

ADVANCE PRICING AGREEMENT - APA, BI-LATERAL ADVANCE PRICING AGREEMENT - BAPA, MULTI - LATERAL ADVANCE PRICING AGREEMENT – MAPA

Esther Hernández
Deputy General Director
Internal Taxes
(Dominican Republic)

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1. IN GENERAL

Advance pricing agreements (APA's) are agreements between the Tax Administration and the taxpayer, with the objective to establish a previous methodology for certain trading or financial operations between them, and which is valid for a specific period of time. According to the OECD: "An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparable and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time".

The purpose of these agreements is to avoid conflicts in the control of international transactions, whether they are unilateral¹, bilateral² or multilateral. They should all be legally based through provisions in their domestic legislation and/or under agreements to avoid double taxation and fight tax evasion generally included in article 25 both in the OECD tax Convention Model as well as in the UN Model, considered as a

¹ It is the one where the tax administration and the taxpayer, within the same jurisdiction, made a mutual agreement, without the presence of any other tax administration. In accordance with paragraph 4.129 of the OECD guidelines, the unilateral APA's can affect the tax obligations of companies involved in other tax jurisdictions; so it is suggested to inform the tax administrations interested or affected by the case.

² They are the ones in which the will and the agreement of several tax administrations from different jurisdictions are combined. In this case, the aim is to reduce the double taxation and establish equitable criteria for all the administrations involved in the agreement.

friendly procedure. It is worth noting that these two conventions are the international reference when referring to the international double taxation.

Given the importance of the use of transfer pricing in transactions between related enterprises, some countries in the region such as Ecuador, Honduras, Mexico, Peru and recently Dominican Republic, have extended their regulations for the control of transfer pricing including the APAs.

2. CHARACTERISTICS OF ADVANCE PRICING AGREEMENTS

The advance pricing agreements are within the framework of an innovative trend with the main object to avoid conflicts between the taxpayer and the tax administrations, reduce compliance control costs, and increase the legal certainty for taxpayers, since it is known that these agreements will govern the ways that each party will play. Among their main characteristics are:

- a. They formally begin under the taxpayer's initiative.
- b. It is an agreement that engage both the taxpayer and the Tax Administration.
- c. It is an agreement with a fixed period of time.

2.1. APA's Phases

1. Phase for providing the documents and information prior to the proposal: taxpayers will first present a series of documents and information referred to the subjects involved as well as the operation and its valuation.
2. Phase for presenting the proposal: once the period for the evaluation of the documentation and information previously presented is over, the final valuation proposal will be submitted along with the technical documentation.
3. Phase for examining the proposal: this is the preliminary examination phase that takes place within the tax administration in which taxpayers may also be required to cooperate, and even be able to present evidences and arguments.
4. Resolution: the resolution shall approve or reject the proposal. The rejection can be both explicit and therefore motivated, as per silence, if there is no answer within the established time, it will be considered rejected.
5. Recourses: the resolution issued by the administration shall not be liable to any appeal.

3. ADVANCE PRICING AGREEMENTS WITHIN THE CONTEXT OF DOMINICAN REPUBLIC

3.1. Background

Advance pricing agreements for pricing of transactions between related parties were included in the Dominican tax legislation in 2006. The amendment included in the Dominican Tax Code (CTD) sought to provide answers to harmful planning strategies carried out by companies involved in the all-inclusive hotel services³.

In Dominican Republic the business model of the all-inclusive hotels makes possible the relocation of profits to territories of lower taxation and tax havens. This is due to the high level of internationalization and characteristics of the industry. The following risks and functions are distributed through different actors, related to the services provided to the final consumer, the tourist, such as: the administration of the establishment, the distribution and the marketing, among others. In the case of Dominican Republic the tax loss generated by the use of transfer pricing in the sector is around USD\$100 to USD\$125 million yearly.

3.2. Tax planning of all inclusive business

The revisions made to the all-inclusive hotels activities showed their strong foreign connections, which facilitates transfer pricing in order to relocate profits to other jurisdictions. This premise could be verified through the analysis of a set of elements that emphasized their abusive use such as:

1. The use of all inclusive hotels of a related company that performs the marketing of the rooms (the retailer), located in most cases in tax haven countries or in a very low taxation country;
2. Constant losses and high debts with the marketing companies. For more than 10 years the sectors' taxpayers showed losses in their financial statements.
3. The night rates per guest declared before the DGII were lower than the operating cost per guest declared.
4. The advertised rates were higher, in more than one hundred per cent, to those declared to the DGII.

³ *The all-inclusive service is a form of hospitality, in which using a fixed rate contract, the hotels provide accommodation services which includes all meals, alcoholic and non-alcoholic beverages, recreational activities and entertainment, access to the beach, among others.*

3.3. APA's examination and negotiation processes

The examination processes carried out before 2006 did not generate the expected results for two reasons: (i) The strong foreign connection presented by the activity and (ii) the lack of legislation for the valuation of operations between related parties. These limitations did not allow the Administration to challenge the planning schemes used by these companies through transfer pricing for moving wealth to other jurisdictions, to schemes of lower taxation and to tax havens and this way reduce the tax burden in Dominican Republic.

The legal provisions on transfer pricing, prior to the 2006, 2011 and 2012 amendments did not allow the Tax Administration to better operate. The above-mentioned provisions neither were updated in relation to the international reality nor established a formal coverage to the regulations on transfer pricing audits.

In 2006, through law No. 495-06, an amendment to the tax code takes place, introducing elements that were necessary for the determination and the valuation of the transfer pricing between related companies and especially for those companies with all inclusive hotel activities. This article established the provisions on advance pricing agreements, being the basis for determining the comparability rates parameters per area, cost analysis and other variables of the all-inclusive hotel activity.

The power to agree APAs was defined as follows:

Section II: For the sector of all-inclusive hotels, which business is connected abroad, the Tax Administration may define advance pricing agreements (APA's) on the prices or rates that will be recognized based on comparability rates parameters per area, cost analysis and other impact variables of the all-inclusive hotel activity. The sector will be represented by National Association of Hotels and Restaurants (ASONAHORES in Spanish) for signing the APA. The agreements will be published by a Resolution and their validity shall be eighteen (18) months. The subsequent agreements may be valid for up to 36 months. In cases in which Advance Pricing Agreement (APA) has expired and there is no new agreement, the previous agreement will continue to be in force until the new APA (Advance Pricing Agreements) is approved. The provisions of the Dominican Republic Tax Code on the determination of the taxes are in force. (Article 281, section f)

These prices or rates shall apply for the purpose of settlement and/or determination of tax revenues for the transfer of industrialized goods and services tax (ITBIS)¹ and from the operating income for

income tax (ISR). The Tax Administration may challenge the taxpayers reached by the APA, the declared values when they do not correspond to the included criteria and will apply the penalties established in the Tax Code. The same treatment might be granted to processes related abroad, such as: the insurance, energy and pharmaceutical sectors. (Article 281, section g)

Perhaps the most innovative element in the former Dominican legislation with respect to the APA's, as they are defined in the OECD and in the laws of countries that have adopted measures for the control of the operations with related parties, is the impossibility to sign unilateral agreements. This made it extremely difficult to reach consensus on the methodology, margins or transfer pricing between the DGII and hotels. Furthermore, the execution of the APA was blocked by a variety of interests within the hotel industry.

The Tax Administration, after modifying the legislation on transfer pricing included in article of the CTD in 2009, leads again an audit process for the all-inclusive hotels, based on an audit sectorial strategy carried out by the areas responsible for external audits. The audits, to determine the taxable income of Dominican source, were based on the powers and elements that allowed the CTD at the time, basically by considering the limitations of the transfer pricing guidelines⁴, and complemented with the economic reality principles and the judicial power to determine ex officio.

For the fiscal period (January-December) from 2007 until 2010, and in some cases 2005 and 2006, after the companies that operate all inclusive hotels submitted their corresponding returns; The tax base for the determinations of the taxable income of Dominican source, was determined on the basis of the rate per night to be paid by the guest or final client abroad. By using the described procedure between 2009 and 2011, 73 audits were performed. As a result, favorable judgments from courts were achieved as well as tax payments due from taxpayers.

Based on the results of the audits performed, taxpayers were informed about the determinations in order to give to give continuity to the legal provisions of the tax code and agree on advance pricing agreements.

⁴ *The article in the CTD on transfer pricing, article 281, 2010 was very limited. Even by specifying that the valuation of the benefits between related parties must be carried out in the manner that had been agreed between independents, the legislation did not include important elements for their determination, for example valuation methods. It is not until mid-2011 that general Rule 04-2011, provides a legislative framework that is broad in terms of transfer pricing as a definition of related party, valuation methods, and comparability adjustments to increase comparability, obligation of referral information and penalties for non-compliance.*

Since the APA were defined as collective agreements and in addition to the internal conflicts of interests of the sector, this prevented the signing of the APA DGII/ASONAHORES, despite the audit processes of transfer-pricing which the sector had been subject to in order to improve its tax compliance. This situation triggered the modification in November 2012 of the article about APAs in the Tax Code, eliminating the section on APA's and introducing new regulations in this regard.

4. CURRENT SITUATION AND FUTURE CHALLENGES

4.1. Modification to the Transfer Pricing regulations

With the publication of the law 253-12, to strengthen the State revenue collection for Tax sustainability and sustainable development, new amendments were introduced in the transfer pricing regulations and, in particular, on transfer pricing agreements

Article 281-bis was added, providing regulations on advance pricing agreements, establishing the general format through which the request for agreement will be presented. This article modifies the above mentioned provisions, allowing the negotiation of unilateral Advance Pricing Agreements.

Taxpayers may request agreements regarding transfer pricing from the Tax Administration, in which the trade and financial operations values with related parties will be established. As usual, this agreement has a fixed period of time and must be signed prior to the operations.

According to article 281 provisions, when requesting an APA, the taxpayer must present a proposal based on the values in which the transactions are paid between independent parties in similar operations. APAs can also include the financing of the taxpayers by third parties, in cases where the taxpayer is subject to interest deduction limitation. All these procedures apply for bilateral as well as multilateral agreements.

Once the proposal is reviewed, the Internal Tax General Directorate has the power to approve it, reject it or modify it, and this decision cannot be appealed. Nevertheless, if the proposal is modified, the taxpayer is not bound to sign the agreement. As established in paragraph 3 of article 281 bis, this agreement is effective for the current fiscal year and the three following tax exercises. Similarly, it applies for the tax exercise expired since the signature of the APA, until the agreement signature date, with a limitation of two tax periods.

In addition, article 281bis, paragraph V on protection regimes (safe harbors) was also included, by which the TA determines the arm's length Price in agreement with the activity or transaction, and the taxpayer may or may not accept the regime. Once this enters into force for sectors or transactions with known and identified risks, it would result in a better and more efficient control of tax planning through controlled transactions.

4.2. Application of the Code provisions

According to the current Dominican Tax Code provisions, the approval of APAs requires to complete the phases of knowledge, negotiation and discussion of the proposals, as well as their signature and verification. Currently, representatives from all-inclusive Hotel sector are discussing the signing of the agreements. Even if unilateral APAs can be signed, these negotiations have been collective.

Procedure:

1. ASONAHORES submits the proposal and documentation related to the operations and their valuation
2. The Tax Administration reviews the submitted proposal.
3. The proposal is discussed and negotiated by both parties (ASONAHORES-DGI). The Administration presents alternative proposals in relation to procedures and valuation of the sector activities.

Characteristics and contents of the agreement.

- a. Various prices are proposed according to the category and geographical location of the taxpayer.
- b. The rate is fixed based on the cost margin method to determine the amount of ITBIS (similar to VAT), and an effective minimal tax rate for the income tax.
- c. Submit Information to verify that it complies with APA
- d. It is valid for 3 years, plus the negotiation months.

5. OTHER EXPERIENCES

The Tax Administration has also negotiated simplified tax regimes agreements with agricultural associations of the Dominican Republic. In 2010, agreements with rice and milk producers of these associations were negotiated. These agreements establish a simplified tax procedure based on income, for those producers no having an organized accounting. Similarly, in 2012, a similar agreement was signed with banana producers.

The main objective is to reduce the compliance costs for small producers, granting them facilities for submitting of their income tax returns. The agreement exempts them from providing information on the tax vouchers and allows them to determine their net taxable income by applying the proper deductions. In spite of this, it must be noted that they are not Advanced Pricing Agreements, but they enrich the experience and negotiating capacities of the Tax Administration

6. LESSONS LEARNED

The development of negotiations to enforce the Advanced Pricing Agreements shows that there is not just a single method to face the taxpayer's planning strategies through transfer pricing.

It was concluded that strengthening these exchange of information agreements is important for our country, since this is the only way to establish objective criteria to apply transfer pricing rules. It would be an additional resource that the administration would have to reach the truth about the facts surrounding the taxpayer.

With the application of the agreements, legal security is improved, since the criteria and methods are agreed upon for operations described in the agreement, and this application may increase foreign investment. In addition, the risk of double taxation is reduced: In this case it prevents double taxation if the other Tax Administrations accept them.

Until today, the tax administration has not signed any Advanced Pricing Agreement with the Hotel sector. However, meetings have been held with representatives of this sector, in order to determine prices for reaching an APA. In this case, the DGII has established the methodology and has performed the estimates in order to establish the method and the net price/margin to be applied on the costs to determine the hotels' profits.