Chapter3 – 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 harmonization, 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 group, in a low-taxing jurisdiction, through incorrect transfer prices. The aim of the price setting is to reduce the overall tax burden of the group.

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 (for "ALP", see Chapter 1 para4.1-4.7). 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). Before joining the OECD, Korea used to apply the GFA to determine the proper level of profits within its national taxing jurisdiction on the grounds that this method not only provided more certainty for taxpayers, but it refused compliance costs for taxpayers. However, around the mid-90's, acknowledging that the GFA is not consistent with the ALP, the Korean tax authorities revoked some of its own guidelines which were based upon the GFA.

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.[1]

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.

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.

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[1] US Internal Revenue Code§482

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

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 Associated enterprise

14. According to article 9 of UN and OECD model. enterprises are considered 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. Each sub-paragraphs covers so-called parent-subsidiary relationship and brother/sister relationship as relevant situations. Although, in each sub-paragraph, the requirement of control is defined as “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 of Article 9 and the OECD TP Guidelines. This is mainly because TP issues start only if special conditions have been made or imposed between two parties.
Thus, the degree of control as a threshold for triggering TP legislations seems completely been left for domestic legislation.

15. As for the degree of participation, many countries apply 50% share-holding threshold, while some countries employ rather lower threshold. However, countries with higher thresholds usually employ substantive rules on control as back-stop, focusing on other elements than shareholding, such as dependency of input materials, distributing networks, financial resources and human resources, etc. on other group members. So, in practice, there seems to be no big difference among countries on this matter.

16. However, threshold criteria can cause dispute in certain circumstances. For example, in Japan, domestic law stipulates that share holdings of 50% and more is the threshold for associated enterprise, which generally compose possible targets of TP examination by tax authorities. Assume a 50/50 joint- venture projects organized by two independent parties. An equal-footing arrangement is generally not understood to pose high risk of income-shifting, although there could be still some room for non-ALP pricing.
Thus, the NTA issued an additional public notice that requires examiners to conduct in-depth analysis on control in such joint venture type operations.

17. For developing countries, analysis of control might be the first hurdle to effectuate its TP administration. In addition, factors for identifying control might be diversified depending on industry sector, geographic characteristics, product cycle, etc. Countries experiences are again considered to be good reference on how developing countries

structure the threshold or how they analyze control elements.

2.3 Coverage of transactions

18.Transfer pricing generally covers all cross-border transactions, no matter whether players 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, transactions between a foreign company with a domestic PE and its affiliated company located domestically never constitute taxable events, because there is no cross-border transaction.

19. However, transactions between local branch offices and its headquarters are regulated by other legislations, such as non-resident/foreign company taxation rules and Article7 of Model treaties. Although under such circumstances Arm's length principle generally prevails to great extent almost in an equivalent manner, legal framework of taxation should be differentiated. For example, dispute resolution mechanism might be different depending on each country's domestic law and relevant treaty.

20.OECD has introduced the new Article 7 based upon its "Authorized OECD Approach(AOA)". It clarifies the attribution principles of Article 7 as possible as it simulate a PE as separate and distinct entity and apply the ALP. Since the UN model never decided to follow the AOA, the current dual system will continue for the moment.

2.4Priority of TPM: Best Method rule vs. Priority on the traditional methods

21. 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.

22. Such difficulties suggest that:

1) in certain cases, both taxpayers and tax authorities are likely to rely on the operating profit basis analysis rather than the price-oriented analysis.
It is mainly because the lack of clarity in the public data with respect to the classification of expenses in the gross or operating profits may make it difficult to evaluate the comparability of gross margins, while the use of net profit indicators may avoid the problem.
However, in this context, both taxpayers and tax authorities are required to conduct careful comparability analysis discussed later in this Manual in deciding on which party should be the tested party, or whether the profit split can be a solution for highly integrated operations for which a one-sided method would not be appropriate.
2) in such cases, flexibility in selecting an appropriate methodology based upon the facts and circumstances would be desirable; and 3) rejecting 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. [3]

23. 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

24. Generally in any methodology, the most critical issue for developingcountries 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 to address this issue. Therefore, the Manual, as a useful

[3] 3 For example, Japan introduced "the most appropriate Method Rule" in their TP regulations in 2011.

interpretative guideline, is intended to assist in this area.

25. To establish useful and effective guidance, comparability analysis (use of foreign data, adjustment of differences, profit split, etc.) and administrability (availability of data base, documentation, and penalties) should be theoretically examined first. After that, discussion on the TPM, safe harbor rules, and burden of proof should be discussed. In developing this guidance, we can also refer to the past experiences from each jurisdiction.

2.3.1 Comparability analysis and administrability

26. The 2010 OECD TP Guidelines point out that non-domestic comparables should not be automatically rejected merely because they are not domestic. The guidelines further recommend that where independent transactions are scarce in certain markets and industries, a pragmatic solution may need to be found on a case-by-case basis.[4] This means that when the data is insufficient, stakeholders can still use them as comparables to assess the arm's length price, after in-depth adjustment on them. The legitimacy of such procedures heavily depends on the accuracy of comparability analysis as a whole.

27. 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. [5]
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.

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[4] The 2010 OECD TP Revised Guidelines para.3.35 and para3.38

[5] Tokyo District Court decision of 16 Oct.2006

28. 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.

29. 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.

30. In India, Transfer Pricing officers have noticed several cases where Indian subsidiaries provide services of advertisement and marketing promotion to their overseas affiliates/parent companies. The core activities of these companies may be something very different. They may be distributors of electronic goods, clothing and accessories etc. Yet they provide a valuable service through their advertisement and marketing promotion activities on behalf of the parent companies.

31. Transfer pricing officers in India have held that the Indian subsidiaries should not only be reimbursed the amount spent by them but should also receive a mark up for the services provided. For the purpose of calculating this markup, the industry sector data that is used does not belong to the industry that the core activity of the taxpayer is conducted, but belongs to that of the service industry, be it provision of market service support or advertisement/brand building as the case may be. This class of cases is of great relevance to developing economies as the subsidiaries located in these geographies will often be found to be providing services that will enable establishing the brand name or market presence of the overseas parent company.

32. Administrability is another important issue for compliance. For tax authorities, documentation and penalties are the main resources for collecting sufficient information by which they test whether taxpayers have established the arm's length result or not. Preparing documentation involves one of the most expensive compliance costs for multinationals, especially if there are unnecessary differences in countries' requirements. The OECD TP

Guidelines has therefore established a common practical guidance from the perspective of efficiency and proportionality.

33. However, there are still some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guidance on the self assessment basis). As discussed in the OECD drafting committee of the 1995 OECD TP Guidelines, non-fault penalties could induce taxpayers to shift their income to low tax jurisdictions. Thus, we should examine the documentation and penalty legislation further. After the evaluation of the efficiency and proportionality, based upon the OECD standard, we should again focus on the early stage of the TP journey by developing countries on this matter.

34. Sometimes the early experience of developed countries some years ago may be more relevant to countries than the latest experiences. As an example, Japanese TP examiners at the initial stage of TP administration (in the early 1990s) experienced trouble in collecting the information about affiliated enterprises that was physically held overseas. At that time, the documentation requirement was very basic under the Japanese domestic legislation; examiners had to exercise their ordinary domestic investigation powers to inquire from taxpayers about the foreign related transactions in general. Soon they identified that not all relevant information was necessarily kept by the Japanese unit, no matter whether that unit was the parent or a subsidiary. Then, Japan started a long journey to adjust the documentation requirement to reflect the actual international business practice of multinational groups by ensuring compliance could be effective but also taking into consideration of the taxpayers' compliance burden. Providing the authorities with legal power to examine the domestic third party transactions and requiring more detailed information in the schedule to be attached to the tax return of a domestic affiliated corporation are examples of outcomes of such a process.

35. In India also, a very strict documentation requirement has been prescribed under the law. However, during audit process, there are instances when tax payers have refused to share information with respect to their Associate Enterprises. In such cases, information is gathered through use of foreign databases. Information can also be called for under 'exchange of information' clauses entered into with treaty partners.

2.3.2 Presumptive taxation methods and the ALP

36. The presumptive taxation method is provided for in the law of some countries. Presumptive taxation provisions, such as that 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.

37. This methodology might be common in statutes operating in relation to domestic taxation and TP adjustments. However, TP adjustments generally cause international double taxation whenever tax authorities exercise adjustment on foreign transactions. Thus, most countries structure such statutes carefully in the manner to be accorded with the ALP. However, it seems that some countries lower the threshold for applying this methodology, at least in terms of establishing comparable transactions. Once again Japanese experience can be used as useful guidance.[6]

38. 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 presumed NTA prices are at arm's length.

39 As stated earlier, Japan introduced examiners' authority to inquire into third party transactions at the early stage of its TP journey. The condition to activate this authority is that when examiners request the corporation to provide records, books or copies thereof, which are recognized as necessary for computing the arm's length price, the corporation 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 is whether burden of proof is on the tax administration or taxpayers, and 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 TPM, this issue has remained decisive on the outcome of lawsuits.

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6 There is no presumptive tax in transfer pricing in India. However, on the other hand,, the usage of data base in other industry sectors seems prevailing. See paragraph 25.

40.During above discussions, burden of proof 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, which side takes initial burden to prove the ALP should be also handled domestically. Thus, presumptive taxation methods depend on which structure of the two(see paragraph 8-10 of this Chapter) concerned country employs. Under the Self-assessment system like Japan, where tax authorities always have burden of proof whenever they propose adjustment, presumptive taxation looks more attractive. On the other hand, anti-avoidance system like USA, where taxpayers have initial burden of proof on the authorities' adjustment, penalty may play rather effective role than presumptive taxation.
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41. 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 the conditions of confidentiality. Thus, during the dispute procedure, the taxpayers against whom presumptive taxation is applied cannot access any materials which form the basis of the presumptive taxation. In order to secure the opportunity of taxpayers defending their position against such taxation, the OECD guidelines advise that the use of secret comparables would be unfair.unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer.[7]

42. In India, at times, information is called for from comparable companies to ascertain correct factual position regarding their financial transactions or functional profile. This information may be in addition to information already available with respect to such company in the public domain. However, such information, if used against a taxpayer for determination of arm's length margin in its case, is invariably confronted to the tax payer and an opportunity is granted to the tax payer to offer its rebuttal against the use of such information.

2.3.3 Safe harbor rules

43. Safe harbor 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

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[7] The 2010 OECD TP Revised Guidelines para3.36. The 2011 Japanese tax law reform followed this disclosure policy.

as an alternative to a more complex and burdensome rule, such as applying the transfer price methodologies. Ther are other types of simplified mechanism for transfer pricing which countries concerned also categorize as safe harbor. For example, if the ratio between international transactions and the overall transactions of a given company is smaller than a percentage stipulated in the law, this company would not be demanded to make transfer pricing adjustment. Another examples is regarding the interest's rate for intercompany loans, which should be accepted if it is within a range determined by tax law based on the capital market rates.[8]

A safe harbor cannot normally be used to the disadvantage of a taxpayer. It often appears as an attractive option

to developing countries, mainly because they could provide predictability and administrability in TP taxation by the simplified establishment of taxable profit. Supporters of this rule appreciate its advantage of low compliance cost and certainty for taxpayers, as well as administrative simplicity for tax authorities.

44. It is often stated that safe harbors allow tax administrations (especially as they are just beginning with transfer pricing) to focus their limited resources, including audit resources, on the worst cases of improper 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 the small-scale cases, safe harbor rules contribute to minimize the complexity of ALP application, which requires collection and analysis of data. The complexity might be disproportionate to the size of the corporation or its level of controlled transactions.[9]

45. 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. For examples, safe harbors can decrease the MNEs' compliance burdens to some extent by its application on a certain class of transactions of a certain defined threshold, such as the mark ups of plain management services whose fees are below a certain value, interest rates in respect of short

[8] These mechanisms are adopted in Brazil.

[9] OECD TP Guidelines (2009 Edition) para.4.94 - 100

term intercompany vanilla loans of moderate value, etc.
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.

46. 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.

47. 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 NTS[10] 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 NTS 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 NTS, to make the necessary adjustments to practice. Safe harbors are discussed in more detail in a later chapter of this Manual.

48. 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.

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

2.3.4 Downward Adjustment

49 . A taxpayer may seek on examination a reduction in a transfer pricing adjustment based

on an unintended over-reporting of taxable income. However, no clear guidance in this regard is found in the OECD TP Guidelines. It only indicates that tax administrations in their discretion may or may not grant the request for down-ward adjustment.[11] It adds that tax administrations may also consider such requests in the context of mutual agreement procedures and corresponding adjustments.

In 2010, Korea clarified in its tax law that downward adjustment should be applied to the case where a tax adjustment is made under a TP method using multiple year data. Therefore, tax officials are no longer allowed a discretion to make the adjustment only for years with a deficient profit and disregard years with excess profits when they adjust taxpayers' profit level under a TPM using multiple year data. .

2.4 Advance pricing arrangements (APAs)

50. 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, comparables and appropriate adjustment thereto, critical assumptions as to future events, etc) . To a great extent, APAs have reduced TP 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 many developed countries. On the other hand, although unilateral APAs are categorized as partial solutions for double taxation, they are also considered useful on specific cases in view of all facts and circumstances.

Thus, in those countries we can see a substantial shift of human resources towards APA related issues not only on the taxpayer's side but also on the administration side. The OECD TP guidelines strongly endorsed the APA as a supplement to the traditional administrative, judicial and treaty mechanism for resolving TP issues.[12]

51. From the perspective of countries adopting an APA program, one of the basic advantages is that since under the APA system multinationals inevitably establish a consistent global pricing policy on their inter-company transactions, developing countries have a good chance to obtain access to the existing documentation which is relevant to their

[11] Refer to paragrapf 3.17 of the 2010 OECD TP Guidelines.

[12] Ibid. para 4.123-164、In addition, the OECD TP guidelines appendixes "Guidelines for conducting APA under the MAP ('MAP APAs')"

local operations. In addition, a second advantage is that if an APA has been agreed between other countries regarding the 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 their jurisdiction on the transaction with their local subsidiary, any existing APA can be a good reference. In any case, countries using APAs could save some possible complicated procedures for TP taxation on those specific cases and,taxpayers would be happy with the reduced cost of compliance.

52. Other countries do not have APAs, at least for some time after their TP regime is put in place, and there can be several reasons for this, including the feeling that they need to develop capabilities before they can properly evaluate what is an appropriate APA for them. Other countries have the concerns that APAs are not useful in the early years of a TP regime because 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.

53.Under the existing legislation, India does not have any regulation dealing with APA.

However, India proposes to introduce APA from 01-04-2012.

54. 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.

55. 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.

56. 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.

57 . 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 seminars conducted by OECD abroad. The Directorate has also been organizing seminars and conferences for experience sharing by officers engaged in audit and for capacity building of officers who join the Directorate for the first time.

3. Dispute resolution

58. As stated earlier, an upward TP 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 structures carefully domestic dispute resolution procedures as well as treaty based resolution mechanisms. For TP cases, domestic remedies are expected to work effectively, in case a TP adjustment lacks 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, on the condition that the treaty partner can make 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 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.

59．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 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 possible use of arbitration or when asked to consider it by a potential treaty partner, are discussed in a later chapter.

60． For developing countries with a different style of article 25 (UN Model), arbitration is a new issue to be addressed, and the reality 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. Thus, in this context the MAP itself should be examined first with a view to it operating as efficiently and effectively as possible.

61. 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.
62. 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 years, the majority of MAP cases have been successfully concluded within the approximately 2 year's period that is a target period with the OECD Model Article 25(5).

63. The Indian experience in this regard has been somewhat similar. The Indian CA has been successfully negotiating with treaty partners for settlement of cases under MAP. After years of experience gained from negotiations with treaty partners and improved situation with regard to exchange of information, Indian CA has been successful in concluding settlement of large cases.

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