advance tax rulings

- It helps to create an **active tax dialogue** between taxpayer and tax administration.
- It stimulates greater cooperation to the extent both parties fix an understanding to pay or not to pay certain taxes

## Establish an international consultancy body

- An independent advisory group could
  - suggest updates,
  - point out controversial issues in the country's legislation,
  - **suggest action** in certain transfer pricing areas, and
  - even audit the country's tax legislation for improvement.



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