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 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 perceived benefit of similar approaches between countries in terms of avoiding double taxation.

3.1.3. With the increase of cases where tax authorities have made adjustments to transfer prices set by the related entities, taxpayers increasingly seek more practical dispute resolution mechanisms to avoid such double taxation. As a result, Competent Authority (CA) discussions (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.

3.1.4. 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.[1] While the pros and cons of these approaches are dealt with in Chapter 9 of this Manual, such approaches will be influenced by the legal environment of each country, and thus may be developed in a variety of styles.

3.1.5. 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 is emphasized

[1] A MAP as such cannot guarantee this as the MAP does not force the competent authorities of the country to agree

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, apportionment, or allocation is necessary in order to prevent tax evasion or clearly reflect the income of any of such organizations, trades, or businesses.[2] 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 is stipulated not in the general legislative principle but rather, if at all, within regulations supporting the legislation.
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> **3.2.4.2.** The second style of statute 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 conducted at arm's length.[3] 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 arm's length principle.

3.2.5. A country's choice between the two above alternatives will depend on the basic principles of domestic tax law in that country. This will include issues such as the form of anti-avoidance legislation, where to place the burden of proof, etc. However, the choice of styles of domestic legislation has made no substantial difference in the legal procedure of structuring the arm's length principle. Arms length methodologies stipulated in each country's legislation will however differ to some extent as described later.

3.2.6. 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. 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 to be found in subordinate legal materials, such as regulations, administrative rules and public notices, etc. While depending upon the legal system of the state concerned, the tax law of certain states may define in great detail issues such as the definition of related parties, transfer pricing methodologies, documentation, penalties and the APAs, other states might opt to only identify the basic structure of tax base allocation among the related parties under the arm's length principle. 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 therefore consider the level of guidance available in their countries, and determine if further detail is needed.

[2] US Internal Revenue Code §482

[3] Japan Special Taxation Measure Act §66-4(1)

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.

3.3. Associated enterprises

3.3.1. The definition of which companies, and therefore transactions, are covered by transfer pricing legislation is a key issue since the arm's length principle applies to transactions between related companies. 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, sub-paragraph 1a) or 1b) with respect to the other enterprise. These sub-paragraphs cover so-called parent-subsidiary relationships and brother/sister relationships as relevant situations. The requirement of control in each sub-paragraph is defined as 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 or in the OECD 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 for domestic legislation.

3.3.2. Many countries apply a 50% shareholding threshold, to set the degree of participation required for "associated" status; some countries employ a rather lower threshold. However, countries with higher thresholds usually employ substantive rules on control as a fall-back, or subsidiary test. These may focus on other elements than shareholding, such as dependency of input materials, distribution networks, financial resources and human resources, etc. on other group members. There is thus no significant difference among countries on this matter.

3.3.3. Differing threshold criteria can result in disputes in certain circumstances. For example, in Japan, domestic law stipulates that a shareholding of 50% or more is the threshold for an "associated enterprise", which is generally a possible target of transfer pricing examination by tax authorities. Assume a 50/50 joint- venture project organized by two independent parties. 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. The NTA has therefore issued an additional public notice that requires examiners to conduct an in-depth analysis on control in such joint venture type operations.

3.3.4. 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 be diversified depending on industry sector, geographic characteristics, product cycle, etc.

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, regardless of whether participants are residents or non residents. Thus, transactions conducted between a foreign company that has a PE in a country's jurisdiction and its affiliate company located abroad are also taxable events under the domestic law. 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.

3.4.2. 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 the Model treaties. 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 relevant treaty.

3.4.3. The choice of method, availability of different types of methods and the priority to be given to various different transfer pricing methods is a matter that is often covered by domestic legislative frameworks. Priority and comparability of the transfer pricing methods is thus one of the most important elements for domestic legislation. This is often done through administrative guidance other subsidiary legislation rather than taxation laws. Many countries have followed that guidance drawn from the OECD Transfer Pricing Guidelines in 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 detailed discussion of the methods under Chapter 6.

3.5. Practical Guidance for cases without sufficient comparables

3.5.1. The most critical issue for developing countries in application of any methodology will 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 5 in particular. Domestic legislative frameworks and especially administration related guidelines should generally address 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, and burden of proof

3.5.2. In clarifying the procedures, it is useful to consider some real-world examples of transfer pricing adjustments conducted by developing countries which have used different country or different industry

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 there are unnecessary 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.

3.5.4. 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 fore efficiency and proportionality. The early experience of some developed countries may be relevant to developing countries just starting up a capability in transfer pricing. E.g. at the initial stage of transfer pricing administration in the early 1990s, Japanese transfer pricing examiners experienced trouble in collecting information about affiliated enterprises that was physically held overseas. Documentation 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 the foreign related transactions. They soon identified that not all relevant information was necessarily kept by the Japanese unit; Japan thus started a process to adjust 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.

3.6. Burden of Proof

3.6.1. The burden of proof in tax litigation means the necessity of proving affirmatively the truth of facts alleged by a litigant by 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 one who has the burden stands to lose if his evidence fails to convince the judge in a trial. A concept which 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.

3.6.2. The burden of proof operates in litigation. However, it is important to keep in mind the issue of who bears the burden of proof when a tax audit is conducted as well as when the transfer pricing assessment is made, because if a transfer pricing assessment is disputed it may ultimately end up in court.

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 precedent in that jurisdiction. The burden of proof rules for transfer pricing cases differ among countries. The position that the taxpayers bear the burden of proof is taken, for example, by the United States, Canada, Australia, India and South Africa.

3.6.4. 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 (1) the IRS's allocation of income is arbitrary, capricious and unreasonable and (2) the prices, royalties or other compensation in question are at arm's length. The burden of proof will be shifted to the IRS or be removed if the IRS has raised a "new matter" not previously addressed in the notice of deficiency or if the IRS has attempted to increase the deficiency amount relating to transfer pricing after the issuance of the notice of deficiency.

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

3.6.6. In Australia, the burden of proof is on the taxpayer, as it must prepare and maintain documentation demonstrating that the terms and conditions of its transactions with related parties are consistent with arm's length terms and conditions. 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.

3.6.7. 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.

3.6.8. In South Africa Section 82 of the Income Tax Act ("ITA") provides that the burden of proof that any amount is (i) exempt from tax chargeable under the ITA, (ii) subject to any deduction, abatement or set-off under the Income Tax Act or (iii) to be disregarded or excluded from capital gains tax, rests with the taxpayer. Upon hearing of any appeal from any decision of the South African Revenue Service ("SARS") to disallow an objection the decision may not be reversed or altered unless it is shown by the taxpayer that the SARS decision is wrong.

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

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

3.6.11. In Germany the tax authorities have 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.

3.6.12. 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, when making a transfer pricing adjustment, must generally prove the correctness of the adjustment. Due 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 its 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.

3.6.13. In Japan the government has the burden of proof when a taxpayer seeks to rescind a disposition 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 precedents on transfer pricing taxation. E.g. 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 that they applied the resale price method correctly.[4]

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[4] 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. 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.

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 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 an administrative burden for both the taxpayer and 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.

3.6.15. The divergent rules on the burden of proof between two countries engaged in the mutual agreement procedure (MAP) may cause difficulty in reaching a MAP agreement. In such event, neither countries nor 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 pricing is consistent with the arm's length principle regardless of which party bears the formal burden of proof. It should be noted that in practice the burden of proof is not always a deciding factor.

3.6.16. 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 civil code of each country, the issue of whether the taxpayer or tax administration take 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.

3.7. Presumptive taxation approaches and the arm's length principle

3.7.1. 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 the last resort to fight against the manipulation of transfer pricing.

3.7.2. This methodology may be common in statutes operating in relation to domestic taxation and transfer pricing adjustments. However, transfer pricing adjustments generally cause international double taxation whenever tax authorities make adjustments on foreign transactions. Most countries

therefore structure such statutes 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.[5]

3.7.3. To invoke presumptive taxation in Japan, the statute allows the tax authority to use the "gross profit rate" methods which are very similar to RP or CP, and, if such methods are not available, the profit methods. 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 NTA's presumed prices are at arm's length.

3.7.4. 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 activate this authority is that when examiners request the taxpayer to provide records, books or copies thereof, which are 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" caused some disputes, when taxpayers insisted that they had 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 the presumptive taxation has been properly applied will determine whether the shifting burden of proof has moved from being on the administration to being on the taxpayer. In Japan, in conjunction with the long-standing "hierarchy" in transfer pricing methods, this issue has remained decisive for the outcome of lawsuits.

3.7.5. The utility of presumptive taxation methods depend on which structure of the two choices above (assessment by the authorities/ tax administration or self-assessment - see paragraph 2.4. of this Chapter) the country concerned employs. Under a self-assessment system such as exists 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 system where taxpayers have an initial burden of proof on the authorities' adjustment, a penalty system may play a more effective role than presumptive taxation.

3.7.6. Another issue closely related to presumptive taxation 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 were able, within the limits of its

[5] There is no presumptive tax in transfer pricing in India. However the usage of databases in various industry sectors seems to be prevalent.

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.[6]

3.7.7. A specific example may be considered to contrast the position in a non-OECD country. In India, at times, 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 margin 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.

3.8. Safe harbour rules

3.8.1. Safe harbour rules are rules whereby if a taxpayer's reported profits are within a range or percentage or under a certain amount, or the like, that amount can be relied on 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 which countries concerned also categorize as safe harbours. For example, another simplified mechanism sometimes used is that if the ratio between international transactions and the overall transactions of a given company is smaller than a percentage stipulated in the law or regulation, this company would not be required to make a transfer pricing adjustment. Another example relates to the interest rate for intercompany loans, which may be accepted if it is within a range determined by tax law based on the capital market rates.[7] A safe harbour cannot normally be used to the disadvantage of a taxpayer.

3.8.2. Safe harbour rules can be an attractive option for developing countries, mainly because they could 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 appreciate the advantage of low compliance costs and certainty for taxpayers, as well as administrative simplicity for tax authorities.

3.8.3. 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 worst 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 in small-scale cases safe harbour rules contribute to minimize the complexity of establishing an

[6] The 2010 revision of the OECD transfer pricing Revised Guidelines para 3.36- The 2011 Japanese tax law reform followed this disclosure policy.

[7] These mechanisms are adopted in Brazil.

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 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 on a certain class of transactions of a certain defined threshold, such as low value-added services[9], interest rates in respect of short term intercompany plain vanilla loans of moderate value, etc.

3.8.5. There are possible down-sides to safe harbours, including possible abuse. An example of such abuse is breaking down what is in reality a large transaction instead appearing to be several smaller ones. There is also a risk that lobbying will make it hard to remove safe harbours 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 harbour rules are too generous; thus not only is revenue unnecessarily foregone but there maybe a perpetuation of small scale or low profit transactions rather than higher risk/higher reward transactions to which the safe harbours will not apply. There may even be a discouragement of investment in high margin activity as compared to low margin activities.

3.8.6. The OECD transfer pricing guidelines discuss some other potential disadvantages of a safe harbour rule, such as the high risk of double taxation, tax planning, difficulties with the mutual agreement procedure and equity and uniformity issues. Following this analysis the OECD guidelines instead of safe harbour rules recommend administrative flexibility in dealing with small-size cases[10].

3.8.7. On the issue of the practice of safe harbours, Korean experience represents a potentially 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 NTS[11] used a standard offer commission rate based on a survey on actual commission rates. This was available as a

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[8] 2010 Revision OECD Transfer Pricing Guidelines para.4.94－101

[9] 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 at:
http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/c_2011_16_en.pdf

[10] However it should be noted that an update of the language of Chapter IV of the OECD Transfer Pricing Guidelines relating to safe harbours is being prepared. Work commenced in 2012 and will continue into 2013 if necessary. The purpose of the update is to create a more balanced assessment of safe harbour measures that reflects actual country practice.

[11] NTS stands for National Tax Service, the official name of the Korean tax administration.

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 NTS finally repealed this ruling as it considered the ruling contrary to the arm's length principle. These developments were accompanied by targeted training projects for international examiners within the NTS, to make the necessary adjustments to practice.

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

3.9. Adjustments

3.9.1. 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 guidance available only indicates that tax administrations in their discretion may or may not grant the request for downward adjustment.[12] It adds that tax administrations may also consider such requests in the context of MAPs and corresponding adjustments. This is an area which developing countries should also consider in design of the domestic legal environment for transfer pricing.

3.9.2. Korean experience may be considered as an example in this regard. In 2010, Korea clarified in its tax law that a downward adjustment should be applied in a case 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 disregard years with excess profits when they adjust the taxpayer's profit level under a transfer pricing method using multiple year data.   .

3.10. Advance pricing arrangements (APAs)

3.10.1. 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.[13] On the other hand, although unilateral APAs are categorized as partial solutions for double taxation, they are also considered useful in specific cases in view of all the facts and circumstances. The OECD Transfer Pricing guidelines strongly

[12] Paragraph 3.17 of the 2010 version OECD Transfer Pricing Guidelines.
[13] In 2010, Japan received 127 applications for APA, whereas it adjusted 100 cases after examination.

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 an APA system is that multinationals inevitably establish a consistent global pricing policy on their inter-company transactions. Developing countries thus have a good opportunity to obtain access to the existing documentation which is relevant to their local operations. In addition, a second advantage is that if an APA has been agreed between other countries regarding similar transactions they have a good chance to refer to that existing APA as a comparable transaction. Thirdly, if the multinational concerned applies for an APA in its own jurisdiction on the transaction with a local subsidiary, any existing APA can be a good reference. In any case, countries using APAs could save the possibility of complicated procedures for transfer pricing taxation on those specific cases and taxpayers would be happy with the reduced cost of compliance.

3.10.3. Other 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 capabilities before they can properly evaluate what is an appropriate APA for them.[15] Other countries are concerned that APAs are not useful in the early years of 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 pros and cons of APAs are discussed in more detail in Chapter 9 (Dispute resolution); 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.

3.11. Dispute resolution

3.11.1. 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 on the other side of the transaction – i.e. by the other country's tax authority. Therefore, every jurisdiction carefully structures domestic dispute resolution procedures as well as treaty based dispute resolution mechanisms. For transfer pricing cases domestic remedies are expected to work effectively, if a transfer pricing adjustment lacks a domestic legal basis or neglects procedural requirements. However, even when a taxpayer partially wins the case, the double taxation is still not recovered unless the MAP works successfully to reach agreement on the arm's length result between the concerned treaty partners, with

[14] Ibid. para 4.123-4-165、In addition, Annex to Chapter 6 "Guidelines for conducting APA under the MAP ('MAP APAs')"

[15] Under the existing legislation, India does not have any regulation dealing with APAs. However, India has introduced APAs from 1 July 2012.

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 stabilizing its own capacity building for the MAP, Japan has made some contributions in this area, bilaterally or multilaterally, for the benefit of new negotiating partners.

3.11.6. The Indian experience in this regard has been somewhat similar. The Indian CA 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 an improved situation with regard to the exchange of information, the Indian CA has been successful in concluding settlements of large cases.