Cocktail of measures for the control of harmful transfer pricing manipulation, focused within the context of low income and developing countries
COCKTAIL OF MEASURES FOR THE CONTROL OF HARMFUL TRANSFER PRICING MANIPULATION, FOCUSED WITHIN THE CONTEXT OF LOW INCOME AND DEVELOPING COUNTRIES
Technical collaborators

**Argentina**
Solange Lizewski
Alfredo Sosa

**Brazil**
Marco Aurelio Valadao
Tatiana Falcao
Andrea Costa Chaves

**Colombia**
Equipo de la Universidad del Externado de Colombia

**Ecuador**
Jairo Godoy

**United States of America**
Margaret Kent
Robert Feinschreiber

**Honduras**
Victor Manuel Sánchez

**Italy**
Giammarco Cottani

**Mexico**
Alejandro Calderón Aguilera
Moisés Curiel García
César Edson Uribe Guerrero
Gabriel Oliver García

**Uruguay**
Márcia Grostein

**Venezuela**
José Luis Galindez Narvaez
Acknowledgments

The CIAT Executive Secretariat especially acknowledges all the experts that have devoted time to review our proposals and offer suggestions that have allowed us to achieve a higher level of objectivity. We also highlight the technical contributions to the proposals of this document, stated within the framework of the 2nd Meeting of the CIAT International Taxation Network, by participants from the tax administrations of Argentina, Brazil, Colombia, Costa Rica, Chile, Dominican Republic, Guatemala, Ecuador, Honduras, Jamaica, Mexico, Paraguay, Peru, Spain and Uruguay; IDB, LATINDADD, OECD, Maastricht University, Externado University of Colombia, World Bank Group, Leiden University and TJN. This event was held in Antigua, Guatemala in 2018, thanks to the sponsorship of EUROsociAL+, Spanish Cooperation (AECID), the Inter-American Development Bank (IDB) and the Guatemalan Tax Administration (SAT).

A notable mention is given to the role of GIZ of Germany, which has not only provided the resources for developing this proposal, but also allowed us to assist for several years the tax administrations of Latin American and the Caribbean countries in developing their capacities for controlling transfer prices. This is one of the main inputs considered for analyzing the problems faced by the region within this sphere of action.

It is worth noting that as a result of the coordination of efforts between CIAT, GIZ, UN and SAT of Mexico, a technical assistance project was carried out for the SRI of Ecuador, whose objective was to develop a risk assessment model for controlling international operations and in particular, transfer prices which inspired the section of this document entitled: “Risk assessment model for transfer pricing and international tax control”. We wish to thank all those who have contributed to the success of this valuable experience.
Message from the CIAT Executive Secretary

The international tax community has been considering for some decades the best practices for controlling transfer pricing. However, technology has been advancing at a greater pace than these measures. Said technological advances, together with the globalization process, have been gradually altering the way of doing business and the control mechanisms used by the tax administrations. This situation placed the issues dealing with “international taxation” in the center of global tax discussions, with transfer pricing control being one of the issues with greater specific weight for developing countries. In spite of the countless hours devoted to the research and analysis of this matter by multiple organizations, the international community continues to trust –almost unanimously – in the general principle that governs transfer pricing for tax purposes: the "Arm’s Length Principle". This causes many known complexities that have not been solved, which should be taken care of.

This situation motivated the CIAT Executive Secretariat to explore flexible proposals regarding issues that require greater development on the part of the international community, thereby generating this “Cocktail”. Its ingredients and condiments constitute proposals that endeavor to arrive at an analysis that may result in more effective controls, greater compliance and if possible, greater level of simplification.

I am convinced that this proposal will be useful for evaluating regulatory and administrative reforms, as well as an additional link to move forward in the research of this very complex and relevant issue for the CIAT countries.

Márcio F. Verdi
Executive Secretary
CIAT
Message from the authors

The transfer pricing system mainly seeks tax equity. It establishes mechanisms that contribute to eliminate economic double taxation, promote international trade and whose implementation involves great challenges for the taxpayers who are compelled to comply with the system, as well as for the tax administrations. Given the lack of adequate rules, the difficulty for accessing information and the limitations of some tax administrations for applying effective controls, there is the risk that individuals carrying out operations with related parties may considerably reduce their tax burden by transferring benefits to jurisdictions with lower taxation, thereby interfering with the equitable and proportional nature of the income tax and social justice.

Experience has shown us that the mere implementation of a regulatory transfer pricing system does not ensure success. In spite of having implemented rules more than 5 or 10 years ago, several Latin American countries have still numerous barriers to overcome as the practical implementation of a transfer pricing system involves many factors. Audits are not the only tool for aligning value creation with the report on earnings and the payment of taxes, however, it is necessary for the tax administrations to count on a combination of resources, such as, clear rules, an appropriate risk management model and a varied range of options for effectively approaching the taxpayers.

That is why, using the past decades of experience in Latin American and Caribbean countries as an example, we were able to verify that the "Arm’s Length Principle" is difficult to apply with the tools available at the global level, within the regional context and with the resources available to the great majority of said countries. The developing and low-income countries need to implement manageable measures according to their possibilities that may be adequate for achieving the desired effectiveness in the practical application of the aforementioned principle and in its case, compatible therewith.

Within the framework of a technical assistance project on international taxation that was provided to ONAT of Cuba with the financial support of the European Union. We discussed the aforementioned problems, as we sampled a cocktail in the mythical Bar “La Floridita” in the Cuban capital –which was frequently visited by Hemingway during his stay in Havana. Here, arose the idea of creating a “Cocktail” of manageable measures for transfer pricing control. Its objective is to respond to the needs of the tax administrations and inspire them so that, regardless of the availability of resources, they may attain the possibility of managing more efficiently and effectively an issue that usually exceeds the capacity of many tax administrations.

In the current context, characterized by globalization, determining each country’s corresponding tax base requires several complementary mechanisms. In this sense, the transfer pricing “Cocktail” provides tools that may be analyzed and appraised by the States, in order to adopt ingredients from the “Cocktail”
which, in the manner proposed in this document or with adaptations to the local context, may allow
countries to control international taxation and transfer pricing more efficiently and effectively within
their own scenario.

Our intention is that each country may carry out an in-depth evaluation of the “Cocktail”, in order
to choose the ingredients and condiments that are better adapted to their regulatory and practical
possibilities, which similarly refers to the different manageable measures posed in this document. The
Transfer Pricing “Cocktail” is the conclusion of several years of analysis, compilation and reflection,
which we expect will be discussed within the sphere of forums at the global level, with the intention of
disseminating and gradually improving it.
Cocktail of measures for the control of harmful transfer pricing manipulation, focused within the context of low income and developing countries
## Content

Technical collaborators .................................................................................................................. v
Acknowledgments......................................................................................................................... vi
Message from the CIAT Executive Secretary............................................................................... vii
Message from the authors............................................................................................................ viii
Introduction .................................................................................................................................. 13

1. INGREDIENT 1: Perspective to apply the "Best Method Rule" ............................................... 20
   1.1. Background ......................................................................................................................... 20
   1.2. Problems ............................................................................................................................ 21
   1.3. Justification ....................................................................................................................... 25
   1.4. Examples of Proposal (Generic/Specific) .......................................................................... 26

2. INGREDIENT 2: Referential profit margins .............................................................................. 29
   2.1. Background ....................................................................................................................... 29
   2.2. Justification ....................................................................................................................... 29
   2.3. Methodology .................................................................................................................... 31
   2.4. Some experiences based on this approach ........................................................................ 31
   2.5. Examples of Proposal (Generic/Specific) .......................................................................... 33

3. INGREDIENT 3: Import/Export of raw materials and commodity transactions ...................... 35
   3.1. Background ....................................................................................................................... 35
   3.2. The so-called Latin American “Sixth Method” .................................................................... 35
   3.3. Justification ....................................................................................................................... 38
   3.4. Examples of proposal (Generic/Specific) .......................................................................... 41

4. Other related condiments ........................................................................................................ 45
   4.1. Condiment 1: Risk assessment model for transfer pricing and international tax control .... 45
       4.1.1. Introduction ................................................................................................................... 45
       4.1.2. Principal requirements for the effective management of tax risks: ............................... 46
           A. Inventory and availability of information sources ............................................................ 46
              Information sources ........................................................................................................ 47
              Statement of income ......................................................................................................... 47
              Statement of Financial Position or Balance Sheet .......................................................... 49
              Information of transactions with related parties ............................................................. 51
              Import / export and electronic invoicing information .................................................... 53
              Stock exchange information ......................................................................................... 53
           B. Integration and analysis considering a multi-year period and economic groups .............. 55
              Multi-year information .................................................................................................... 55
              Timely information ......................................................................................................... 55
              Analysis by economic groups and activities ..................................................................... 56
              Centralized management of information ........................................................................ 56
              Practical application of risk indicators ............................................................................ 56
              Selected practical application to specific sectors ............................................................. 58

4.2. Condiment 2: On the probability of tax evasion ..................................................................... 62
   4.2.1. Introduction .................................................................................................................... 62
   4.2.2. Methodology .................................................................................................................. 63
   4.2.3. Some experiences based on this approach ................................................................. 63
   4.2.4. Examples of Proposal (Generic/Specific) ..................................................................... 65

4.3. Condiment 3: A survey for measuring tax evasion and tax losses ....................................... 67
   4.3.1. Introduction .................................................................................................................... 67
   4.3.2. Methodology .................................................................................................................. 68
   4.3.3. Some experiences based on this approach ................................................................. 68
   4.3.4. Examples of Proposal (Generic/Specific) ..................................................................... 69
of measures for the control of harmful transfer pricing manipulation, focused within the context of low income and developing countries
Introduction

Following the international financial crisis officially declared in 2008, international tax issues have acquired greater relevance in the world's political agenda. Likewise, with globalization, national and international economies and markets have been substantially integrated, thereby generating strong pressures for adapting the international tax system to the current context. An evidence thereof is the BEPS Action Plan1 (BEPS: “Base Erosion and Profit Shifting”) agreed in 2015.

The rules that were being promoted have shown weakness, lack of effectiveness and a low level of adaptability for responding to changes in the taxpayers’ behavior, whose tax planning schemes have given way to the base erosion and profit-shifting phenomenon. In this sense, from the international experience it follows that some Multinational Enterprises (MNEs) have been tempted to artificially transfer profits to other jurisdictions, thereby shifting the profits away from the jurisdictions in which they were generated. This erodes the tax base and threatens the autonomy and sovereignty of the states. In other cases, technical differences or distortions are generated, which are not the result of tax issues and cannot necessarily be considered as abuses, but whose effect could likewise erode the tax base.

To verify the foregoing, in a preliminary study of a Latin American emerging economy, it was established through statistical analysis that, the greater the intensity of international transactions between subsidiaries, the lower the payment of income tax in large corporations. This is exemplified in the following graph:
Cocktail of measures for the control of harmful transfer pricing manipulation, focused within the context of low income and developing countries

The behaviour detected strengthens the hypothesis that groups artificially transfer profits to other jurisdictions, through international transactions between subsidiaries (otherwise known as transfer pricing manipulation).

The principle that governs transfer pricing (the "Arm's Length Principle") provides that transactions between subsidiaries should be agreed under the same conditions that which would have been settled by independent third parties in the market –thereby seeking to ensure that the value creation process of the enterprises is aligned with the earnings report and the payment of taxes. However, the transfer pricing methodologies are complex and subjective in their application and evaluation, for both the taxpayers and the tax administrations, which substantially limits their effectiveness.

The foregoing is linked to the main objective of the enterprise; the maximization of profits and the minimization of costs, taxes being a cost that in some cases are optimized in a responsible manner and in others not. The rules for transfer pricing control are also applied, thus making them a potential collection tool for the tax administrations wishing to increase their efficiency and effectiveness.

Although implementing transfer pricing may be complex, this should not be used as an excuse by MNEs to artificially transferring profits between their subsidiaries in order to achieve savings, nor, to place themselves in the extreme limit of compliance with the rules, thereby promoting tax evasion practices. Under the current status quo, it is only possible to adequately allocate the group’s profits through integral and analytical transfer pricing and market assessments, avoiding the generation of excess profit within the group’s remuneration system, and also ensuring the non-existence of double non-taxation and artificial profit shifting. It is important to specify that, in some cases, the motives behind the transfer pricing manipulation are unrelated to taxation. Nevertheless, there will always be an impact on taxation since transfer pricing is a zero-sum game; if a jurisdiction reports greater profits with respect to a transaction that involves two jurisdictions, the other will report less profits or earnings, accordingly.
From another perspective, it can be said that the "Arm’s Length Principle" effectively operates as a "craft" tool based on the search for market values as part of an intensive exercise examining facts and circumstances on a case by case basis (for example: the case of negotiations in mutual agreement procedures between Competent Authorities). Nevertheless, it has not been possible for this principle to be used as a massive control tool for ensuring that taxpayers reasonably comply with the regulations. Accordingly, this leads to distortions in the level of competitiveness between those enterprises that manipulate transfer prices and achieve a lower tax burden from those who do not.

In this sense, it is convenient that beyond the establishment of this theoretical principle (found in Article 9 of both the UN and OECD Model Tax Conventions, as well as in domestic legislations), the tax administrations endeavor to implement specific, practical and manageable measures to be used by countries that identify a tax risk in transfer pricing. This document is considered a complement and not a substitute of the aforementioned Article 9, maintaining the idea that earnings be reported where they were generated, thereby strengthening the spirit of the "Arm’s Length Principle".

Although the "Arm’s Length Principle" theoretically seeks perfect scenarios by utilizing methodologies to search for comparable transactions for every type of intercompany transaction among subsidiaries, ensuring that the tax profit be adequate, in practice, the implementation of these methodologies calls for an in-depth analysis, whose massive evaluation by tax administrations is almost impossible due to their limited resources (lack of information, qualified staff, material resources and the required analysis time) and the corresponding low coverage under which the international audit areas normally operate. In this sense, the general principle must be applied in a reasonable and practical manner, from the view that perfection is practically impossible to achieve in most of the contexts.

Although there have been unilateral and international efforts for simplifying, clarifying and rendering more applicable the "Arm’s Length Principle"—especially in development contexts—, this issue continues to be a highly technical and complex matter, which makes it difficult for businesses, including the small and medium ones, to comply with said obligations. This requires taxpayers to invest considerable resources in the search for the most appropriate method for ensuring transfer prices reflect market values. Given the subjective nature of the principle, taxpayers should count on a sound and positive contributive culture, a firm conviction and willingness to adequately comply with their tax obligations (also known as tax morality).

The application of the "Arm’s Length Principle" is complex and data-intensive both when selecting the most appropriate transfer pricing method, and when selecting the potential comparables to be used. In some cases, a low risk-perception from taxpayers (with respect to the control of transfer prices by the tax administration) has led to an inadequate application of the aforementioned principle, such as when it is carried out at the lowest possible cost, by resorting to simplistic and imprecise methodologies such as when transfer pricing becomes a minimum profit margin policy based on comparables (for example: cost plus 5% policy).

Thus, a series of key conditions have been identified, which together, establish the fundamentals for the correct implementation of the "Arm’s Length Principle" and the respective comparability analysis, but unfortunately, they are difficult to partially or totally be brought together in many countries. Said conditions are listed below:
- Tax culture and state of law.
- Success in the implementation of mechanisms aimed at improving transparency on the part of the taxpayer and the tax administration, to improve mutual trust.
- Adequate risk perception.
- Access and capabilities of the administrative and judicial courts to ensure quality in the judicial processes.
- Technical capacity of the international tax profession, including that of the tax administrations.
- Consistent accounting standards.

With respect to the tax administrations, the decisive factors that constitute prerequisites for attaining the best conditions to correctly implement the "Arm's Length Principle" are the following:

- Effective tax management (example: installed capacity, effective risk evaluation and adequate control program).
- Manageable universe of taxpayers.
- Access to useful local and global public information for transfer pricing control.
- Adequate faculties of the tax administration to allow access to the information and the adoption the necessary measures to safeguard the tax base.

In view of the above and along with the thrust of several organizations, which include international and regional organizations, civil society (Example: LATINDADD, TJN, OXFAM, IGF, ICTD, among other NGOs), tax intermediaries and members of the business community, it has been perceived the need to identify measures that may allow for achieving the following objectives:

- Provide taxpayers legal certainty over a complex and also subjective system.
- Simplify the way taxes are calculated and paid in the international context.
- Tackle and prevent tax evasion and avoidance.
- Reduce transaction costs for the taxpayer and the tax administration.
- Avoid economic double taxation at the international level and promote international trade.

The tax administration's capacity for assertively identifying risks is key for achieving several of the proposed objectives.

To this end, the ingredients of the "Cocktail" propose manageable measures and procedures for the tax administrations. Their objective is identifying transfer pricing manipulation risks, prioritizing and controlling them, reducing controversies, improving collection effectiveness in transfer prices cases and, to the extent possible, reduce therewith the compliance cost of taxpayers subject to the transfer pricing regime. All of the foregoing has been proposed with special emphasis on the context of developing and low-income countries.

It also entails the design of high impact and broad coverage measures and procedures that ensure that the "Arm’s Length Principle" may be reasonably self-determined by the taxpayers, based on simpler but at the same time rigorous mechanisms that may reduce uncertainty and subjectivity in the management of the principle, thus, ensuring that taxes are paid where the economic activity is carried out and the value is created. The measures and procedures proposed in this document, in addition to focusing on
improving the management capacity of tax administrations, endeavors to impact on the behavior of taxpayers subject to the transfer pricing regime.

It is thus crucial that the tax administrations opportune their tax base erosion resulting from the aforementioned problematic, and that they do not allow significant amounts to accumulate derived from a taxation gap attributed to the application of transfer pricing regulations. Given this scenario, three "ingredients" and a five complimentary "condiments" are proposed. It should be noted that the point of inflexion for applying the recommendations of the first two ingredients occurs between enterprises that carry out routine activities or not, and make unique and valuable contributions or not.

<table>
<thead>
<tr>
<th>Suggested ingredients and condiments for preparing the Cocktail:</th>
</tr>
</thead>
<tbody>
<tr>
<td>▶ Ingredient 1. Perspective to apply the “Best Method Rule”. This section considers the difficulties in identifying the best method for evaluating a controlled transaction between related parties. It contrasts each one of the five transfer pricing methods, creating an exercise that assesses and rejects each method, until arriving at the most appropriate one. This requires substantial knowledge of the analyzed transaction, as well as the information available and, specifically, the available potential comparables. In this sense, a model for clearly identifying the best method is proposed.</td>
</tr>
<tr>
<td>▶ Ingredient 2. Referential profit margins. In specific cases, depending on the industry and the particular situation of the enterprise, it is proposed that referential profitability standards be established (approximate to that of open markets). The proposal considers this measure for low risk (routine) as well as high-risk entities, using comparables and consolidated information from the MNE’s as a reference to arrive at an integrated risk assessment system.</td>
</tr>
<tr>
<td>▶ Ingredient 3. Import/export of raw materials and commodity transactions. International operations involving the commercialization of commodities is a sensitive issue for many developing countries. According to the OECD Guidelines the most appropriate transfer pricing method is the Comparable Uncontrolled Price (CUP) method. However, this ingredient proposes more prescriptive measures that are easier to implement and control.</td>
</tr>
<tr>
<td>▶ Other related condiments</td>
</tr>
<tr>
<td>a. Condiment 1. Risk assessment model for transfer pricing and international tax control: the design of procedures that allow for systematic and timely identification of transfer pricing manipulation risks constitute a challenge for many tax administrations. Since this is an important process that influences the spending of tax administration resources (which are usually scarce), the present ingredient has been developed. It constitutes an illustrative proven guide for tax administrations to better approach this process. Risk management influences decisions such as; the selection of taxpayers to be audited, the risk of taxpayers that may be considered eligible to apply for simplified regimes, and the application of preventive measures, among others.</td>
</tr>
</tbody>
</table>
b. **Condiment 2. Geographical market adjustments**: This condiment is meant to reduce the differences that arise between comparables due to their operation in different jurisdictions or economies, in accordance with the common transfer pricing comparability standards. Three different approaches are proposed for improving comparability: (1) adjustments of working capital as substitute to the country risk, (2) adjustment of “country risk” on assets, and (3) adjustment to the “weighted average cost of capital”. This proposal favours the second option as it can be applied in the most simple and direct manner: by adjusting the operating assets of the comparable enterprises that are impacted by the varying profitability levels of the jurisdictions or economies at stake.

c. **Condiment 3. International double taxation (access to the “Mutual Agreement Procedure”).**
This section analyzes how the aforementioned proposals could coexist with the provisions found in double taxation treaties and the mutual agreement procedure. The main objective of the proposed measures is to ensure fair and timely tax collection, while maintaining conditions favourable for international trade.

d. **Condiment 4. Alternative mechanisms for dispute resolution between taxpayers and tax authorities.** In view of the intensity that is required from the analysis of facts and circumstances, and the general complexity and subjectivity existent in transfer pricing, it is necessary to explore the implementation of new procedures (e.g. mediation or other dispute resolution mechanisms) that may allow taxpayers and tax administrations to seek technical solutions and mutual consensus with respect to their differences. These methods have been proven useful and effective when adopted in an environment of cooperation and transparency, and under the principles of flexibility, speediness and immediacy.

e. **Condiment 5. Sanctioning system to enhance compliance with the transfer pricing regime.**
This section assesses which elements are necessary to consider for documentation and sanctioning regimes, in order to allow the tax administration to obtain sufficient, relevant and reliable information.

This document presents practical proposals to enhance compliance with, and execution of, the "Arm’s Length Principle". The aforementioned proposals could be adopted either through explanatory or secondary interpretation rules, or through amendments to the laws (such as anti-abuse or safe harbour measures), according to the intensity, scope and prescription that governments consider as adequate. Based on this idea, it is important that states balance the legal certainty of the tax system against the purpose to avoid double taxation. The following graph suggests different ways that these measures may be implemented, as well as a brief description thereof:
Additionally, a diagram illustrating the advantages and disadvantages of the different forms for implementing the proposals is found below:

<table>
<thead>
<tr>
<th>Manners of implementing the measures</th>
<th>Double no taxation</th>
<th>Double taxation</th>
<th>Subjectivity</th>
<th>Juridical certainty</th>
<th>Exhaustive documentation</th>
<th>Prescriptive measure</th>
<th>Technical capacity</th>
<th>Non-technical capacity</th>
<th>Review process</th>
<th>Burden of proof: Tax Admin</th>
<th>Burden of proof: Taxpayer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anti-abuse measure</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓</td>
</tr>
<tr>
<td>Opt Out Safe Harbour</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓</td>
</tr>
<tr>
<td>Optional Safe Harbour</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓</td>
</tr>
<tr>
<td>Normative interpretation</td>
<td>✓✓✓✓</td>
<td>✓✓✓</td>
<td>✓✓</td>
<td>✓✓✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓</td>
</tr>
<tr>
<td>Transfer pricing guides</td>
<td>✓✓✓✓</td>
<td>✓✓✓</td>
<td>✓✓</td>
<td>✓✓✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

**Source:** authors

**Note:** The larger the number of checkmarks, the more intense is the effect generated.
1. INGREDIENT 1: Perspective to apply the "Best Method Rule"

1.1. Background

According to the experiences of several CIAT member tax administration officials, it has been found that transfer pricing professionals recurrently fail to develop an adequate and complete evaluation when selecting the transfer pricing method that is most appropriate, according to the circumstances of each particular case. Also known as the “Best Method Rule”, this procedure for selecting the best methodology should consider the following elements:

- The respective strengths and weaknesses of the five recognized transfer pricing methods;
- The suitability of the method selected, considering the nature of the controlled transaction (determined by means of a functional analysis);
- The availability of reliable information (particularly the existence of adequate comparables) necessary to apply the selected method; and,
- The level of comparability between controlled and uncontrolled transactions (including the reliability of the necessary adjustments to eliminate the differences that may exist).

Practitioners commonly resort to predetermined and generic reasons for justifying the incorrect application of a method, which generally turns out to be the least costly one. Moreover, it is the Transactional Net Margin Method (TNMM) which is favoured, this being a unilateral approach inasmuch as it only evaluates one of the counterparts of the transaction. This method measures the operational profitability of a segment of the business, commonly evaluated by using the financial statements of the local subsidiary (domestic entity), and comparing it with the operational profitability of comparable businesses in the analyzed segment. This practice, which is part of the taxpayers’ self-assessment, may generate tax base erosion to the detriment of certain countries.

Moreover, the problem dealt within this section is that some practitioners are not adequately trained, well-oriented, or have obsolete and inadequate beliefs in the selection of the method. In addition, they do not invest sufficient time and analysis for conceptually identifying the best method for evaluating a controlled transaction between related parties, by comparing each of the five transfer pricing methods in an assessment and discarding exercise. This begins with the substantial knowledge of the analyzed transaction, as well as the information available and specifically, the potential comparables at hand. The foregoing situation is worsened when we refer to subsidiaries of multinational groups in low income or developing countries. On many occasions, these countries do not have public information available regarding their economy or potential local comparables. This can make applying the appropriate transfer pricing methods difficult or even impossible.

The correct application of the “Best Method Rule” begins with a conceptual analysis of the suitability of each of the five transfer pricing methods and the possible information sources for their application. This analysis will result in the most appropriate approaches according to their applicability, by taking
into account the type of transaction analyzed and possible availability of information for evaluating it. However, within the framework of the aforementioned analysis, other premises should not be prioritized to discard methods. For example, the administrative burden associated with the implementation of a method, or, the level of access to information from the counterpart to the transaction, a motive to which the taxpayer usually alludes to, saying that although they are part of the same entrepreneurial group, they are independent legal entities. These latter isolated premises (i.e. the administrative burden and lack of access to information from the foreign entity) cannot, nor should they, limit the application of the “Best Method Rule”.

It is precisely the criterion mentioned in the foregoing paragraphs where an innovation is raised, which gives origin to a proposed measure that renders more prescriptive the application of the “Best Method Rule”, whose objective is to educate, guide, oblige and, as appropriate, sanction the taxpayers and their advisers. The ultimate goal is that they may specifically follow the procedures for the selection of the best method. Simultaneously, the intention is not to allow a relaxed selection of methods, thereby avoiding that professionals may resort to inadequate methods which perhaps may be easier and less burdensome to apply, but which interfere with and render impossible that the “arm’s length” principle may ensure that businesses pay taxes where the business is generated. The intention is not to render the transfer pricing analyses longer and more costly, but rather that they be focused on the relevant and methodologically adequate elements.

In this sense, the countries’ tax base face a critical challenge with respect to the profits reported by multinational entrepreneurial groups. They probably involve relevant intangibles developed by these groups locally (e.g. in low income or developing countries) but whose profits are not being correctly reported in their returns and are not paying taxes. This results from the inappropriate application of the transfer pricing methodologies and entails the artificial transfer of earnings to other entities and jurisdictions, thereby affecting the integrity of the tax system.

I.2. Problems

It has been determined that professionals and enterprises resort to the generalized practice of automatically applying a unilateral approach to the domestic entity, without considering other methodological possibilities. This poses two main problems: (1) the exclusion of methods that could be more appropriate in the particular case, and (2) the application of a method that is neither adequate nor acceptable for the specific situation. With respect to the first item and by way of example, it must be mentioned that it is very common that the generalized and systematic reasoning for accepting the TNMM – taking into consideration the "domestic entity" – and the rejection of the other transfer pricing methods, be based on the following arguments:

<table>
<thead>
<tr>
<th>Recognized Transfer Pricing Methods</th>
<th>Tested Party</th>
<th>Acceptance/Rejection of the Method</th>
<th>Reasoning</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td>Not Applicable</td>
<td>Rejected</td>
<td>With respect to this method, no other evidence was obtained on similar products/services that were agreed between third parties under the same circumstances as this particular case, so it was decided to discard its application.</td>
</tr>
</tbody>
</table>
Cocktail of measures for the control of harmful transfer pricing manipulation, focused within the context of low income and developing countries

<table>
<thead>
<tr>
<th>Method</th>
<th>Domestic Entity</th>
<th>Foreign Entity</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>RPM</td>
<td>Rejected</td>
<td>Rejected</td>
<td>Due to the fact that this method is based on comparing the gross profit between the domestic entity and comparable entities, a high level of consistency in the classification of costs is required. Since there is no conclusive way to evidence whether the comparables follow a uniform criterion in the allocation of costs and/or operating expenses (which would result in possible distortions to the results), it was decided to discard this method.</td>
</tr>
<tr>
<td>CPM</td>
<td>Rejected</td>
<td>Rejected</td>
<td>This method was chosen because its evaluation is based on the operating profits and therefore is tolerant to differences in the characteristics of the goods/services, and in the possible discrepancies between the classification of costs and expenses that may exist from an accounting perspective. The domestic entity was considered to be the tested party because it performs the simplest comparative functions, has not developed non-routine intangible assets, nor does it make unique and valuable contributions. Finally, it has the required degree of detail in the financial information available.</td>
</tr>
<tr>
<td>TNMM</td>
<td>Accepted</td>
<td>Rejected</td>
<td>The foreign entity was not considered to be the tested party because it is the most complex entity and its financial information is not available.</td>
</tr>
<tr>
<td>Transactional PSM</td>
<td>Not Applicable</td>
<td>Rejected</td>
<td>The application of this method takes place when two or more related parties make contributions of unique or valuable intangibles, or, when the transactions between related parties are closely linked. As this is not the particular case, this method was discarded.</td>
</tr>
</tbody>
</table>

It follows from the foregoing chart, that there may be occasions where the systematic application of the TNMM may cover situations where the direct method of comparison of goods (“Comparable Uncontrolled Price Method”, also known as the "CUP") could be the best or most appropriate method. An example of this situation occurs when evaluating a transaction involving the transfer of goods whose prices are found in a recognized and transparent market. In these cases it is possible to find reference prices used by independent third parties to agree on these operations (see the “Raw Materials Import/Export” section), so then it would be appropriate to apply the CUP Method.

One should also consider when the Resale Price Method (RPM) and the Cost Plus Method (CPM) is most appropriate, especially when analyzing limited risk distribution activities (purchase from related parties and sale to third parties) and manufacturing by contract (purchase from third parties and sale to related parties), respectively. With regard to the Profit Split Method (PSM), it would be most appropriate when both parties of the transaction make unique and valuable contributions.

Furthermore, the TNMM ensures that the operational profitability originating from a business segment that involves related transactions will not be affected by conditions that differ from those that would have occurred between independent companies in comparable circumstances. In other words, that the operational profitability may be found within the market parameters.

However, its implementation and analysis focuses on measuring the financial profitability of only one of the counterparts of the transaction (unilateral approach), according to the earnings obtained by similar businesses in the market. In this sense, the methodology does not evaluate the two counterparts
and therefore, it is necessary to select one of the two entities that are part of the analyzed transaction (example: domestic or foreign entity), which shall be designated as the tested party to evaluate the "Arm's Length Principle".

According to the OECD's Transfer Pricing Guidelines, the subsidiary to be selected as the tested party in the application of the TNMM should be the less complex one, and should not make unique and valuable contributions\(^1\) in the value chain, as stated in paragraph 2.65 of the aforementioned guidelines:

\[
2.65. \text{A transactional net margin method is unlikely to be reliable if each party to a transaction makes unique and valuable contributions, (see paragraph 2.4). In such a case, a transactional profit split method will generally be the most appropriate method, see paragraph 2.115. However, a one-sided method (traditional transaction method or transactional net margin method) may be applicable in cases where one of the parties makes all the unique and valuable contributions involved in the controlled transaction, while the other party does not make any unique and valuable contribution. In such a case, the tested party should be the less complex one. See paragraphs 3.18 and 3.19 for a discussion of the notion of tested party.}
\]

In this sense, determining whether the domestic or foreign entity will be the most appropriate "tested party" requires an extensive analysis (i.e. resorting to qualitative and quantitative criteria as supporting evidence) for both parties to the transaction, thereafter, making it possible to apply the “Best Method Rule”. In other words, the transfer pricing analyses should not ignore the information from any of the counterparts in the transaction, as it eventually and erroneously occurs in practice. In some cases, obtaining information from the foreign counterpart to the transaction is an almost impossible challenge for the tax administration, which are faced with a lack of will, cooperation and transparency from certain taxpayers.

On the other hand, if there is information from both parties to the transaction, one must distinguish the entity that has unique and valuable contributions from the entity that does not. Only then will it be possible to choose the less complex part for the correct application of the unilateral approach. For example, the less complex entity will hardly be an entity in charge of exploiting natural resources, a tourism operator, an entity manufacturing sophisticated pharmaceutical products, or a distributing entity responsible for market penetration, making valuable contributions and being the entity responsible for the success or failure of the business.

The OECD Transfer Pricing Guidelines note that the application of the TNMM method will barely be reliable if each party makes “unique and valuable” contributions (paragraph 2.65). However, they reiterate that this type of unilateral approach can be applied when one of the parties makes all the

---

1 In conceptual terms, the unique and valuable contributions are defined as attributes held by an entity but which (i) are not comparable with those of independent third parties in potentially comparable operations (“unique contribution”), and (ii) generate value in a significant manner, implying the expected generation of greater future economic benefits than would be expected in their absence (“valuable contribution”\(^9\), which basically frames the success or value generating factors of the business. Thus, if an entity carries out activities associated to the value generators of the business, (generally when there is control of the risks and the financial capacity for assuming said business risks) and these circumstances are not understood by the potential comparables, the contributions would be considered unique and valuable and the application of the unilateral approach would not be viable.
unique and valuable contributions involved in the related operation, while the other party does not. This could be either the domestic entity or the foreign entity party to the controlled transaction.

When a transfer pricing analysis is made, it is necessary to obtain preliminary qualitative and quantitative information from both parties to the controlled transaction (i.e. domestic and foreign entities), since this is the most adequate way of correctly distinguishing between approaches within the framework of the “Best Method Rule”. Since this analysis is bidirectional by nature, one should be careful not to automatically select the domestic entity as the tested party, without fully supporting or evidencing the reason for arriving at said conclusion. These situations avoid that the domestic entity’s valuable contributions and related profitability are ignored, and that aggressive schemes go unnoticed when the counterpart lacks substance or is a front company. This violates the “Arm’s Length Principle” and erodes the tax base, especially in capital importing countries (such as developing and low income countries).

Thus, to the extent that one or several members of the entrepreneurial group make unique and valuable contributions, the related parties must be remunerated for their contributions according to market conditions, beyond a routine return. This will include in some cases the way in which the profits or losses of the group are distributed, taking as similar situations between independent third parties as a reference, or simply identifying the contributions of each member of the group. This will determine the entity or entities that are entitled to obtain remuneration for their unique and valuable contributions, whilst resembling market conditions (for example, using the profit split method).

As stated, unique and valuable contributions relate to value drivers, which can be manifested through intangibles or comparability factors that generate some competitive advantage for the business. Moreover, intangibles have been recognized as a basic premise for the success of entrepreneurial groups, identified through the activities that generate them. For example, the advertising, marketing and promotional activities that are carried out to increase awareness and attention when entering new markets, as well as the research and development activities that aim to attain new and better production processes and technologies.

It is important to mention that every day there are an increasing amount of businesses being identified that carry out value adding functions in relation to the generation and exploitation of intangibles. Moreover, in cases that involve business strategies such as market penetration, expansion and market maintenance, the profits are not being correctly reported, due to artificial transactions between related companies that allow for these functions to be reported in other jurisdictions. This is possible thanks to the extensive and inappropriate use of unilateral transfer pricing methods in the domestic entity without due consideration of the other transfer pricing methods. This problem deals with the use of unilateral approaches when making valuable contributions (example: intangibles), and involves volatile scenarios where it is practically impossible to find adequate comparables.

In this context, it is necessary to highlight the correct application of the transfer pricing methods. This implies analyzing the value generating and intangible functions as part of the "Best Method Rule". Thus, in situations where the domestic entity may count on unique and valuable contributions that could render impossible the application of the unilateral approach therein, one may resort to the counterpart of the transaction as the tested party (provided it does not carry out value added functions). Or else, one may consider the aggregate profitability of the transaction through the Transactional Profit Split method, which is precisely designed for situations where both entities of the transaction contribute unique and valuable intangibles. This is less dependent on the use of comparables that finally split the
global profitability between the related enterprises based on objective parameters. Paragraph 2.65 of the Transfer Pricing Guidelines clarifies this principle:

2.65. A transactional net margin method is unlikely to be reliable if each party to a transaction makes unique and valuable contributions, (see paragraph 2.4). In such a case, a transactional profit split method will generally be the most appropriate method, see paragraph 2.115.

In short, the unilateral approach is practical although it has its limitations, specifically when the analyzed entities have unique and valuable contributions. Therefore, it is necessary to analyze these situations and their implications and try to find adequate and feasible measures for allocating profitability in these situations that may be similar to the market conditions. In this way, one may contribute to improve the legal certainty, either by designating the foreign counterpart as the tested party with the unilateral approach, through the application of the Transactional Profit Split method or other transfer pricing methods, even through anti-abuse measures in specific situations, as shown in the following diagram:

<table>
<thead>
<tr>
<th>Company A (domestic)</th>
<th>Company B (foreign)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Without unique and valuable contributions</td>
<td></td>
</tr>
<tr>
<td>The tested party must be the least complex entity (Company A or B)</td>
<td>The tested party is Company B</td>
</tr>
<tr>
<td>Without unique and valuable contributions</td>
<td></td>
</tr>
<tr>
<td>The tested party is Company A</td>
<td>A unilateral approach is not possible, could try the transactional profit-split method</td>
</tr>
<tr>
<td>With unique and valuable contributions</td>
<td></td>
</tr>
<tr>
<td>Company A is selected without knowing if it was the least complex entity</td>
<td>Unilateral approach is not possible, other methods will have to be used</td>
</tr>
<tr>
<td>No access to information from Company B (foreign)</td>
<td></td>
</tr>
</tbody>
</table>

1.3. Justification

To ensure the correct application of the “Best Method Rule” and avoid overusing the unilateral approach, it is necessary that the transfer pricing regulation be more prescriptive in the approach (e.g. TNMM for the domestic entity). This will ensure access to the information of the counterpart in the transaction, and will not allow the use of an entity having unique and valuable contributions as the “tested party.” Thus it will guide taxpayers toward a better and proper selection of methodologies that may guarantee
that the profit report and tax payment are aligned with the value creation of each of the entities in the group.

One of the solutions to this problem is to clarify and interpret the comparability standard starting from the differences between the tested entity and the potential comparable. These differences result from a view into the detailed functional analysis and the complete business cycle to assure that there are no significant differences related to valuable contributions (those dealing with the success factors or value drivers which usually involve the use or creation of intangibles). If these differences are not adjusted, one would necessarily have to reject these potential comparables in the application of the unilateral approach given that it implies the presence of unique and valuable contributions.

It is clear that when the domestic entity incurs in non-routine functions and contributes or maintains unique and valuable intangibles, it cannot be used as tested party. Thus, one could opt for the counterpart of the transaction as tested party provided it does not incur in non-routine functions and does not contribute or provide unique and valuable intangibles. The OECD Transfer Pricing Guidelines reiterate that the reliability of the unilateral transfer pricing methods will be substantially reduced if the entity or entities carrying out the non-routine functions are selected as tested parties (see paragraphs 6.58 and 6.141 of the Transfer Pricing Guidelines).

Likewise, when facing a domestic entity wherein there are no comparables and which at the same time carries out functions, uses assets or assumes risks in relation to the development, enhancement, maintenance, protection and exploitation of intangibles, (that is, which are expected to contribute to the value of the intangibles), it is appropriate to use the information from the counterpart (through a functional analysis and financial information). This is so regardless of whether said counterpart operates in the local jurisdiction or abroad, in order to apply the appropriate transfer pricing methods (e.g. global aggregate profitability approach [profit split method] and/or unilateral approach from the perspective of the counterpart in the transaction).

However, given a lack of information from the counterpart and the inability to apply appropriate transfer pricing methods to the particular case, tax administrations would be forced to select alternative approaches, such as ensuring routine profitability for the entity or business segment. Additionally, they could assign a reasonable earning to expenses associated with the unique and valuable contributions (probably intangibles) that were not calculated in the comparability analysis. This, taking into consideration that the functions of the domestic entity go beyond the parameters of the comparables, while there are expenses that corresponded or immediately benefit another entity in the group (probably the counterpart of the transaction).

I.4. Examples of Proposal (Generic/Specific)

In terms of scope, control, and certainty, different measures are proposed for solving the problem at hand: how to properly apply the “Best Method Rule” and reduce the excessive use of the unilateral approach. One such measure could be to further clarify the definition and application of the comparability analysis in a rigorous manner by identifying between a valuable and non-Valuable contribution and describing in detail the process of acceptance and rejection of comparables, as well as the application of adjustments.
This clarifying measure is more prescriptive and detailed than what recognized transfer pricing guides and manuals establish regarding the “Best Method Rule” application. This is so, inasmuch as it identifies and highlights the differences that may arise from the comparison of valuable contributions; they should not go unnoticed in a comparability analysis and if differences are not solved, they could result in the definitive exclusion of said comparables from the analysis.

Under this premise, it is proposed that consideration be given to a rule that may clarify the following:

**Comparability criterion and reasonable adjustments**

Operations or businesses may consider themselves comparable when there are no differences between the analyzed business and the potential comparables that may significantly affect the price or amount of the compensation or profit margin referred to in recognized transfer pricing methods for achieving the “arm’s-length principle” and in certain cases, when such differences exist (of comparability between the analyzed transaction and the comparables), these can be eliminated through reasonable comparability adjustments, as described below.

To determine possible differences affecting the comparability analysis, one must consider the following comparability elements: (i) the transaction characteristics, (ii) the functions or activities, including the assets used and risks assumed in the transactions of each of the parties involved, (iii) the contractual terms, (iv) the economic circumstances, and (v) the business strategies, including those related to market penetration, duration and expansion.

To apply the foregoing, one must use, as an interpretation instrument, the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations approved by the Council of the Organization for Economic Cooperation and Development (OECD) (or the UN Practical Transfer Pricing Manual for Developing Countries).

Thus, the element mentioned in the foregoing paragraph (ii) (functional analysis) also includes the identification and consideration of the valuable contributions within the functions or activities, the assets used, and the risks assumed in the transactions defined as those business conditions or attributes that generate value in a significant manner, which implies the expectation of generating greater future economic benefits than what would be expected for lack thereof. This is generally evidenced through created or utilized intangibles, or through comparability factors that define some competitive advantage of the business, including the development, enhancement, maintenance, protection, and/or exploitation of intangibles.

Thus, if the comparability differences between the transaction or the tested party and the potential transactions or businesses proposed as comparables are determined on the basis of valuable contributions and significantly affect the price or amount of the compensation or profit margin referred to in the methods, one would be faced with unique and valuable contributions. In this sense, it would technically be incorrect to consider the aforementioned operations or businesses as comparables.

Independently, in order to propose a more prescriptive measure, focused on directing the application of the “Best Method Rule,” and so that it may be adjusted to the practical possibilities of the different countries, a measure that is conceptually based on a more direct, practical, and proportional way of identifying valuable contributions is described. It has to do with activities that have been identified as development, enhancement, maintenance, protection, and exploitation of intangibles (generally when control is exercised on the risks and financial capacity for assuming said risks), which covers such common concepts as advertising, promotion, publicity, and royalties for trademarks expenses, as well as research and development expenses. These activities are generally reflected in investments, costs or identifiable expenses in the taxpayers’ financial statements.

In view of the above, if the intensity in the activities generating the intangibles identified in the financial statements of the entity are significantly and statistically different from those contributed by the
potential comparables, they will be considered under this approach as differences affecting the price or amount of the compensation or the profit margin referred to in the transfer pricing methods. For this reason, it would not be valid to use them as comparables in the transfer pricing analyses. To identify and evaluate said activities, which generate intangibles, one may resort to qualitative rejection criteria which adequately measure this impact. For example, by identifying the significant differences in the intensity of operational expenses, especially advertising, promotion, publicity, research, development, and royalties, between the tested party and the potential comparables.

To promote the correct implementation of the “Best Method Rule”, and especially to prevent overuse of the unilateral approach, the following is proposed: If a taxpayer does not carry out an adequate comparability analysis to discard potential comparables due to significant differences, in cases where the valuable contributions made by the referenced entity significantly exceed those identified in the comparables, the costs and expenses associated with said surplus valuable contributions, on not being considered in the compensation system, they are not associated to the entity’s earnings and accordingly, there could be fiscal repercussions. In this sense, said costs and expenses would lack economic rationale for said entity, since they may be benefiting another subsidiary of the multinational group, which could have been avoided with the implementation of the “Best Method Rule”.

In this respect, an innovative measure that would definitely lead taxpayers to align the earnings report to their business, could be focused on encumbering the possible surplus expenditures in situations where the unique and valuable contributions are not aligned with the compensation system of the referenced entity, inasmuch as they are not adequately considered in said system, and do not benefit or generate profit as an independent entity. These two modalities are:

▶ Determine that said expenditures are a benefit for a foreign entity, for which it should have a withholding tax through the national legislation, or as appropriate, by means of a treaty.
▶ Determine that said expenditures are not viable for tax purposes, since they are not strictly essential for achieving the purpose of the business, even though said expenditures may benefit or be made on behalf of another subsidiary of the group.

The last measure would not be triggered if the transfer pricing methods (“Best Method Rule”) are applied correctly and in an orderly manner. In this way the taxpayer is not obliged to use the information from the counterpart in the transaction to correctly apply the “Best Method Rule”, but rather they provide guidance when said information is not available and they cannot adequately compensate, through recognized transfer pricing methods, the unique and valuable contributions, which thus provides legal certainty to the taxpayers.

---

2 Together with the proposed exercise, one should analyze whether the dynamics of not considering said activities in the compensation system could give way to the classification of permanent establishment if said activities are carried out in the name of another subsidiary of the group.
2. INGREDIENT 2: Referential profit margins

2.1. Background

The purpose of this section is to propose a simplified measure for calculating, evaluating, and setting preliminary referential profitability margins according to each taxpayer type (such as economic sector, entrepreneurial group, if it is a routine entity and if it carries out operations with related parties). This would be part of an integral and effective international taxation and transfer pricing risk evaluation system. The latter may also influence in a positive, persuasive and significant way, the taxpayers self-assessment through the issuance of information and clear risk parameters, thereby promoting a contributive culture and the legal certainty of the regime.

In this sense, the foregoing section (Perspective to apply the “Best Method Rule”) is relevant as it lays the conceptual basis to distinguish between the routine activities or businesses that may be evaluated through a unilateral approach, and those activities that make unique and valuable contributions and would have to be evaluated differently. Thus, different alternatives should be sought for determining their profitability according to the market conditions.

2.2. Justification

This simplified measure constitutes an innovation for those countries that have not evaluated or applied it, as it has an effect on the work of the tax administrations, as well as the obligations of taxpayers subject to the transfer pricing regime. The proposal consists, first, of an integral, more direct and greater control measure. Through the latter, it will be possible to identify and calculate a preliminary taxation gap for each of the taxpayers and economic and industrial sectors which the State wants to protect based on market references. It would thus provide tax administrations the capacity for distinguishing, in an initial risk evaluation stage, the magnitude of possible tax base erosion according to the economic and industrial sector. Likewise, it would allow for prioritizing the measures and possible candidates (with a significant tax gap) for a second risk analysis stage, as part of an integral risk evaluation system.

Secondly, through this same measure, sector reference-related financial parameters may be disclosed to small and large taxpayers, mainly profitability ratios from relevant industries, productive factors intensity, and other relevant financial reasons. In this way, legal certainty can be offered and clearly inform situations where the tax administrations may consider there is a non-compliance risk, in relation to the profitability system implemented by the taxpayer and the results recorded in the company’s financial statements and tax returns.

This does not mean that this measure serves to evaluate or directly and definitively establish the transfer pricing market values. Rather, it provides a means for knowing the most adequate preliminary risk indicators for decision-making in a complex and subjective international taxation regime. One of the purposes of this disclosure of referential indicators to the taxpayers by the tax administrations is to guide the businesses for complying clearly and expeditiously with their tax obligations. It specifically refers to the general market trends, to minimize the complexity and practical difficulties faced.
Through this proposal with this renewed risk perception, the businesses and their decision makers will know with certainty, when they have surpassed the parameters and find themselves in a possible tax risk situation. In this way, they may react on time to evaluate, document and, if applicable, adjust their transactions or cross border tax schemes. All this, under the premise that this measure does not interfere with the taxpayers’ obligation in relation to transfer pricing and transactional analysis.

It is important to mention that this measure will be well aimed, depending on the quality of the information used. That is, the institutional databases of the Tax Administration, as well as the external databases consulted (e.g.: databases that include and organize the financial information of companies listed in worldwide stock exchanges or companies that publish their financial information).

For internal database analysis, it will also be necessary for the taxpayers to be correctly classified in the appropriate economic or industrial sector within the institutional databases. Otherwise, it will be desirable to undertake a classification or reclassification, taking into consideration the most comparable industry catalogue to those used in international practices (e.g.: Standard Industrial Classifications).

Firstly, routine taxpayers will be applied sectoral financial parameters. These will be calculated based on internal information (companies of the economic or industrial sector according to the databases of the tax administrations) as well as external information (databases of businesses that publish their information, whether or not listed in the stock exchange).

This will occasionally require the implementation of adjustments to the financial parameters in order to adapt them to the national market where taxpayers operate (e.g.: for adjustments according to geographical location, see: “Geographical Market Adjustments”). These sectoral indicators have also proven to be useful at the international level, especially in procedures between Competent Authorities in the context of international tax treaties.

Non-routine taxpayers will be preliminarily evaluated by considering the consolidated profit margin reported by its multinational group, it being possible to resort to public information as well as the information included in the Country-by-Country Report – Action 13 of the BEPS Action Plan. In this context, the right to residual profits or losses of the group arises from the alignment between the value added functions existing between the subsidiary and consolidated group.

This position seeks to avoid tax base erosion (BEPS) according to conditions that are similar to those of the market and use, as preliminary reference, available and adequate financial information pertaining to the group’s business reality as a whole and in its specific context. This approach would also be useful for complex businesses that cannot be classified in a single industry.

The majority of taxpayers can be considered as routine entities, it being applicable an analysis of sectorial reference indicators, while for non-routine entities, it will be necessary to apply an alternative approach based on the group’s consolidated information that may resemble the market conditions.
2.3. Methodology

Calculating the referential profit margin starts with the payment of taxes as this is the ultimate motivation for any tax planning strategies. Basing the ratio of direct taxes paid over the entity’s income, and comparing this to the ratio of an unrelated entity in the same economic or industrial sector (choosing an entity without a significant amount of intercompany transactions would help to avoid biased results). Other levels of profitability are also considered (e.g.: operational and gross level) to analyze the tax and financial performance of the taxpayers belonging to each sector and thus, detect with greater accuracy the possible cause of the preliminary tax gap. For additional details, see the section of "Condiment 1. Risk assessment model for transfer pricing and international tax control".

The preliminary tax gap amount calculated from the entire collection of taxpayers, or a relevant group thereof (e.g. large taxpayers), will result from the difference between the profit ratio of the taxpayer or specific sector and the reference profit margin. This will allow for evaluating and subsequently identifying possible tax base erosion schemes, from fictitious deductions as well as income not reported at all levels. This will be so when they result from erroneously reported or fictitious intercompany transactions, which include those taxpayers with null tax payments.

According to this approach, it is necessary to divide the entities between routine and non-routine to apply the sectorial financial parameters or the profitability of the consolidated group. To this end, it will be necessary to resort to financial premises or ratios that adequately determine the circumstances under which companies are considered routine. This could be assessed, for example, through the intensity of relative operational expenses (entity’s functional profile indicator). Alternatively, if there is more detailed information, for example, through expenses such as advertising, marketing, publicity, research, development, and royalties, with reference to thresholds identified in the specific sector.

Lastly, according to the entity type, this measure will assign average profitability references by specific sectors at several levels (e.g. tax, before tax, operational, and gross level) to calculate the preliminary tax gap by taxpayer or economic sector, as part of the quantitative analysis of the holistic risk assessment system. This information may be used internally by the tax administrations when planning and programming processes, and subsequently be disclosed to the taxpayer as a preventive measure in compliance with the "Arm’s Length Principle" or as an anti-abuse measure through a safe harbor, optional or mandatory, with exit, according to the needs of each jurisdiction.

2.4. Some experiences based on this approach

As mentioned at the beginning of this section, considering referential profit margins is not a completely new experience. There are studies of experiences with profit margins that where found to support and effectively fulfill their purpose.

Many developing countries evolving in transfer pricing management rules have concluded that it is relevant to consider more effective practices. In this sense, several Latin American and Caribbean countries have implemented or are considering implementing in their rules the advance pricing agreements (APA). Nevertheless, the tax administration must have a certain level of experience and the taxpayer must perceive some risk that may motivate an approach to negotiate with the tax administration. In this sense, the knowledge of the economic sectors and, in particular, of its profit
margins, is a powerful resource for the Tax Administration to arrive at a reasonable agreement. In this way, and regardless of the measure proposed further on, the basic work of getting to know the profitability of the sectors is also a relevant factor for the aforementioned purpose.

For example, by using an approach similar to the one proposed, the Dominican Republic has achieved substantial progress in audits to the lodging sector, specifically in “all-inclusive” resorts. This sector represented 2% of the Dominican Republic’s GDP and 7% of its exports.

To protect the Dominican sourced tax base from this sector, in 2006 transfer pricing control guidelines for this sector were introduced in the internal legislation. With these tools, the tax administration determined the arm’s-length rates to subsequently sign a sectorial advanced pricing agreement on taxpayers from the “all-inclusive” resorts sector.

The rule read as follows: “In the all-inclusive resorts sector, whose business has particular relationships abroad, the tax administration may determine Advance Pricing Arrangements (APA) regarding prices or rates that will be accepted according to comparability parameters by zones, cost analysis, and other impact variables in the “all-inclusive” resort sector. For the signing of the APA, the sector will be represented by the National Association of Hotels and Restaurants (ASONAHORES). The agreements will be published through resolution and its term will be eighteen (18) months. Subsequent agreements may have a duration of up to 36 months. Whenever an APA expires and there is no new agreement, the previous agreement will continue in force until the new APA is approved.”

The legislation settled the parameters to establish the rates that would be determined as of the comparability analysis by zones, cost analyses, and other impact variables in the “all-inclusive” resort sector. The transfer price was determined based on the rate per night paid by the guest or final customer abroad, of 7-night packages excluding transportation, for selected dates according to: (a) the resort category, (b) its location, and (c) the season, high or low.

This method considers the price of the final consumers in their destination market and discounts the margins earned by wholesale and retail agents for the commercialization of the rooms. The transfer price (TP) is defined as:

\[ PR = \text{Average public rate of destination markets} - \text{Brokerage margin} \]

The average public rate of the destination market is the average of the rates at which the “all-inclusive” lodging night is sold in the native country of the final consumer/tourist. This rate was obtained through surveys.

The brokerage margin is the sum of the commercialization margins of tourism agents, such as Tour Operators or wholesale and retail travel agents. The commercialization margin would be the sum of those factors. This arm’s-length margin obtained by independent entities was 20% and 25%. This price was the base for determining the revenue from Dominican source, with respect to the Income Tax (IT) as well as the Transfer of Industrial Goods and Services Tax (similar to the Value Added Tax - VAT).
This method became a margin of reference when auditing companies in this sector. Also, it was used as a safe harbour for taxpayers, who in subsequent periods could use this to determine their Dominican sourced revenue.

This process led to 50% of the multinational entities providing this service whose revenues represented 83% of sector revenues, being audited. In spite of the success achieved, this section was eliminated from the sectoral APAs of the Tax Code. One of the reasons might have been the complexity of negotiating or achieving consensus with all the agents of an economic sector.

On a separate account, in Law 19 of Brazil, taxpayers have the possibility to request the Ministry of Finance for modifications of the fixed margins settled for the “resale price” and “cost plus” methods. According to the rule, the request must be made according to justified circumstances that may be determined by means of technical publications, research or reports. The Secretariat of Finance of the Ministry may dismiss the request, if it considers that the information submitted by the taxpayers is inconsistent. The Law also provides that the change of margins may be done under an own-initiative procedure, as published on September 17, 2012. In this case, the approach is different since the taxpayer is the interested party who must justify the differentiated margin and not the tax administration, which calculates it. Likewise, this process is not an APA either, as the tax authority may change the margin if it considers it appropriate. However, it may be considered as background linked to analyses that may support the use of referential profitability margins.

From the examples described above, it follows that the proposal is not a completely new experience. Nevertheless, it must be admitted that this approach would be innovative for many countries wishing for simpler control processes and taxpayers that expect greater certainty and, if possible, lower compliance costs.

2.5. Examples of Proposal (Generic/Specific)

It is praiseworthy that the countries, in a sovereign manner, are acting by implementing more prescriptive and less discrentional measures on industries or sectors considered sensitive, to prevent tax base erosion. This is so, either because their collection substantially depends thereon, or because they lack sufficient installed capacity for a direct intervention through specialized audits.

Thus, these measures endeavor to harmonize, simplify, and contribute to the “arm’s-length principle” application to routine and non-routine entities. In addition, whoever applies them correctly may be entitled to a lower administrative burden, with respect to supporting documents (e.g. simplified transfer pricing compliance requirements).

Based on the foregoing, a measure to settle a referential profitability margin scheme as optional safe harbor, with effects on compliance obligations is described hereunder:
Compliance Criteria related to Referential Profit Margins

Taxpayers whose aggregate profitability (without segmentation) may be equal to, or above the financial parameters according to its industry subsector or the consolidated profitability of the multinational group, according to the particular characteristics indicated in the tax administration's publication, shall be exempt from submitting the documents showing that the intercompany transactions were agreed as if they would have been carried out by independent parties in comparable transactions, as well as for the local file and master file, as long as it is stated by the taxpayer in the related parties informative returns.

Moreover, taxpayers who, on comparing their profits with the referenced margins, are significantly beyond the parameters to the detriment of the tax base, will be considered as candidates for a second risk evaluation stage that will be focused on confirming and identifying the causes whereby the profitability would be beyond the proposed parameters. This includes the analysis of tax erosion causes in international taxation, such as “base eroding payments” between related parties such as: services, royalties, interests, hedges, etc. However, this system will also detect taxpayers with eroding effects on the tax base whose causes are unrelated to transfer pricing and international taxation, giving way to other types of investigations and analyses.

For example, a country with limited audit capacity could implement a program with specific measures on transfer pricing, with clear and more direct rules, achieving tax effectiveness in a regulatory manner and avoiding unnecessary risks. This measure would allow for diagnosis, in a feasible and expeditious manner, possible risks in the compliance process for tax administrations as well as taxpayers, from an innovative perspective focused on prevention, planning, and orientation.

In sum, this measure is especially useful for developing and low income countries as it does not require counting on a robust tax specialist team focused on international taxation and transfer pricing. Likewise, a holistic and accurate diagnosis of the tax risks related to the taxpayers and economic sectors will allow a better use of their resources to implement, as appropriate, corrective and preventive programs (e.g. creating awareness, sanction/incentive) aligned with their objectives and capacities.
3. INGREDIENT 3: Import/Export of raw materials and commodity transactions

3.1. Background

The purpose of this section is to propose a convenient measure for countries where international purchase/sale of raw materials from the natural resources, constitutes an engine for the local economy. As a general canon, this type of transactions are considered as sensitive and risk activities for developing and low-income countries, since they generally represent an important portion of their tax revenues. This proposal would provide the tax administrations a more prescriptive measure that would allow to manage taxation originating from such transactions.

According to this approach, the authors share the criterion proposed by the OECD Transfer Pricing Guidelines which states that, in international transactions involving raw materials purchase/sale, the transfer pricing method applicable should be the Comparable Uncontrolled Price method, using the spot market price as reference. In this regard, the most appropriate transfer pricing method for the purchase/sale of raw materials is precisely the Comparable Uncontrolled Price method.

In addition, the OECD recommends that when evaluating a transaction involving the transfer of raw materials between related parties, whose prices have references in an international or national recognized market, an accepted and transparent statistical or price reporting agency, or a public price-setting agency, the raw material quotation price should be considered.

3.2. The so-called Latin American “sixth method”

More than a decade ago, the Argentinian Federal Administration of Public Revenues (AFIP) observed that large exporter groups – mainly related to the raw materials sector: grains, oils and oleaginous substances, hydrocarbons, mining and fishing- carried out triangular trade arrangements, from invoicing goods to a destination, but sending the stock to another, using traders based in jurisdictions with low or null taxation or in some preferential tax regime. The purpose of this scheme was to attribute earnings to an intermediary, by relocating income, through a selling price manipulation to reduce the tax burden in the raw materials original country.

Based on this evidence, Argentina developed the so-called “sixth method”. The name was assigned from the fact that it was settled in the sixth paragraph of the article of the Argentine rule that covers the five OECD transfer pricing methods. It was developed as a measure to restrain abusive tax planning schemes in transactions involving raw materials or commodities, wherein nonexistent or simulated intermediaries may get involved.

The original version dealt with raw material export transactions for products such as cereals, oleaginous substances and other land products, hydrocarbons and their related products and in general, goods with a known quotation price in recognized and transparent markets. It provides that if an “international
intermediary” (who does not meet “economic substance” conditions), intervenes and is not the effective consignee of the goods, then the price considered will be that found quoted in an international transparent market, on the date of shipping of the goods. This is done, regardless of transportation means, instead of the price that would have been agreed with the international intermediary, to determine the locally sourced income.

This measure has provided satisfactory results, by discouraging conducts that leads to tax evasion in a key sector of Argentina’s economy, as well as by its characteristics that focus on the international commercialization of raw materials or commodities, and lessen the subjectivity of applying of the OECD. The measure has been observed mainly in Latin-American countries and organizations. This has motivated its amendment and incorporation in Ecuador, Peru, Guatemala, Honduras, Paraguay, Dominican Republic, Uruguay and other countries.

After analyzing the some of the procedures in the Latin American region, we can conclude that the so-called “sixth method” does not constitute a single approach, since it has been implemented in some countries with different approaches, which may lead to diverse results in its application.

The way in which different characteristics or criteria are combined, may lead to an impact by the rule, as well as in the actions taken by the tax administration for its management. Although for practical reasons, this publication refers to these measures as the “sixth method” we are aware that the “sixth method” does not exist as a single measure and it constitutes a range of measures with different characteristics that can be adapted to the economic sectors and local contexts of each country, both in terms of its legal nature and its practical application.

Not all of these countries have managed to capitalize on their experience from this type of measure; however, the most experienced have been Argentina, Uruguay, Paraguay, Ecuador and the Dominican Republic. Later, in the section entitled “Examples of proposal (Generic/Specific)” the main approaches considered by Latin American countries regarding this figure are described.

Despite claiming that this method may be appropriate under certain cases, the OECD has recognized the practical difficulties that may arise in the valuation of these products, particularly in developing and low-income countries whose economies are highly dependent on such goods.

During the OECD discussions on this topic, several countries identified the following key issues to demonstrate a risk of tax base erosion in cross-borders transactions involving raw materials or commodities:

- The use of inter-company agreements that manipulate the price either through the date chosen or by agreeing to a lower adjusted price than that quoted internationally in order to erode the tax base of the source country;
- Significant adjustments to the sales price or allocation of significant fees charged to the taxpayer located in the country of origin of the raw materials or commodities (e.g. attributable to processing activities, transportation, distribution and marketing) by other subsidiaries in the group’s supply chain; and

---

3 See provisions contained in article 15 -including its article added below- of the income tax law (law 20.698 according to text ordered by decrees No 649/97 -B.O. 06/08/97- and its modifications; text reformed by the mentioned law 25.063 and by laws 25.239 and 25.784), and in the articles incorporated after article 21 of its regulatory decree (decrees 1344/98-B.O. 25/11/98).
Involvement in the supply chain of entities with seeming functionality, usually located in jurisdictions with little fiscal transparency and low or no taxation⁴.

The OECD identified that several Latin American countries had adopted unilateral domestically measures to price commodities trading and commodities and, therefore, warned the need to analyze and provide greater transparency on the application of the transfer pricing methods for these transactions.

Thus, the findings from the BEPS action plan and other proposed legislation has been studied and discussed, with the aim to set guidelines that would allow to clarify the application of the "Arm’s Length Principle" for raw materials⁵. In early October 2015, the final report of Action 10 of the BEPS Plan, which included the addition of new paragraphs in the OECD Transfer Pricing Guidelines, was published⁶. According to the OECD, these additions meant to establish an improved framework for raw materials or commodities transaction, to achieve greater consistency in the way that tax administrations and taxpayers determine the "Arm’s Length Principle". For instance, paragraph 2.18 contains an example for applying this method for a sale of coffee bean.

New paragraphs of the OECD Guidelines of Transfer Pricing are focused on the following points:

- They clarify the applicability and prioritization in the implementation of a direct comparison method to valuate commodities. In this regard, the guidelines now require that (i) this method is generally the most suitable to analyze these transactions between related companies; (ii) under a set of considerations, recognized and transparent market prices can be used as a reference to determine the "Arm’s Length Principle"; (iii) it may be necessary to perform comparability adjustments to assure that the relevant economic characteristics of the controlled and uncontrolled transactions are comparable enough.
- A guideline for determining the pricing date of raw materials or commodities is added, to prevent taxpayers from using pricing dates on its agreements, which allow the adoption of the most advantageous and erosive contribution to the tax base. It is accepted that the tax authorities may allocate, under certain conditions, the date of shipment as the pricing date for raw materials or commodities transactions⁷.

The provisions included into the OECD Transfer Pricing Guidelines consider some of the main elements and experience of Latin American countries that have introduced domestic standards for pricing raw materials or commodities (“sixth method”).

---


⁵ As part of that work, OECD invited in late 2014 to a public discussion on the document “BEPS - Action Plan 10: Draft for discussion on transfer pricing aspects of international operations with commodities”. The stated objective of the initiative was to provide guidance on the three issues identified above (manipulation of the dates of concerted prices, use of significant discounts as mechanisms to erode the final price of the good, and involvement in the supply chain entities with limited or non-existing functions- located in jurisdictions with opacity or zero tax or low - tax) which could result in the erosion of the tax base of the countries involved in operations commodities intragroup.

⁶ Regarding this issue, OECD incorporated into its Guides - Chapter II, immediately after paragraph 2.16 - further guidance regarding transactions of raw materials or commodities.

⁷ OECD (2015). OECD project and the G-20 on the erosion of the tax base and Benefit Transfer. Ensure that the results of transfer prices are in line with the creation of value. ACTION 8 to 10 - Final Reports 2015. Paris: OECD.
According to data provided by the tax administrations, the implementation of this simplified measure has yielded direct and indirect results as shown below:

- In Argentina, between 2001 and 2007, the tax generated from the export of cereals and oils increased by more than twelve times.
- In Ecuador, for the biennium 2009-2010, the new method established in 2008 resulted in an 18% increase in the value of declared exports. This is more than 6 billion dollars.
- In Paraguay, the audits carried out in 2011, exclusively in agricultural export companies regarding fiscal year 2007, caused an 8% increase in total collection of income tax, for such year.
- A similar method was applied in the Dominican Republic for income derived from “all inclusive” resort and hotel services, which until 2010 declared losses and selling prices for their services, below international prices. In this case, the shifting of profits was made by trading companies (linked to the hotel broker) located in countries with low or no taxation. To correct this, a method for calculating “competitive rates” was set, to replicate market prices for such services (hotel category, location and season, in a sample of similar countries). The new system increased the revenue from the “all inclusive” resorts and hotel sector by 818% more income tax and by 70% more VAT.

These methods can help to reduce avoidance and tax evasion, strengthening the collection and improving transparency and horizontal equity of tax systems.

### 3.3. Justification

The recurrent behavior in different countries by agents engaged in tangible goods import/export (in terms of the Argentinian version of the “sixth method”), raises the need to seek alternatives to the orthodox transfer pricing rules. In theory, just the “arm’s length” standard is ideal; however, several decades of experience shows that the practical application is difficult, moreover, when referring to developing countries.

Tax avoidance in raw materials export sectors can be very harmful to the Treasury for developing countries. As an example, according to data from the United Nations Economic Commission for Latin America and the Caribbean (ECLAC, 2016), apart from Mexico, Costa Rica and El Salvador, the rest of Latin American countries are between 50% and 80% dependent on trade in agricultural and mining commodities. Similarly, tax avoidance in the tourism sector may affect the achievement of the tax strength of countries that mainly rely on these activities (e.g. Caribbean countries). The negative effect becomes even more critical when the evasion or avoidance is linked to the exploitation of non-renewable natural resources, which creates environmental damage, depleting the country’s wealth and benefits.

Appropriate taxation of the main sources of foreign income is also essential to achieve horizontal equity of the tax system. This requires that the applicable taxes for these activities are closer to the true prices, by aligning value creation with earnings reports and tax payments. For example, we refer to the case where an agent buys at a fictitious low price and then sells to another entity that is the true destination of the export market price. In this case, there are no companies or transactions that may be considered as comparable, being difficult to prove the link between the exporter and the intermediary. Without a proper anti-abuse control mechanism, this could be a legal transaction for tax purposes and arduous to control by the tax administration.
The spirit of the so-called “sixth method” focuses on circumstances where individuals carry out international transactions of specified tangible goods. Moreover, it can apply when the following characteristics are present:

- Constant operating losses or low yields of the taxable base;
- Offshoring income and possible location in countries with low or no taxation;
- Evade export duties;
- They conceal the identity of the true purchaser and the actual transaction price;
- They carry out exports to countries other than those corresponding to the addresses of buyers on the invoice; and
- Close agreements with related parties in times when market prices are low by seasonality, but agree on fixed prices and/or delivery dates in times of rising international prices.

According to its characteristics, we believe that the application of a measure such as the so-called “sixth method” does not necessarily imply the application of a new transfer pricing method, as it has sometimes been interpreted. Its juridical status will depend on how it is implemented, this leading to inherent advantages and disadvantages. In this regard, we believe that the so-called “sixth method” would work better as a specific anti-abuse measure, thus avoiding litigious situations that arise from strict compliance with the general principle governing transfer pricing. For example, this measure could stipulate that under particular circumstances the CUP method shall be the most appropriate for transactions of raw materials, thus it would not be an anti-abuse measure. However, to achieve better implementation of the measure, countries may, according to their abilities, choose to take a more prescriptive view (closer to an anti-abuse measure); for example, not considering comparability adjustments in the application of the CUP method. Furthermore, they may impose a series of minimal conditions and characteristics as a requirement when the transactions involve an international broker. This, in part, could isolate the given results from the general principle governing transfer pricing (“Arm’s Length Principle”), but as discussed in the section on international double taxation, it would not contravene with international treaties.

In this sense, the result of specifying this as an anti-abuse rule is to accept that its application is not always a value that meets the "Arm's Length Principle" as it would be required with the strict application of a transfer pricing method. However, even its understanding as an anti-avoidance rule, this measure would apply to determine the profitability of operations in specific risk circumstances, aiming to collect taxable income that the taxpayer has improperly located in other jurisdictions, through transfer pricing manipulation and the use of intermediaries.

It is no coincidence that Ecuador, through Decree no. 973 SRI. # 736 dated April 19th, 2016, has decided to modify the so-called "sixth method", eliminating the legal text inspired by the Argentinian experience and attributing to its tax administration specific powers for their implementation, which allowed the tax administration to adopt it as an anti-abuse measure. Despite Ecuador’s initial successful experience in implementing the “sixth method” - especially in the banana sector -, its experience showed the difficulties in linking this measure with the "Arm's Length Principle".

It should also be noted that when designing a measure inspired by the Argentinian “sixth method”, it is essential to make clear the following aspects, on which there is no international consensus:
Cocktail of measures for the control of harmful transfer pricing manipulation, focused within the context of low income and developing countries

- Clear definition of raw materials and commodities;
- Scope of application of the measure (export / import);
- Legal nature of the measure;
- Information system necessary for its management; and
- Risk Analysis of erosive behaviors.

It is worth mentioning that the recommendations of implementation of the CUP method agreed by the OECD for comparing goods under the BEPS reference, is an important breakthrough that provides elements for a better implementation of such method. However, there remains a high level of complexity in the application of the "Arm’s Length Principle" and does not solve much of the risks on international transactions involving these goods. In this sense, the action raised in this section could be interpreted as a complementary tool to the work done by the OECD.

Given the limited resources available to the tax administrations of developing countries and their need for effectiveness in collection from these transactions, it is desirable that the adopted measure be:

- Flexible enough to be adapted to different relevant sectors or sub-sectors. Therefore, it is essential to carry out an analysis to monitor the behavior of relevant economic sectors and identify the risks that achieve the necessary feedback to adjust the measure to specific situations;
- Manageable - adequately improve management and control according to the jurisdictions needs; and
- Versatile in its application, to limit a discretionary power. The tax administration may appeal to cooperative compliance programs to define reference prices in complex economic sectors, avoiding arbitrary public prices which may be unreasonable to apply rules based on the “sixth method”.

Measures inspired by the “sixth method” have been effectively applied in Latin America to control transfer pricing in sectors such as cereal, oil, banana and fishing, with positive results (it should be noted that while the banana does not have a regulated price in a transparent market, there are local markets that publish prices that have been used as reference). In cases where there are risks of triangulation or lack of formality in operations and when the perfect application of “orthodox” methods is not possible due to the application of the "Arm’s Length Principle’, our understanding is that measures inspired by the “sixth method” favor control, thus reduce tax evasion and avoidance.

Similar measures to the “sixth method” were also adopted by the United States. For decades, the IRS has been applying similar methods in some industries (e.g. precious metals bought or sold such as gold and silver in coin or bar). During the 1980’s, the US Treasury sought to expand the focus into two additional industries, agribusiness and petrochemical. Under the analysis of these industries the 1482-3 (b) (5) section was enacted, categorizing this methodology as “Public Exchange and Quotation Media” and this approach was part of the direct comparison of goods (variation on the CUP method). This measure does not address the fishing industry treatment in the United States; however, Argentina has successfully applied this measure in the fishing sector.

Although this measure may have an impact on revenues due to the adjustments in raw materials or commodity transactions, the biggest expected impact is related to the increase in voluntary compliance due to a change in the taxpayers’ behavior to generate tax savings by avoiding transfer mispricing in these types of transactions.
3.4. Examples of proposal (Generic/Specific)

The various alternatives considered by countries that have implemented measures to control prices of commodities or similar goods are detailed below, indicating in each case the aspects to consider when legislating this measure. In all cases, we consider that the implementation of a measure inspired by the “sixth method” that fits the context and the legal and practical possibilities of the country, could provide significant benefits to correct the harmful behavior of taxpayers operating in marketing international commodities or raw materials.

<table>
<thead>
<tr>
<th>Topic</th>
<th>Alternatives</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transactions to which the measure applies</strong></td>
<td>Only export transactions&lt;br&gt;Only import transactions&lt;br&gt;Import and export transactions</td>
<td>Option 3 provides greater scope to the measure, it may be of interest to developed countries, importers of commodities or developing countries that export processed or unprocessed commodities</td>
</tr>
<tr>
<td><strong>Nature of the measure</strong></td>
<td>The measure as a way to apply the CUP method of comparing goods&lt;br&gt;The measure as a way to reach a price attributed to the “Arm’s Length Principle”&lt;br&gt;The measure as a specific anti-abuse rule&lt;br&gt;The measure as a calculated tax on the difference between the reference price and the price agreed by the parties</td>
<td>Given the litigation that the measure could cause when it is linked to the CUP method of comparing goods or to the “Arm’s Length Principle” for developing countries, it may be appropriate to consider it as a specific anti-abuse rule. Option 4 would also be convenient if we want to link the measure to the calculation of a tax different than the Income Tax.</td>
</tr>
<tr>
<td><strong>Products or goods under the scope</strong></td>
<td>Renewable natural resources&lt;br&gt;Non-renewable natural resources&lt;br&gt;Goods with quotation on recognized and transparent markets (defined or not by the tax authorities).&lt;br&gt;Some rules allow the tax authorities to extend the measure to other products under certain conditions:&lt;br&gt;The international intermediary has no economic substance.&lt;br&gt;Tax Administration deems it appropriate.</td>
<td>It is important to define the transactions on which the measure is applicable. This depends on the country profile and its capabilities. To conduct this analysis, it is essential to link the measure to cases in which it is possible to know the markets where the goods under the scope are destined, the public price of goods sold and the negotiated amount, as well as the conditions under which they are marketed.</td>
</tr>
<tr>
<td><strong>Relationship condition</strong></td>
<td>The relationship condition between the exporter and the importer and/or the actual recipient is essential for the implementation of the measure.&lt;br&gt;The relationship condition between the exporter and the importer and/or the actual recipient is not a requirement for the measure application.</td>
<td>For a fair and well-defined measure implementation, it may be desirable that the relationship condition exists. However, given the complexity in some cases to determine its existence, it may be required that the measure be applicable to all import and/or export cases that meet certain requirements.</td>
</tr>
<tr>
<td><strong>International broker status</strong></td>
<td>A requirement to apply the measure is that there is an international broker who allegedly has no economic substance. This condition does not exist</td>
<td>This condition is essential to define the application, especially when it is chosen to be considered as a special anti-abuse measure. For some countries, it may be difficult to determine the existence of an international broker without economic substance. It could also be complex for the taxpayer to prove that such broker has substance when it is not related. If installed and administrative capacity exists, adopting this condition would be appropriate and may justify its application as an anti-abuse resource, as it is directly linked to a risk derived from the taxpayer behavior. To include this option, it is suggested to clarify the characteristics that the intermediary should have and/or the jurisdiction in which it is located.</td>
</tr>
<tr>
<td><strong>Other conditions for application</strong></td>
<td>Depending on the circumstances, an evaluation of risky situations that trigger the application of this measure could arise, with or without evidence to the contrary. For example, price distortions, manipulation of contract dates, destination / origin of goods, etc.</td>
<td>If the tested party is implemented as an anti-abuse measure, it is advisable to define all possible situations that would give rise to its application so as not to leave gaps that may lead to avoidance. The method’s design depends on the objectives and context of each country.</td>
</tr>
</tbody>
</table>
Cocktail of measures for the control of harmful transfer pricing manipulation, focused within the context of low income and developing countries

<table>
<thead>
<tr>
<th>Method hierarchy</th>
<th>Mandatory under the conditions settled in the rule. Optional, being able to apply this measure or the CUP method.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Given the possible inappropriate use of transfer pricing methods by taxpayers and a complex control from the tax authorities in these types of transactions, it is important to define in which cases the measure would apply in a more prescriptive and mandatory way. If the conditions make it possible (e.g. tax culture and installed capacity of the Tax Administration), it is recommended to analyze the possibility for this measure to be optional.</td>
</tr>
<tr>
<td>Prices to consider</td>
<td>Highest price between: The quotation price in a recognized and transparent market on the shipment date. The price agreed with an international broker. Different treatment between exports and imports: Exports: international prices research at the last shipment date, unless proven that it was agreed on another date. Imports: cannot be overpriced based on international parameters of the purchase date. Multiple criteria in a single rule: Price in a recognized and transparent market on the date of shipping/unloading. Average price of 4 months or 120 days before unloading or after shipping. Price of the agreement's signature date. Average price from 30 days after the agreement's signature date. Market value of a recognized and transparent market at the shipping date, previous trading day or any shipping day (the approach varies on each country). International price in a recognized and transparent market (lowest quote in international markets), lower costs (port services, quality control, insurance and freight) and other items (losses, financial expenses from loans), equal to the referential price. Exporting price in the source market or of importing price in the target market, according to customs documentation. Some countries support the price agreed by the parties when the agreement is filed before the tax authorities or other governmental institutions at a predefined time.</td>
</tr>
<tr>
<td></td>
<td>Each country should define a formula or pricing mechanism according to its reality (e.g. relevant business context for its economy). It is advisable to rely on a public market price and, according to the needs, restrict the use of comparability adjustments to avoid subjectivity and promote greater control and management of the measure.</td>
</tr>
<tr>
<td></td>
<td>In defining the date that should be considered for the price in a recognized and transparent market on each rule, it is important to notice relevant markets or industries to the country's economy and consider their business cycles and seasonality. For example, if the date of shipment of goods is considered, it is important to identify the goods shipping timing and consider it in the price calculation.</td>
</tr>
<tr>
<td></td>
<td>It should be noted that for each type of good, a specific mechanism of trading and markets fitting each of them may be considered. Depending if we deal with publicly traded goods with “spot” or future quote, we must analyze the date to be used for proceeding with the respective comparability analysis. E.g.: date of contract, date of shipment, others.</td>
</tr>
<tr>
<td></td>
<td>It has been identified as a good practice that taxpayers have the possibility of signing their agreements before the Tax Administration, which drastically reduces the subjectivity in the analysis and control of such transactions.</td>
</tr>
<tr>
<td></td>
<td>As an alternative to the consideration of the date of pricing under the agreement, when taxpayers register them before the government agencies, a tax administration-after evaluating their convenience- could negotiate the pricing dates with the taxpayer. This could avoid the risk of not knowing the context in which operations were performed by basing the date of pricing on too formal criteria.</td>
</tr>
<tr>
<td></td>
<td>Some experts believe that, under certain circumstances, the agreement date could generate problems in implementing this measure, suggesting that the rule focus is always the shipment date.</td>
</tr>
<tr>
<td></td>
<td>In addition, while costly for the tax administration and requiring extensive networks for the exchange of information, some experts propose to consider the price according to the destination or origin customs value. This could, under certain circumstances, create risks of undervaluation or overvaluation (depending on how efficient are each customs offices).</td>
</tr>
</tbody>
</table>
Exceptions to the application of the measure

Situations where the taxpayer could not be subject to this standard (presenting evidence/information and risk level) are established. No situations that exempt the taxpayer from its application are established.

Exemption options might be advisable under some circumstances (e.g. through an anticipated price agreement (APA)). If certain criteria or conditions exist to implement the measure involving presumptions of tax erosion, it is recommended that there is a possibility so the taxpayer can prove otherwise. It is important that the regulations clarify under which precise circumstances the measure may not apply.

The options in the table above are only examples based on existing standards, being possible to adapt the standard to different industries and contexts, considering the key elements of this measure (e.g. applicable to raw materials, definition of a quote date, conditioning its application to specific circumstances, etc.).

The design of such measures and their implementation requires a thorough understanding of the economic sectors to which they apply, the study of the major import/export markets for each good, access to relevant customs information and international data, and appropriate risk management systems. It is also important to consider the significant difference between the application of these measures in transactions involving publicly traded goods with “spot” quotes and those that use futures contracts (e.g. sugar and coffee). The latter becomes relevant to consider in a “secondary regulation” the referential publications (by type of relevant raw material), the precise date or range of dates to be considered for the price or the price range selection of the measure. This rule should be used for economic sectors that can use public prices, which are highly relevant to the country.

If there is a business reason for not complying with a measure based on the so-called “sixth method”, we consider recommending as an “escape route” that taxpayers submit their case to a bilateral advance pricing agreement (APA).

This raises immediately a number of minimal conditions for designing and implementing such measures:

- Detailed knowledge of the economic sectors on which the measure will apply. Given the different approaches in which this measure can be applied, this document does not indicate the industries or activities to be affected; only a few examples are provided. The concerned countries must analyze the sectors to thoroughly assess the appropriateness to design a “sixth method” approach and possibly consider all the characteristics that allow it to be adjusted to each of the sectors evaluated.
- Knowledge of the characteristics of the markets in which the goods to be taken into account are traded.
- Access to customs information, agreements, assets, functions and business risks, and to the international exchange of information between relevant counterparts. The information requirements depend on the design of the approach.
- Risk management system that allows selecting the cases in which the measure would apply.
- Wide tax exchange of information network. In particular, it is recommended to sign the Multilateral Convention on Mutual Administrative Assistance in Tax Matters promoted by the Global Forum on Transparency and Exchange of Information of the OECD.
Given the practical difficulties observed in determining transfer pricing for raw materials or commodities, the task is not as simple as it seems. This emphasizes the possibility for countries to establish a simplified measure of valuation for these goods, even via an anti-abuse or “safe harbor” rule, without impeding tax administrations from remaining vigilant to cases that may create situations of double taxation.

While guaranteeing the taxpayer the right to a hearing and the exercise of effective opposition and defense, the simplification in the interpretation and application of transfer pricing methodologies should always be considered. This implies bringing the tax system into a field that must be manageable and reliable for the taxpayer. Taking a contrary position can cause a substantial and inevitable loss of tax revenues, which would affect the development of the countries that need it most.
4. Other related condiments

4.1. Condiment 1: Risk assessment model for transfer pricing and international tax control

4.1.1. Introduction

This section includes a practical guide for designing and implementing a risk assessment model for transfer pricing and international tax control. It proposes elements to design a comprehensive, easy to apply approach, with the possibility of being adapted to the different contexts of the tax administrations. For this purpose, we took as a reference the documents and manuals developed by various organizations like the OECD, IMF, CIAT, etc., that deal with the identification and evaluation of general and specific tax risks in international taxation and transfer pricing, especially those providing a practical approach for the application of indicators.

The guide is structured as a progressive path to follow; a series of step-by-step actions with clear and measurable objectives at each stage. The guide does not determine deadlines for the implementation of each step as this depends on numerous factors specific to each tax administration, for example, the availability of information necessary to carry out measurements and determinations specific to the needs of each jurisdiction. The diagram below summarizes the content in this section and proposes a suggested route for the control of tax risks from taxpayers who carry out international operations and transfer pricing.

The starting point is the inventory and availability of information relating to transactions with related parties (stage 1 of diagram); which means that if we do not have the necessary information for the risk assessment, the subsequent stages may not develop properly. Stage 2 refers to the integration of the information and its minimum requires characteristics. Among these are; the availability of information, the ability to access it in a timely manner, reliability, integrity and its presentation (e.g. a multi-annual structure, etc.). These two stages are further detailed in the subsequent section of this chapter. A discussion of stage 3 of the diagram (“Practical application of indicators”) is found at the end of Section IV.1, it includes an analysis of risk indicators and a comprehensive description of the topic of risk management for subjects who carry out transactions involving transfer pricing and international transactions. Stage 4 of the diagram, “Comprehensive Risk System” provides a description of the proposed calculations and the use of indicators.

Compliance Management of Large Business. (2009) OECD.
Corporate Loss Utilization through Aggressive Tax Planning. (2011) OECD.
Tax Administration Diagnostic Assessment Tool, Field Guide. (2015) MFI.
Working with Large Business. (2013) HM Revenue
Finally, in stage 5, the practical application of the different stages is described and illustrated through a specific case, proposing good practices for implementation and documentation.

It is important to note that for the purposes of this section, the term “management of tax risks” refers to actions that identify, measure and quantify the tax risks relating to transfer pricing and international taxation. As a stage prior to integrating a broader strategy of tax compliance that specifies actions in response to these tax risks.

4.1.2. Principal requirements for the effective management of tax risks:

A. Inventory and availability of information sources

For an effective management of tax risks, it is generally required to take inventory of the information available to the tax administration, whether it has been provided by taxpayers in their tax returns, in information statements, or coming from third parties (banking, stock exchanges, customers, etc.). As a best practice, it is recommended to analyze all tax information or additional information available to conduct effective risk management.
When it comes to the detailed information presented in the tax returns, some specific questions arise, including:

- Where can the derivative financial transactions and the effects of income deductibility/accumulation be found?
  - In the statement of financial position (balance sheet)
  - In the income statement
- Where can debts with foreign related parties, and the financial burden from such loans, be found?

The difficulties associated with the disclosure of specific information are increased when it comes to transactions with related parties, international operations, or corporate restructurings that have significant effects on the tax payments of the company or companies belonging to the same business group. It is therefore imperative to identify and quantify the effects of those relevant transactions, for effective risk management.

This section proceeds to identify some common sources of information for related party transactions and international operations that are available to tax administrations, with the intention of making them available to risk analysts in a multiannual form, classified by economic activity (mining, retail, car manufacturers, telecommunications, etc.). This ensures that the information is available in real time, or as soon as possible after the information has been received by the tax administration.

The sources of information listed below, as well as its content, serve as a guide to illustrate the central idea of identifying and making available to risk analysts, all information that is useful for risk assessment on issues of transfer pricing and international operations. Under the assumption that each country obtains diverse taxpayer information that differs in form and content from that requested and received; the aim is to encourage consistency in the analysis of the information available.

### Information sources

#### Statement of income

One of the main sources of information is the income statement, which has the basic structure shown in the following table (“Income Statement”). The main components are sales, cost of sales, operating expenses, other products and other expenses (from discontinued operations), to obtain a profit or loss before tax.
Table. Income statement

<table>
<thead>
<tr>
<th>J.H Trading Inc.</th>
<th>Income statement from January 1 to December 31, 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>-585,000</td>
</tr>
<tr>
<td>Gross income</td>
<td>414,200</td>
</tr>
<tr>
<td>Operating costs</td>
<td>-306,750</td>
</tr>
<tr>
<td>Operating income</td>
<td>107,750</td>
</tr>
<tr>
<td>Other products</td>
<td>13,081</td>
</tr>
<tr>
<td>Other expenses</td>
<td>-9,821</td>
</tr>
<tr>
<td>Profit before taxes</td>
<td>110,710</td>
</tr>
<tr>
<td>Income tax (IT)</td>
<td>-30,999</td>
</tr>
<tr>
<td>Workers’ benefits tax (SSC)</td>
<td>-23,942</td>
</tr>
<tr>
<td>Net income</td>
<td>55,769</td>
</tr>
</tbody>
</table>

Prepared by_________________  Authorized by_____________

Sales can be broken down as shown in the table “Sales” to identify whether they were domestic or export sales and if they were made to related parties or independent parties. An important element of the “Sales” table is the indication of the date the information was displayed. In the example, a multiannual form is presented, to facilitate the identification of trends and significant changes in the operations.

Other important elements are the refunds, discounts or rebates on sales, with the same time reference indicated for the sales, so that if there are refunds, discounts or rebates on sales to related parties abroad, their effect is assessed to determine if these revenues could be a risk in terms of transfer pricing.
The purchases and expenses that make up the cost of sales can be broken down in the same way as sales, i.e. if performed with national or foreign related parties (Table “Cost of sales”). The same rule should apply to operating expenses (Table “Operating Expenses”). As shown in the following table:

**Table. Cost of sales**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial inventory</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National net purchases</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Related Parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrelated parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net purchases of imports</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Related Parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrelated parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Final inventory</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Workforce</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Related Parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrelated parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indirect manufacturing expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Related Parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrelated parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of sales and / Services</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Table. Operating expenses**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Related Parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrelated parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Statement of Financial Position or Balance Sheet**

The Statement of Financial Position is the accounting report showing the economic and financial situation of a company at any given time. Furthermore, it reveals the way in which the business operates; through debt or equity, with intangible or fixed assets, providing services or having inventory, as a holding company or a subsidiary, etc. The statement not only shows the economic situation but also its operating structure, which is a relevant issue for risk analysis. Transactions with related and international parties can be spotted in the Balance Sheet to help identify potential tax risks.
The table “Statement of Financial Position” shows selected information regarding certain transactions such as foreign accounts payable/receivable, or foreign debts which may pose a risk due to the general deductibility of interest expenses which can erode the tax base.

Other concepts such as inventories, machinery and equipment, buildings, land, deferred charges and extraordinary expenses help identify transactions that could represent operational structures whose purpose is to reduce tax payments.

<table>
<thead>
<tr>
<th>Table. Statement of financial position.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>STATEMENT OF FINANCIAL POSITION</strong></td>
</tr>
<tr>
<td><strong>Active</strong></td>
</tr>
<tr>
<td>Cash and deposits in credit institutions abroad</td>
</tr>
<tr>
<td>Investments in securities with foreign institutions (except shares)</td>
</tr>
<tr>
<td>National accounts and notes receivable (related parties)</td>
</tr>
<tr>
<td>Accounts and notes receivable from abroad (related parties)</td>
</tr>
<tr>
<td>Inventories</td>
</tr>
<tr>
<td>Other current assets</td>
</tr>
<tr>
<td>Equity investments abroad</td>
</tr>
<tr>
<td>Lands</td>
</tr>
<tr>
<td>Buildings</td>
</tr>
<tr>
<td>Machinery and equipment</td>
</tr>
<tr>
<td>Furniture and office equipment</td>
</tr>
<tr>
<td>Computer equipment</td>
</tr>
<tr>
<td>Transport equipment</td>
</tr>
<tr>
<td>Deferred charges and expenses</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
</tr>
<tr>
<td><strong>Passive</strong></td>
</tr>
<tr>
<td>Accounts and Notes Payable National (Related Parties)</td>
</tr>
<tr>
<td>Accounts and Notes Payable Overseas (Related Parties)</td>
</tr>
<tr>
<td>Customer prepayments Related Parties</td>
</tr>
<tr>
<td>Customer advances unrelated parties</td>
</tr>
<tr>
<td><strong>Total liability</strong></td>
</tr>
<tr>
<td><strong>Stockholders’ equity</strong></td>
</tr>
<tr>
<td>Social Capital from contributions</td>
</tr>
<tr>
<td>Social Capital originating from capitalization</td>
</tr>
<tr>
<td>Contributions for future capital increases</td>
</tr>
<tr>
<td>Accumulated utilities</td>
</tr>
<tr>
<td>Net Income</td>
</tr>
<tr>
<td>Accumulated losses</td>
</tr>
<tr>
<td>Loss of exercise</td>
</tr>
<tr>
<td><strong>Total Equity</strong></td>
</tr>
</tbody>
</table>
In some cases, taxpayers disclose expenses or tax deductions that may be considered erosive to the tax base and which should be taken into account when identifying tax risks, such as; royalties and technical assistance fees, losses from derivative financial transactions, prorated costs and services in general, amongst others.

**Information of transactions with related parties**

Information on related party transactions is critical to the effective management of tax risks and to prevent the tax base erosion and the profit shifting. This information could be provided by the taxpayer to the tax authorities annually and in electronic form, thereby allowing for its automatic integration into the risk assessment model. In some cases, the taxpayers provide the transfer pricing study, which would ideally be expected in electronic form, to be processed and analyzed systematically by the tax authorities for them to obtain the most benefit from such information.

As part of the information provided, details of transactions with related parties are regularly obtained, such as the entity’s identification details (name or company name, tax identification number, country of residence) and the concept of the operation for each related party (income or expenses operation, specific concept, amount, transfer pricing method used, transfer pricing adjustments, etc.).

One of the variables considered in the risk assessment model is the relevance of the transactions, determining which are the primary risks needing to be identified. Moreover, identifying which type of transactions have the largest amounts (i.e. sales operations, inventory purchases, interests, general services, royalties, technical assistances, etc.) can assist in quantifying and prioritizing the tax risks most pertinent to the tax administration.

The suggested analysis for each transaction is summarized in the following tables. A basic form of taxpayer-specific analysis is presented, this is used for risk indicators and annual variations. Additionally, the information can be categorized by identifying the jurisdictions in which transactions are agreed to, either as an entry or exit point. For example, if a taxpayer exports all of its production to the United States and the following year the same production is exported to Switzerland, this may indicate a restructuring in the operation of the company, which should be analyzed to assess the tax effects of such change.

The following table shows common deductible transactions that may help to assess risks in transfer pricing or tax base erosion; for example, purchase of inventory, royalties, services, interest, advertising, etc.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1500</td>
<td>INVENTORY PURCHASE NETA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1601</td>
<td>PORTFOLIO PURCHASE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1700</td>
<td>CAPITAL EXPENDITURES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1800</td>
<td>ROYALTIES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1900</td>
<td>TECHNICAL ASSISTANCE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>FEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The revenue from operations with related parties may also have the same effect of eroding the tax base, including those shown below:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2100</td>
<td>LEASE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2200</td>
<td>GUARANTEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2300</td>
<td>ADVERTISING</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2400</td>
<td>TOLLING SERVICES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2500</td>
<td>OTHER SERVICES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2600</td>
<td>FINANCIAL SERVICES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2700</td>
<td>COMMISSIONS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2800</td>
<td>ACCRUED INTEREST EXPENSE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2900</td>
<td>PAID BY INSURANCE PREMIUMS AND REINSURANCE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2901</td>
<td>CAPTIVE REINSURANCE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3000</td>
<td>FISCAL COST OF SHARES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3001</td>
<td>PRO RATA COSTS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3002</td>
<td>RETURNS, REBATES AND SALES DISCOUNTS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3009</td>
<td>RECEIVABLE PROPERTIES IN COMODATO</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3010</td>
<td>COSTS AND / OR ACQUIRING RIGHTS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3012</td>
<td>INVESTMENTS IN INTANGIBLE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3013</td>
<td>COSTS AND / OR REFUNDS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3016</td>
<td>ADVANCES OF EXPENSES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3100</td>
<td>OTHER PAYMENTS (SPECIFY)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total Deductions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>TOTAL INCOME FROM SALES OF INVENTORIES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>300</td>
<td>INCOME FROM PROVIDING SERVICES IN GENERAL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>301</td>
<td>INCOME FROM THE PROVISION OF TECHNICAL SERVICES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>302</td>
<td>INCOME FROM THE PROVISION OF MANUFACTURING SERVICES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>303</td>
<td>INCOME FROM PROVIDING FINANCIAL SERVICES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>400</td>
<td>INCOME FROM MAQUILA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>500</td>
<td>REVENUE FROM ADMINISTRATIVE SERVICES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>600</td>
<td>INCOME FROM INSURANCE AND REINSURANCE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>700</td>
<td>INCOME FROM COMMISSIONS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>800</td>
<td>ROYALTIES INCOME</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>900</td>
<td>INCOME FOR TECHNICAL ASSISTANCE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1000</td>
<td>ACCRUED INTEREST INCOME</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1100</td>
<td>RENTAL INCOME</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1200</td>
<td>INCOME FROM SALE OF SHARES</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1300</td>
<td>INCOME FROM SALE OF FIXED ASSETS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Import / export and electronic invoicing information

Furthermore, import/export transactions or digital invoices can also be useful sources of information for transfer pricing risk assessment. Although these sources are not made to identify transactions with related parties, they may be useful for specific industries, such as mining, where there is an international market price that can be compared to the prices between related parties.

Moreover, digital invoicing makes it possible for transactions between related parties to be compared with transactions between independent parties, such as a sale of shares, fixed assets, intangible assets, inventories, etc. This system gives the added advantage of obtaining and analyzing information in real time or almost immediately after the completion of transactions.

Stock exchange information

Information from the stock exchange is important for several reasons. Firstly, it requires financial accounting results to be reported in a consolidated form which is generally not influenced by transactions between related parties. The results are reflected on a consolidated basis for all the companies in the group, thereby eliminating the effect of intragroup transactions. Isolated accounting reports from individual taxpayers are not presented.

Furthermore, there are regulatory controls to ensure that the amounts reported are reflective of the company’s reality. Thus improving the reliability of gross income, operational income and earnings before taxes of companies. Since they are public companies, these controls also regulate the performance of the board, disclosure policies, risk control (e.g. tax), amongst others.

However, information from the stock exchange may vary with the tax information. There are legal differences in the calculation of income and deductions for tax purposes, which do not necessarily coincide with International Financial Reporting Standards (IFRS), the benchmark for reporting information on the stock exchange.
Additionally, the stock exchange also requires information on corporate restructurings to be reported, as such events must be notified by the board of directors to the shareholders, along with other similar elements that could have a significant effect on tax payments.

An example of the elements that a publicly listed enterprise must disclose is presented in the diagram below. The public information relates to a Mexican consumer products company: Walmart of Mexico, which in 2009 had a sales retailer company in Mexico (Nueva Walmart), as well as a clothing retailer company (Suburbia), a group of chain restaurants (Vips), real estate companies, service companies, a bank, and as of 2009, held the shares for the Central American retailer (Walmart Central America). However, in 2014 the entity alienates certain business lines such as the bank, the restaurants and the clothing retailer.

The red circles in the diagram identify the four entities that were involved in these important events with potential tax effects. The information obtained from the stock exchange consisted of the following content:

- **Central America business acquisition:**
  - Amount of the operations.
  - Source of funds for the purchase.
  - Impact of the financial effect, if the purchase is made through debt.

- **Sale of the bank, the restaurant segment and clothing retailer:**
  - Amount of the operations.
  - Financial profit or loss from such operations.
  - Tax profit or loss from such operations.
  - Identification of the alienators.
  - Transfers of intangibles.
  - Related parties involved in the operations.

As can be seen in this case, the information obtained from public enterprises on the stock exchange can be very useful. Furthermore, it can be contrasted with the information obtained by the tax administration to add value during the risk assessment process.
B. Integration and analysis considering a multi-year period and economic groups

The previous section discussed the information used by the Tax Administration to effectively assess tax risks in terms of transfer pricing, international taxation and the erosion of the taxable base through the transfer of benefits.

The next step is to know how to make it available in an integrated, reliable and expeditious manner to the analysts. Making it comparable over several fiscal periods, identifying companies within the same economic group or companies engaged in the same economic activity. In addition, given the importance, complexity and level of confidentiality needed, it is important that this valuable information is handled in a centralized and controlled manner.

Multi-year information

It is recommended that the information be incorporated in a multi-year form, ideally comprising at least five fiscal years. While risk indicators can be created with information from one year, significant variations between exercises provide more certainty and perspective for specific operations, operational restructurings or changes in behavior patterns that have a significant risk for the tax administration.

Timely information

Although it may seem obvious, it is important to emphasize that the information should be attained in real time, or as soon as possible, once the taxpayer submits it to the tax authorities. Risk perception on the part of the taxpayer increases when they are notified promptly of the results that the tax administration detected in the transactions reported; the likelihood that the taxpayer will correct their tax situation and the chances of ending up in a situation of litigation diminish.

Source: Public information taken from the annual reports to the Mexican Stock Exchange.
Analysis by economic groups and activities

In general, companies belonging to the same economic group or controlled by the same shareholders tend to hold similar patterns of behaviors in terms of tax risks or strategies used to reduce their taxable base. These strategies are commonly shared and used by all entities, therefore, it is important that economic groups be identified and assessed in terms of risks. Additionally, companies operating in the same economic sector, such as mining, banking, telecommunications, insurance, etc., have, on many occasions, operating structures with similar characteristics. Therefore, any similar effects on their financial results may help to assess the risk of these companies.

Centralized management of information

The specialized issues dealt with and the relevance of the information makes it necessary to handle it in a centralized manner with security controls for the personnel who have access to the information. It is important to consider the past experiences of regional, local or zonal administrations to determine the analysis and integration process of the information. The role of a central area is to make it available, to train the personnel, and to control the use of said information.

Finally, information should be easily accessible and intuitively manageable by analysts; consequently, at this stage, the Information Technology (IT) area of computer technicians or engineers makes it possible to provide this information, and the analysts—usually accountants, lawyers or economists—are the users of the taxpayer specific information.

Practical application of risk indicators

The literature on tax risk indicators (in general and specifically in transfer pricing) is wide; most developed countries have public information concerning this topic and institutions such as the OECD, the IMF, the World Bank Group, the European Union and CIAT have also worked on documenting the best international practices in this regard. The next section develops certain risk indicators relating to transfer pricing, which operate in conjunction with the general indicators of compliance risk.

a. Generic indicators

These are some general indicators to measure the tax compliance risks:

▶ Tax utility or tax loss

The indicator is the ratio of: Taxable income or tax loss / Tax revenue.

Calculating this indicator over the past five years for each taxpayer can be used to identify declines in profit or recurring losses; comparisons with companies in the same activity or the same economic group, and significant variations in tax results with financial results. Significant changes in the variable of tax revenue is a frequent condition of operational restructuration.

▶ Profit or loss before taxes

The indicator is the ratio of: Profit or loss before taxes / Sales.
The logic of this indicator is very similar to the previous indicator; if the comparison of both indicators shows a significant difference (a higher number for the second indicator), this is evidence that the company is profitable for its shareholders, but not for the tax authorities, which indicates a risk that should be analyzed.

▶ Excessive indebtedness

The indicator is the ratio of: Integral Financing Cost / Sales.

Excessive debt burden, as well as significant increases in this indicator show a decrease in the taxable base.

▶ Exposure to international operations

The indicators used are the following ratios:

▶ Income to related parties abroad / Total income.
▶ Payments to related parties abroad (e.g. sales of goods, services, royalties, interest, etc.) / Total tax deductions.

The greater the exposure to international operations, the higher the risk of transfer price manipulation and potential tax base erosion through the shifting of profits abroad.

▶ Evidence of acquisitions, sales of businesses and restructuration

Indicators are the following ratios:

▶ Investments in shares / Assets.
▶ Fixed Assets / Assets.
▶ Buildings / Fixed assets.
▶ Machinery and equipment / Fixed assets.

The statement of financial position is the basis for detecting such events and can be identified by variations in the fields of assets, liabilities, and capital.

▶ Differences between sales subject to income tax and sales subject to value added tax

The indicator is the ratio: VAT taxable sales / Sales subject to corporate income tax.
This calculation aims to identify significant differences between the two variables, considering exemptions that are usually more relevant for value added tax.

In addition to the above, it is necessary to emphasize the convenience of analyzing the information available to the tax administration, such as:

- The use of complex derivatives and hybrid financial instruments that taxpayers should disclose in their statement of financial position; in the income statement (e.g. interests); in transactions with related parties, or, included in the price of products.
- Complex or high value-added functions can be identified through the statement of financial position by reviewing the assets with which it operates; from derivative financial transactions; from debts to banks or related parties; from the holding of shares; from the presence of intangibles; from inventories; whether it's a manufacturing or service company; from investments in research and development; from self-funded capital; from foreign business operations in different currencies and exchange rates, etc.

Assessing risk indicators depends on the availability of information, thus importance is given to taking inventory of the administration's information sources and their desirable characteristics (availability and in a multiannual form).

Selected practical application to specific sectors

We calculate the tax risk indicators for the entire group of taxpayers, and segment them based on different economic activities carried out. The application of certain indicators differs significantly depending on the activities of taxpayers. Therefore it is necessary to differentiate them, in order to be more successful in allocating tax risks to taxpayers between the different economic sectors as discussed below.

**Mining**

Mining is an industry where usually the products are exported to related foreign parties and traded on international transparent markets with public reference prices, their sales are expressed in US dollars so the exchange rate is an important factor in countries where the common currency is not the US dollar. There is usually strong initial investments and projects have a lifespan limited to the depletion of ore veins. Investments may contain significant components of debt, usually denominated in US dollars, including minerals to be extracted in the future which are already committed for subsequent sale to obtain the necessary funds for operating. Therefore, the issuing of futures and financial derivatives is commonplace. In addition, these industries are generally subject to additional taxes for the extraction of minerals that are paid by units-drawn or weight thereof. They are also labor-intensive, making trade unions and workers’ rights more relevant in this industry.

**Financial institutions**

The financial sector is a highly regulated, controlled and monitored sector. Due to its importance in the economy of a country, in addition to the tax laws it also has to comply with financial laws. The highly specialized transactions and use of credit means that there are generally only a few taxpayers in the sector (banking, insurance, bond and securities, etc.). These companies are usually operating nationally and even keep accounts with different characteristics to other companies. The exchange
rate and interest rates are relevant to their operation so futures contracts, forwards, swaps or other
derivative financial instrument are risk factors that must be analyzed by the tax administrations.

**Retail companies**

Due to economies of scale, bigger companies can offer lower prices which slowly eliminates all the
smaller competitors, therefore, concentrating top income in the hands of such companies. These
companies have a large number of suppliers and part of their success is negotiating the purchase
prices of the products to give better prices to their customers and in turn get better profit margins.
Furthermore, much of their business is financial as they receive cash payment and use credit to pay
their suppliers (e.g. paying up to 90 days after receipt of the goods). They are also constantly expanding,
investing part of their profits in new stores and most of them are publicly listed companies on the stock
exchange.

The foregoing descriptions of the three economic activities (mining, financial institutions and retail)
are just examples of the characteristics that must be observed to identify the best risk indicators by type
of economic sector and specific taxpayer.

**4.1.3. Specific risk aspects of transfer pricing**

As part of this process, it is essential to strengthen the risk assessment for transfer pricing, to increase
the effectiveness of identifying and decreasing the tax gap between taxpayers.

A timely and effective diagnosis of the taxpayers’ behavior will generate appropriate risk perception and
help taxpayers determine their taxes correctly. Thus, tax controls should focus on identifying certain
behaviors that do not comply with the rules (i.e. the "Arm’s Length Principle") and which erode the
taxable base.

This is closely linked with the limited resources available to tax administrations, thus optimizing
available resources becomes a challenge to overcome, since it is virtually impossible to audit all
taxpayers. Therefore, in a world of risk, a proper assessment of the risk level of tax base erosion,
transactions between companies (transfer pricing risk), enables tax administrations to initiate more
accurate audit processes by which transactions between subsidiaries comply with the conditions under
which independent third parties would have agreed in comparable transactions (the "Arm’s Length
Principle").

In this sense, it is a priority to establish the procedure that the members of the transfer pricing risk
department should follow based on applicable regulations and capacity. This starts from research,
analysis, evaluation, generation of inputs, until the issuance of an audit for checking the fulfillment
of the taxpayers’ obligations, raising awareness of default risk, and exercising the power to review in a
timely and efficient manner in accordance with the applicable regulations on transfer pricing.

**4.1.3.1. Necessary resources**

For the proper functioning of the tax administration, especially the operations of risk assessment
in transfer pricing, it is necessary to have certain basic elements. These include human and material
resources that seek to integrate a team with the appropriate transfer pricing knowledge and the ability to examine, evaluate and implement a risk assessment program, as well as material and technological resources to develop the function.

4.1.3.2. Strategic plan

The department of risk assessment regarding transfer pricing and international taxation must be guided by the tax administration’s proposed plan. This strategic plan should target specific taxpayer behaviors, using mass media to create risk awareness and which can incentivize taxpayers to accept potential corrections in the payment of their taxes, avoiding costly processes such as audits and subsequent appeals.

4.1.3.3. Information management

It is important to analyze the information available to the tax administration for verifying taxpayer compliance, stating in detail the facts or omissions discovered during the analysis.

One of the objectives of the personnel in the transfer pricing or international tax risk assessment department is to enrich the analysis of the information contained in institutional systems, to confirm and/or rule out the alleged irregularities that triggered the investigation, providing evidence for their findings. It is recommended that the information be safely stored in a backed-up system that can guarantee confidentiality. Adequate control, use, and storage of data and documentation is necessary when analyzing a particular case or a group of taxpayers.

4.1.4. Risks evaluation

Risk evaluation is a preventative tool for reducing activities that may negatively affect the payment of taxes. It focuses on known risk behaviors, and is supported by:

- Reporting Standards. Established standards specifying the information that must be submitted by taxpayers to perform an exercise in gathering, assessing and early detecting risks in the field.
- Information exploitation systems. Computer systems that allow the team to exploit and handle the information submitted by taxpayers.
- Intelligence and conceptual frameworks. Ideology and conceptual framework from which the manner in which we should proceed is prioritized and ordered in each of the key aspects of the role.

With regard to intelligence and conceptual framework, the greatest challenge is to identify taxpayers, their possible high-risks situations and transfer pricing or international taxation related transactions, efficiently and accurately, with the least possible cost, to make better use of the limited resources available to the tax administration. The establishment of these procedures in an orderly manner, before initiating an audit process, is the main function of the risk assessment department.

Although the risk assessment process cannot be reduced to a mechanical exercise, it is important to follow regular and structured stages in risk assessment. Depending on the economic and legal situation in each country, a variety of approaches to risk assessment are taken. For example; sophisticated computer systems can be used, in order to compare the financial results reported by taxpayers in their
tax returns against indicators and available economic data by sectors (see section “Referential profit margins”) as part of a process identify specific cases of increased risk.

Under that premise, an appropriate risk assessment allows, amongst other things:

▶ Identifying risks on transfer pricing and international taxation for each specific taxpayer (e.g. with the support of specific risk indicators).
▶ Helping the tax administration in determining the risk level of each taxpayer in order to establish the level of detail in the audit process (e.g. by the type of risk involved in the scheme).
▶ Allowing the tax administrations to develop a practical and coherent strategic plan for audits of transactions and common structures that give rise to the risk.
▶ Determining resources to use in the audit process, depending on the detail that this requires, etc.

With regard to the risk indicators in the field of transfer pricing and international taxation, the most used in practice are presented as follows:

▶ **Significant transactions with related parties established in low-tax jurisdictions.** When transactions are made with related companies located in low-tax jurisdictions there is a risk of price manipulation that may be incorrectly attribute the excess profits to the low tax jurisdiction.

▶ **Transfer of intangibles to related parties.** Transactions of this nature cause difficult questions regarding valuation, especially when there is existence of unique intangibles and consequently a shortage of comparables.

▶ **Business restructurings.** Aspects related to “transfer pricing” within the framework of business restructuring are the subject of specific studies published on the subject. The substance and form of the restructuration and the market value of the resulting financial and commercial relations should be reviewed.

▶ **Specific payments.** Interest payments, insurance premiums and royalties made to related parties cause transfer pricing risks because the rights are highly mobile and there is consequently a risk that payments do not reflect the real value added by the related party.

▶ **Recurring losses.** A deficit presented year after year when there are no signs that a change has been made in business operations or financing may be evidence that the reported results do not reflect the true value of the business.

▶ **Low results.** Results are inconsistent with industry standards, or the functions performed by the company are irregular. This may be evidence that the transactions between related parties are not properly agreed to.

▶ **Effective tax rate.** Significant variations between the effective tax rate reported at group level and nominal rates to which it is subject may be the result of the allocation of transfer pricing actions locating profits in jurisdictions outside the substantive business.

▶ **Excessive debt.** Debts that appear to be in excess of the agreed amount that the company could borrow if it were an independent company, or interest rates that are apparently above market range rates.

▶ **Poor or non-existent documentation.** Evidence that prices and methods used are inadequately documented may cause doubts about the reliability of the agreed prices.

In practice, it has been difficult to factor in and weigh together all of the indicators proposed for an accurate risk assessment, given the specific field and taxpayer. Therefore, they were divided into two
groups, those that identify the causes of potential tax avoidance structures and those that identify the effects of these structures. Greater importance is usually given to the effect indicators (e.g. recurrent losses), which are more visible and obvious, however, to implement an efficient risk model, it is important to consider both premises (causes and effects) as a whole.

In this regard, dividing them into elements that identify effects and elements that identify causes is important. Not only does it provide greater clarity in identifying behaviors of potentially elusive transactions or structures, but it allows for a monetary estimation of the potential tax base erosion, as well as estimating the respective risk of related party transactions. Similarly, the tax administration can discern the cost-benefit thresholds to better optimize their resources.

4.1.5. Risk indicators (effects)

Impact on Gross Profitability / Operating Profitability (substandard results or losses). Related party transactions have an effect on the gross or operational levels, therefore this indicator can help to identify whether the gross or operational returns are within a reasonable parameter. I.e. the standard as dictated by external comparable companies in the same sector, the industry standard, or the consolidated profitability margins of the group to which the taxpayer belongs (this last point could sometimes be extreme and generate isolated or recurring losses).

▶ Impact on Gross Profitability / Operating profitability (low results and losses). The related party transactions affect the gross or operational level, so this indicator is relevant to identifying whether the return to these levels maintains a reasonable parameter, i.e., it is not placed below the standard external comparable of the companies in the sector, the industry standard and even the consolidated profitability of the group to which the taxpayer belongs, which sometimes could be extreme and generate isolated or recurring losses.

▶ Impact on Financial Performance (debt and excessive interest). It is important to recognize that below the operating level, companies also perform transactions derived from the relationships between related parties themselves. These, by their nature, denote significant risks. For example, financial transactions between related parties or other changes for which we must also assess whether the profit before tax, after the financial impact, reflects a reasonable market trend.

▶ Impact on Tax Profitability (non-financial fiscal notions). Finally, in terms of profitability, we must not forget that between income before taxes and taxable income there are variations and impacts that sometimes deal with related party transactions to be analyzed. For this reason, we must also assess whether the tax profitability shows a reasonable trend that addresses the notions of the business of the taxpayer and not artificial situations aimed at decreasing it.

To reach a correct determination of the profitability of the entity analyzed, it is important to identify the industry to which it belongs and the main function that it develops (which would be supported if the activity of the taxpayer is identified), similar to how often potentially comparable companies are selected when identified by Standard Industrial Classification (SIC) or the North American Industry Classification System (NAICS). We must confirm whether the entity incorporates relevant value drivers in its activities, which may be related to the identification of intangibles as well as unique and valuable contributions in the comparability analysis. The evaluation of non-comparable profits operates correctly when reasonable comparables are available. This theoretically applies, and practically happens, when the tested party does not carry out high value generating functions.
For these purposes, we must seek comparables that cover the following notions and characteristics of comparability focused on identifying and integrating into the analysis the functions performed by the tested party (considering whether or not they are of high value):

- Volume of operating expenses (i.e. operating/net sales) expenses. NOTE: Operating expenses in the company analyzed also include, where appropriate, the royalty expenses.
- Advertising, marketing and promotion (AMP) expenses (i.e. AMP expenses/ net sales, AMP expenses /operating income, AMP expenses/ contribution margin [net sales - variable expenses])
- Volume of Research and Development (R&D) expenditures (i.e. R&D expenses / net sales, R&D expenses / operating income)
- Volume of intangibles (i.e. intangible/ total assets, [intangible + costs DEMPE9 ] / total assets)

Under this notion, if the entity does not report high-value functions, the application of specific profit margins from comparables may be direct, the same as generally found in low-risk scenarios. On the contrary, if the entity performs high value functions and no comparables are available, it could be analyzed on a consolidated basis with the other entities of the group in the local jurisdiction (trying to see the business fully and avoiding that the dynamics of fragmentation of multinational groups prevent from correctly analyzing the taxpayer), compared with industry standards and profitability of multinational business group to which it belongs (e.g. comparing the profitability of the company with the industry sector or the consolidated group).

These risk indicators themselves show the monetary impact of the possible erosion to the taxable base, since they are classified in a way that adds the impact from gross, operational, financial and fiscal tax structures. This identifies the potential gap in the tax base that may be due to erosion, reflecting the risk assumptions as amounts of estimated revenue losses.

Following this calculation of the potential tax base erosion, it is important to subsequently identify what amount of the calculation was derived from related party transactions. This information can then be used to create a more tailored auditing process.

It is very important that the scope be well defined before conducting an analysis of a group of taxpayers who are categorized by behaviors, regions and/or economic sectors. The process should begin using formulas and performance criteria established by the tax authorities or by the objectives of the specific case being considered.

All of the research stages and subsequent results must be well documented to facilitate the decision-making and, if necessary, redefine the research, relying on special processes of extracting data from the tax administrations’ databases.

External information sources should also be considered such as, the chamber of commerce or other trade groups present in the region, as well as information from the controlling entities (Holding) located abroad, to see if the group’s results are consistent with the results of the company subject to revision.

---

9 Development, enhancement, maintenance, protection and exploitation of intangibles.
4.1.6. Risk indicators (causes)

To complete the hypothesis that a transaction or structure is eroding the tax base, it is necessary to identify the effects as well as the possible causes for these results. Therefore, it is especially important to identify the risky transactions between related parties, which could be leading to this behavior, such as:

- Unidentified income. The fact that a related party transaction has little to no revenue does implicate that there is no risk. In fact, it could indicate that its value is less than what independent third parties would have agreed to in comparable transactions, thus it would become a relevant risk.

- Payments that erode the tax base (interest, insurance, royalties, services, other expenses). Such payments on rights that are highly mobile are high risk, since they have been used by companies to transfer profits artificially; this sometimes relocates the creation of value reporting profits, thus reflecting an implicit risk.

- Transactions with low-tax jurisdictions. An aggravating factor in the identification of related party transactions is that such transactions are carried out with low-tax jurisdictions, which has the implicit incentive to minimize the payment of taxes, which could carry out transactions without economic substance; therefore, it would be important to identify that component.

- Restructuration (reassignment of functions, assets [intangibles] and risks). There are also transactions that take place in a single moment, affecting the profitability of the company in a single year, such as the restructurings, that could involve the reassignment of functions, assets and/or risks, and generally involve a high subjectivity in their calculation, so it is important to note the risk involved in these transactions.

From the above, we can identify the gap in the possible erosion of the tax base, and also the possible cause and magnitude, as well as the risk level of said element, since the risk of transfer pricing exists when transactions between related parties have the potential to transfer profits for the purpose of eroding the local tax base. With these premises in hand, the decision on the start of an audit process is much clearer and effective, with knowledge of the potential impact on the collection.

We must consider that there are certain pieces of circumstantial risk that should be taken into consideration beyond the monetary magnitude of the potential tax base erosion. For example, a lack of documentation or non-existent year-end adjustments must be weighed into the analysis. These aggravating factors should also be taken into account for the selection of cases for audit.

The risk assessment process does not end with the determination that there is a material transfer pricing risks presumably worth an audit. The information developed in the risk assessment process can also be very helpful to give direction to the audit regarding the issues to be examined carefully and the information to be developed to carry out a detailed investigation.

Since transfer pricing audits often require a high level of resources from the tax administration and from the companies, the risk evaluation can serve to focus any audit on the most important issues. In this regard, a risk assessment should consist of something more than a mere acknowledgment of facts that suggest the existence of a risk; it should also consider the implications of these facts and identify specific questions to be considered during the audit.
Based on the above, it is recommended to develop working papers for all the activities analyzed, as well as the appropriate conclusions or reports, including the results of the investigation. Once the procedures have been established in the corresponding work plan, there can be a check of the hypothesis that gave rise to the analysis.

In addition, we recommend that a specialized group of experts in the field should present the results of the analysis, to define, if necessary, measures to improve and subsequently authorize the control phase of the analysis.

4.1.7. Integral system of tax risk management

In the previous sections, we outlined a guide for assessing tax risks concerning transfer pricing and international tax issues that involved the identification of available information, its management, analysis, practical use and the construction of general and specific indicators. Consequently, a desirable stage would be to integrate the above in a comprehensive system to manage the tax risks. This consists basically of a software tool that integrates the tax information with the characteristics indicated in this document, to calculate and link the general and specific risk indicators. The system should also generate reports by taxpayers with such information that are easy to interpret and apply for the risk analysts.

A system of this kind should be composed of sections with the information available to the tax authorities, and those sections should be as broad and comprehensive as necessary. Each section can have its own indicator, however, it would be useful for specific sections to integrate both general and specific indicators. For example, combining an indicator of low tax results, with an indicator of high exposure to international operations, or a debt indicator with an indicator of interest payments to foreign related parties.

The following table is an example of basic information used for these sections, however, each jurisdiction could incorporate more elements. A review and selection of the information, indicators, structure and temporality should be made. Updated information is key, thus it is recommended to define regulations for maintaining and automatically updating the information. It may also prove useful to review these practices with the users of said information, to consider their needs when developing the system.

<table>
<thead>
<tr>
<th>Sections:</th>
<th>Information must contain:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section 1. General data</strong></td>
<td>Name, Activity, Address, Partners and shareholders, Etc.</td>
</tr>
</tbody>
</table>
| **Section 2. Tax determination** | 5 years of comparative information  
Indicators of tax payments or tax losses  
Income indicators |
| **Section 3. Statement of income** | Identify related party transactions  
Gross and operating income or loss, before taxes  
Comparative for 5 fiscal years  
to identify comprehensive financing cost with related parties |
Finally, once the system is created, it would be useful to provide a training program for the correct use of this tool, as well as the necessary processes for the development, consultation and feedback of the system, and for its maintenance and improvement. In large and complex institutions, such as tax administrations, resistance to change is strong, therefore, a clear strategic plan that ensures the correct implementation and maintenance of the system is required.

### 4.2. Condiment 2: Geographical market adjustment

#### 4.2.1. Introduction

Some transfer pricing methods work by measuring a company’s profit margin (e.g. Transactional Net Margin method or any unilateral approach). Thus, in order to apply these methods, especially when the tested party is the domestic counterpart, taxpayers first have to find comparable companies operating in the local or domestic economy. However, given the limited public information about companies in developing and low-income countries, it has become commonplace to resort to public information of entities operating in other territories or foreign countries (mainly developed countries or economies).

This dynamic use of comparable entities that operate in a market different than the one being analyzed, can create certain problems. The market in question will have a different rate of development that can affect the business and financial situation of the companies selected. Moreover, the comparable benchmark and profit margins that evaluate whether transactions between related parties comply or not with the "Arm's Length Principle", could yield erroneous conclusions in these circumstances. It is extremely important to ensure that this problem does not exist or is minimized by making reasonable comparability adjustments, focusing directly on improving the comparability of companies or transactions.

From a policy perspective, in the transfer pricing analysis companies are comparable to the tested party only if there are no differences between them that could significantly affect the price or profit margin referred to by the transfer pricing method. When there are such differences, they are eliminated by reasonable comparability adjustments.

To determine the comparability differences between the selected companies, there are five important elements that must be taken into consideration: (1) the characteristics of the operation, (2) the functions they perform, including assets used and the risks involved, (3) the contractual terms, (4) the...
economic circumstances, and (5) business strategies, including those related to penetration, retention and expansion of the market.

However, out of these elements, the one which specifically relates to the consideration of comparables from different markets is the “economic circumstances”. This arises in more detail in Section 1.110 of the OECD Transfer Pricing Guidelines (2017) as follows:

“D.1.4. Economic circumstances

1.110 Arm’s length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which independent and associated enterprises operate that do not have differences that have a material effect on prices, or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets taking into account available substitutes for goods and services. Economic circumstances that may be relevant to determining market comparability are: geographical location; size of the market; the degree of competition and the relative competitive position of buyers and sellers; availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power, the nature and extent of market regulation by the government; production costs, including costs of land, labor and capital; transportation costs; market level (for example, retail or wholesale); the date and time of transactions, and so forth. The facts and circumstances of the particular case will determine whether differences in economic circumstances have a material effect on the price, and if reasonably accurate adjustments can be made to eliminate the effects of such differences. A more detailed guidance on the importance of comparability analysis of the characteristics of local markets, especially the features of local markets that generate localization savings is provided, in section D.6 of this chapter.

In addition to the above, Section 1.144 of the Transfer Pricing Guide also points out the relevance of adjustments for differences in geographic markets, as shown below:

“D.6.2. Other features of local markets

1.144 Features of the local market where business operations take place can affect the arm’s length price with respect to transactions between associated companies. While some features may give rise to localization savings, others may generate comparability concerns not directly related to such savings. For example, the comparability and functional analysis in connection with a particular matter may suggest the relevant characteristics of the geographic market in which products are manufactured or sold, the purchasing power and product preferences of households in that market, whether the market is expanding or contracting, the degree of competition in the market and other similar factors that affect prices and margins. Similarly, the comparability and functional analysis in relation to a particular matter may suggest that the relative availability of local country infrastructure, the relative availability of a pool of trained or educated workers, the proximity to profitable markets and other similar features in a geographic market where business operations occur create market advantages or disadvantages. Appropriate compatibility adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified. ”

The market or territory where companies operate is recognized as part of the “economic circumstances” analysis. This analysis helps to identify whether the conditions of the territory or economy of the comparable company are different from the conditions in the territory or economy in which the tested party operates. Furthermore, it must be ascertained whether these differences influence the profit margins that are referred to by the transfer pricing method.

To identify if the conditions of the comparable differ from that of the tested party, we can rely on macroeconomic indicators. These show the profitability indicators in the capital markets of the
territories or economies, as well as the differential in the rate of return, which is commonly known as a country risk rate or country risk spread (e.g. If the return on capital invested domestically is higher than the return on capital invested abroad, this may be driven by an increased risk of doing business domestically, which is compensated by a higher yield).

In this context, the spread between the two rates of returns is an element that could be considered for improving comparability. An adjustment to the profitability indicators of companies may become part of the transfer pricing analysis as it will minimizing the differences that exist in the economic circumstances between the two territories and economies. Therefore, it reduces the risk of an erroneous conclusion when applying the "Arm's Length Principle", potentially leading to more realistic results in the transfer pricing analysis.

Some ways to eliminate the differences between the territory and the economy where the comparable operates and where the tested party operates, are presented below:

▶ A financial indicator is selected, reflecting differences in profitability of capital markets between the economy of the tested party and the economy in which companies considered comparable operate. For example, an indicator that reflects these differences in profitability in emerging markets is the country risk rate (e.g. for US comparable, the EMBI, "Emerging Markets Bond Index" published by the international firm JP Morgan Chase. This measures the country risk between economies and calculates the differential between the rates of government bonds, at the same average term). For these purposes, it is assumed that there is a greater financial return on investment in an emerging economy (considering their quality of risk and probability of default) than in a developed economy.

▶ If the financial performance in the economy of the entity analyzed show rates divergent from the economy in which companies considered as comparable operate, the causes may include factors such as level of economic growth, inflation, competitive or possibly oligopolistic conditions, labor costs, and so on. Therefore, to counteract the effect of these differences, it is necessary to adjust the financial information from companies considered comparable, so that the differential effect between the yields of both territories and economies would be annulled. This impact is focused directly to the financial resources used by the company to operate, i.e., capital invested, which conceptually includes debt and equity, or from accounting perspective, the operating assets of these companies.

▶ The amount of adjustment (calculated as a factor of operating assets [country risk x operating assets]), is incorporated in a way that it is reflected in the profits of the comparable companies. In this way, it obtains an adjusted return, based on the profitability factor selected by the taxpayer; this allows placing the entity analyzed and considered comparable companies in the same level of comparability regarding their “economic circumstances” and thus be able to assess compliance with the "Arm's Length Principle".

The Platform for Collaboration on Tax - a joint initiative of the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), the United Nations (UN) and the World Bank Group (WBG) - published on June 22, 2017 a toolkit with a practical guide for developing countries focused on protecting the tax base. Within this toolkit, there is a punctual reference to the problems caused by using foreign comparables, this issue is further developed and possible solutions are proposed, as follows:
“5.5.2 Adjustments for differences in geographic markets

Approaches to adjustments that seek to eliminate the differences in country conditions are varied. There is currently no widely accepted method. A straightforward way to adjust for market differences would resolve many of the challenges facing transfer pricing practitioners in developing countries. In the case of many transactions, the complexity of capturing market differences seems, however, to rule out any simple solution.

Academic studies point to the potential importance of country specific effects. Potential proxies that could be relied upon to account for these differences are, however, not readily available. Practitioners, nevertheless, have to manage the ensuing uncertainty, including weighing the potential differences created by country specific effects against other differences that may be present in the best available local data (if any such data is available), and proceed in making country adjustments, where they improve the reliability of the comparison. A number of approaches to country adjustments are discussed below; but they are exposed to methodological challenges.

5.5.3 Adjusting country risk by adding a premium (or discount) the profitability level indicator (PLI)

Country risk can be defined as the risk induced by the country location of a business activity rather than the fundamental nature of the activity. This risk may derive from the political or economic environment in which that business operates. Country risk is not only a transfer pricing construct, but a real variable that businesses take into account when making investments or entering into third-party transactions.

Most proposals for country risk adjustments simply seek to add a premium/discount to the comparables’ results. Such risk-based adjustments are designed to account for differences in risks assumed in relation to competition, credit, foreign exchange, product liability, technological obsolescence, etc. Arguably, however, to adjust for an increase in risk, the range of results should be wider, rather than simply higher. Greater risk, while equating to a higher profit potential, may or may not result in higher actual profits and could in fact result in greater losses.

There are numerous ways that country risks are adjusted in practice. These range from very complex to very simple, having relative advantages and disadvantages. One approach is by using working capital adjustments as a proxy for country risk. Büttner (2012) presents the use of the spread in countries’ long-term government bond yields applied to operating assets as the basis for such an adjustment to the operating profit. Gonnet et al. (2014) suggest adjustments to operating profit based on differences in the weighted average cost of capital (WACC) of the tested party and the comparables.
It should be noted, however, that there is little empirical evidence on the reliability of the proposed approaches. Careful consideration should be given as to whether such approaches can account for differences in risk and expected profitability (to the extent that they exist) for commercial ventures in different countries.

Examples of country risk adjustments are provided in appendix 12."

To eliminate differences between comparables that operate in different territories or economies, there are three different approaches: (1) adjustment of working capital as a substitute for country risk, (2) adjusting “country risk” to assets, and (3) adjusting the “weighted average cost of capital”. For this study, we consider the second option to be the most simple and direct application, reflected in an adjustment to the operating assets of the companies considered comparable, impacted by the difference in the return on capital markets between the territories and economies (“country risk”).

This country risk adjustment assesses the return of the comparable companies, incorporating the risk they would have if they were operating in the market or territory where the tested party operates. This, in practice, adds to the profits of the comparable entities, the result of multiplying the operating assets used and the difference between the percentage of sovereign debt yield of the territory where the tested party operates and the territory where the comparable operates. In addition, since the country risk adjustment is implemented considering the balance sheets of the companies, it is similar to the so-called “capital adjustments.”

4.2.2. Example of country risk adjustment

Appendix 12 of the toolkit for developing countries to protect their tax bases presents an example of country risk adjustment which is described below:

<table>
<thead>
<tr>
<th>APPENDIX 12</th>
<th>Examples of country risk adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example 10</td>
<td>Simplification of country risk adjustment</td>
</tr>
<tr>
<td>The tested party (TestCo) is a contract manufacturer operating in Country A, and the only available comparable (CompCo) is a contract manufacturer operating in Country B.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>TestCo Country A</th>
<th>CompCo Country B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>100</td>
<td>120</td>
</tr>
<tr>
<td>Total costs</td>
<td>80</td>
<td>90</td>
</tr>
<tr>
<td>Operating profit</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>Operating assets</td>
<td>80</td>
<td>100</td>
</tr>
</tbody>
</table>

---

10 World Bank Group (2016), Transfer Pricing and Developing Economies: A handbook for policy makers and practitioners, Appendix A4.5.1. The example is based on a presentation of Buttnar (2010), Use of Foreign comparables and Comparability Adjustments for Economic (Market) Differences [Using international comparables and comparability adjustments to economic differences [market]] held in a workshop on transfer pricing and information exchange, OECD, Quito, Ecuador, August 24 to 27.
The country risk in Country A is considered higher than that in Country B, and thus it is considered necessary to adjust for this country risk. The adjustment is calculated by adjusting the operating profit of CompCo to reflect the additional return on operating asset in accordance with the country specific risk premium. The average long-term government bond yield is used as a proxy for the country specific risk premium. The average long-term government bond yield for Country A is 9% and for Country B it is 5%. Hence, the yield gap in government bond is 4%. The adjustment for country specific risk is then calculated as follows:

\[
\text{[Operating assets of CompCo] } \times \text{[country specific risk premium]} = \[100\] \times \[4\%] = 4
\]

This additional 4 of profit, which reflects the increased return for the notional country specific risk borne by CompCo for the purposes of the comparability analysis, is then added to the operating margin of CompCo. CompCo’s profit will increase from 30 to 34.

4.3. Condiment 3: International double taxation (access to MAP)

4.3.1. Introduction

Tax treaties seek to eliminate international juridical double taxation by allocating taxing rights between the Contracting States (State of residence and source State) and establishing a method to eliminate double taxation in the State of residence where there is a concurrence of taxing powers on the same taxable event. However, conflicts on the implementation and interpretation of those treaties can arise.

To address this problem, treaties for the avoidance of double taxation establish a means of dispute resolution (Mutual Agreement Procedure) adopted from the United Nations "Model Double Taxation Convention between Developed and Developing Countries" (Article 25), as well as the "Model Tax Convention on Income and on Capital" of the OECD (Article 25).

In relation to the proper application of transfer pricing, when the competent authority of a country considers that transactions between related parties do not comply with the "Arm’s Length Principle", they may adjust the profits reported by an enterprise. If this happens, there is the possibility of economic double taxation if the competent authority of the other country does not make a corresponding adjustment to the profits of the related party with which the first enterprise held the operations that were subject to adjustment. That is why, through the MAP (Mutual Agreement Procedure), competent authorities look to comply with the conditions of the "Arm’s Length Principle" and, at the same time, eliminate economic double taxation.

4.3.2. Background

Article 25 was first introduced in the OECD Model Tax Convention of 1963, as an instrument for eliminating international juridical double taxation and as a mechanism to provide support for injured parties to resolve their disputes in a friendly manner without the need for taxpayers to go to the national courts of any State.

MAP is inherently an inter-state procedure, unlike domestic remedies where the taxpayers themselves are actively involved in the preparation of their defense. Although the taxpayer does not participate in
the resolution of international disputes due to the states’ sovereign authority to levy taxes, they do play an important role as they may initiate the proceedings through their request\textsuperscript{11}. It should be noted that there are substantive differences between the initial content of Article 25 and the current version. Modifications have intended to provide greater clarity concerning the time limits for submitting requests, the interaction with domestic legislation, as well as the inclusion of a mandatory binding arbitration clause which seeks to give legal certainty to taxpayers regarding the resolution of their case.

These discrepancies resulting from the modifications to the model are summarized below:

<table>
<thead>
<tr>
<th>ARTICLE 25 - 1963 VERSION</th>
<th>ARTICLE 25 - 2017 VERSION</th>
</tr>
</thead>
<tbody>
<tr>
<td>MAP could only be requested before the competent authority of the State of residence.</td>
<td>MAP may be requested before the competent authority of either Contracting State.</td>
</tr>
<tr>
<td>No time limit for submitting the request was established in the article.</td>
<td>The case must be presented within three years from the first notification of the action not in accordance with the Convention.</td>
</tr>
<tr>
<td>MAP was restricted by the time limits found in the domestic law of the Contracting States.</td>
<td>MAP will be implemented notwithstanding time limits specified in the domestic laws of the Contracting States.</td>
</tr>
<tr>
<td>Possibility for authorities to communicate directly was established so that, when considered appropriate, they could conduct a verbal exchange of views through a commission comprised of representatives of the competent authorities of the States.</td>
<td>A more general perspective provides the possibility for authorities to communicate directly, including through a Commission comprised of themselves or their representatives.</td>
</tr>
<tr>
<td>No arbitration option.</td>
<td>It is possible to submit unresolved issues to arbitration during the course of a MAP.</td>
</tr>
</tbody>
</table>

**4.3.3. Comparative Law: Internal legislative framework on MAP**

**Belgium.** A guide exists on MAP and advanced pricing agreements that explains the nature of the MAP, how to request it, its effects, and its origin, among other issues\textsuperscript{12}.

**Canada.** There are no specific provisions for MAP in Canadian law\textsuperscript{13}, but there is a guide to advice taxpayers about the procedure and the competent authority\textsuperscript{14}.

**Spain.** There is a regulation on mutual agreement procedures in direct taxation, which rules on aspects of MAP including scope, competent authority, rights and obligations of the taxpayer, terms, requirements to submit the request, and implementation\textsuperscript{15}.

**United States.** The Internal Revenue Service Manual provides in Section 2 of Chapter 69, Part 4, provisions relating to mutual agreement procedures. In particular, it regulates the notification made to

\textsuperscript{11} Bantekas, Ilias, The mutual agreement procedure and arbitration of double taxation disputes, Colombia, 2008, p. 184.
\textsuperscript{12} Cfr. Procedure amiable Advance Pricing Arrangement (APA), Federal Public Service of Finance, Belgium.
\textsuperscript{14} Competent Authority Circular on Tax Assistance under Canada’s Conventions (JC71-17R5), 2005
\textsuperscript{15} Cfr. Royal Decree 1794/2008, of 3 November, under which the Regulation of mutual agreement procedures is approved on direct taxation, BOE n. 278 of 18/11/2008 updated last in 2015.
taxpayers on a potential double taxation, the role of the personnel in charge of requests for MAP, and the procedure to be followed once a case of MAP\textsuperscript{16} has been presented.

**Ireland.** Guidelines related to the MAP requests are published by the Ministry of Finance of Ireland to advise taxpayers on time limits for presenting a request, requirements, procedures, and effects regarding internal procedures, among other aspects\textsuperscript{17}.

**United Kingdom.** The domestic legal framework for MAP is established mainly in sections 124-125 of the Taxation of International and Other Provisions Act 2010 -TIOPA 2010-.\textsuperscript{18} In particular, these sections regulate the resolutions issued under a MAP, as well as their effects and the time limits for presenting a case\textsuperscript{19}.

**Switzerland.** Guidelines were published in 2016 in a briefing paper by the Federal Department of Finance State Secretariat for International Financial Matters\textsuperscript{20}.

### 4.3.4. The effectiveness of MAP as a means of International Dispute Resolution on transfer pricing

Article 9 of the OECD Model Convention establishes the possibility that a Contracting State may include, and consequently tax, the profits that would have accrued to an enterprise if their operations had been carried out in compliance with the "Arm's Length Principle", but which did not so accrue due to the operation being carried out between related parties. In this situation, if the other Contracting State considers that the adjustment is justified, it can perform an appropriate correlating adjustment to the taxes levied on those profits, for which both competent authorities may consult each other, using the MAP as the mechanism to achieve this end.

A correlating adjustment can reduce or eliminate double taxation in cases where a tax administration increases the taxable profits of a company (primary adjustment) resulting from the application of the "Arm's Length Principle" in operations involving an associated enterprise in the other tax jurisdiction. It is also possible that the first State may reduce or eliminate the primary adjustment as part of the consultation process, so that the correlating adjustment would be smaller or even unnecessary. Thus, the correlating transfer pricing adjustments are the only way to eliminate the economic double taxation that may arise in such cases.

It should be noted that under paragraph 3, Article 9 of the UN Model Double Taxation Convention, the provision corresponding to adjustments should not apply in cases where judicial, administrative, or other legal proceedings have resulted in a final ruling under which, due to actions giving rise to an adjustment of profits under paragraph 1, one of those enterprises concerned is liable to penalty with respect to fraud, gross negligence, or willful default.

\textsuperscript{16} Cfr. Internal Revenue Manuals, Part 4, Chapter 69, Section 2, United States.
\textsuperscript{17} Cfr. Guidelines for Requesting Mutual Agreement Procedure ("MAP") assistance in Ireland Part 35-02-08, last updated in 2017, Ministry of Finance of Ireland.
\textsuperscript{18} Cfr. Making Dispute Resolution More Effective - MAP Peer Review Report, United Kingdom (Stage 1), OECD, 2017, p. 11.
\textsuperscript{19} Cfr. Taxation (International and Other Provisions) Act 2010, sections 124 and 125, UK.
4.3.5. Frequent reasons to request a MAP on Transfer Pricing

Internal legislation. Although the "Arm’s Length Principle" is the internationally accepted basis for allocating profits between related parties, the specific transfer pricing provisions differ between countries. Thus, Article 25 of the OECD and UN Model Conventions provide the mechanism for authorities to resolve conflicts of juridical and economic double taxation derived from such cases.

Classification and assessment of the facts. Economic double taxation may also arise because of different interpretations of the underlying facts in a specific case (more commonly when interpreting the treaty or applying the "Arm’s Length Principle" as governed in Articles 9 and 7 of the OECD Model Convention). For example, there may be a dispute as to whether a party is related to another in a particular case. In general, classification conflicts are concerned with the impact of domestic legislation on the interpretation of the treaty.

Consequently, international disputes relating to transfer pricing between two competent authorities arising from two different interpretations of the facts shall be resolved through MAP. In such cases, conflicts of interpretation may be elucidated in accordance with the OECD Transfer Pricing Guidelines, within the scope of MAP.

Application of different transfer pricing methods and selection of comparables. It may be that there are conflicting criteria for how to select the proper transfer pricing method to be applied in operations between related parties (for example: when a State advocates for the use of a unilateral method, and another State for the use of the transactional profit split method). Often, such conflicts are related to the functional and comparability analysis.

Another point of conflict for MAP relating to transfer pricing is the selection of comparables; tax authorities often conduct their own search for comparables or reject those offered by the taxpayer. Thus, in practice, for most disputes it is necessary to reconcile and resolve varying perceptions on technical aspects in order to select comparables between the competent authorities.

4.3.6. The efficiency of MAP in transfer pricing cases

Transfer pricing is a controversial topic from an international perspective as tax administrations can perform transfer pricing adjustments which may potentially lead to economic double taxation. In the context of tax treaties, the shortcomings of the MAP lead to an inefficiency in resolving these types of controversies.

Firstly, MAP does not mandate that competent authorities reach an agreement, their only obligation is to “endeavour” to resolve the issue. Nor does it specify a time limit for resolving the case (in treaties where arbitration is not provided as a means of resolving disputes). Additionally, the participation of the taxpayer is limited to presenting the request to start the proceedings without intervening once the process has started.

Secondly, the MAP request must be presented within a specified time period; this can be three years from the first notification of the action not in accordance with the treaty (or possibly a different period as established in the particular bilateral treaty). Not all treaties have a clause that enables access to arbitration in case of unresolved MAP issues. The basis for this clause is found in Article 25 (5) of the OECD Model and 25 (5), alternative B of the UN Model, or Part VI of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, which derives from Action 15 of the OECD/G20 BEPS project. It is worth noting that arbitration does not constitute a minimum standard of the Multilateral Convention and most countries have not declared their intention to adopt it.

A significant number of tax authorities have reported that the most important effect of the arbitration clause has been to accelerate and prioritize the MAP rather than resolve disputes in arbitration itself. Issues will be resolved either in the context of MAP or through arbitration, the latter method provides competent authorities flexibility to reach a solution other than that provided for by the arbitration panel22.

4.3.7. Mexican experience with MAP

Mexico's tax legislation contains provisions for utilizing the MAP provided in their tax treaties for the avoidance double taxation. These provisions address the nature of mutual agreement proceedings, the opportunities they provide and the effect they have on other means of appeal, and admissibility.

4.3.7.1. Legal nature and application

The Federal Fiscal Code (CFF for its acronym in Spanish) states the following in Article 125:

> The dispute resolution procedures provided for in the double taxation treaties of which Mexico is a party, are optional and may be requested by the interested party before or after termination of the means of appeal provided by this Code. Dispute resolution procedures are inadmissible against final decisions that terminate the motion for reversal or trial before the Federal Court of Tax and Administrative Justice23.

Similarly, Article 34-A provides that resolutions in accordance with the APA provisions may be valid during the tax period in which they apply, during the immediately preceding period, and during the three periods following the request. However, the term may be longer if derived from the Mutual Agreement Procedure found in the double taxation treaties signed by Mexico24.

4.3.7.2. Effects

Article 121 of the CFF notes that the motion for reversal (proceedings to challenge actions of the tax authorities, for example, tax credits) will be suspended if the taxpayer initiates a mutual agreement

---

23 Federal Tax Code, Article 125, third paragraph.
procedure under a tax treaty. Such suspension will conclude when the resolution is notified, thereby ending the procedure\textsuperscript{25}.

Similarly, Article 144 of the same regulatory body establishes that the procedures for tax collection will be suspended during MAP. In this case, the taxpayer will not be required to secure the corresponding tax credit\textsuperscript{26}.

In connection with the above, Article 124 of the CFF provides that the motion for reversal\textsuperscript{27} is not admissible against administrative acts issued in mutual agreement procedures if that procedure started after the decision that ends a motion for reversal or after the conclusion of a trial before the Federal Court of Administrative Justice.

4.3.7.3. Admissibility

The Miscellaneous Tax Resolution of 2018 indicates how to file a request for initiating a Mutual Agreement Procedure, as well as defining the cases where it will not be admissible. It is established that:

\begin{quote}
2.1.32. The request to initiate the mutual agreement procedures found in the double tax treaties signed by Mexico, will be held under the procedure form 244/ CFF “request to start a mutual agreement procedure contained in a treaty for the avoidance of double taxation (MAP) “contained in Annex 1-A.

A mutual agreement procedure request will not proceed when:

I. It is based on a treaty for the avoidance of double taxation, article or relevant part of the treaty that is not in force.

II. It is presented outside the timeframe established in the relevant treaty for the avoidance of double taxation.

III. It is not expressly stated under which circumstances the treaty was contravened. Or, there is no mention of how the transgression of the articles(s) or relevant parts thereof took place. Or, there is a lack of understanding as to the taxpayer’s opinion of how the interpretation of the relevant provisions should have been applied.

IV. The request refers to taxes not covered in the relevant treaty for the avoidance of double taxation.

V. The request refers to a matter of domestic law that does not fall under the scope of the treaty for the avoidance of double taxation, or, it deals with the implementation of procedural provisions under domestic law.

VI. The taxpayer signed a Conclusive Agreement with the tax authority with respect to the same facts or omissions on which it pretends to request the start of a Mutual Agreement Procedure.
\end{quote}

\textsuperscript{25} Cfr. Ibid, Article 121, third paragraph.
\textsuperscript{26} Cfr. Ibid, Article 144, third and fourth paragraphs.
\textsuperscript{27} Cfr. Ibidem , Article 124, Section VIII.
In addition, Article 5 of the Income Tax Law establishes that if an amount of income tax has been paid in another country that exceeds the amount established according to the provisions of the relevant treaty for the avoidance of double taxation, the surplus amount may only be credited once the MAP is exhausted.

**4.3.8. Action 14 of the BEPS project - Making the dispute resolution mechanisms more effective**

As mandated by Action 14 of the BEPS project, countries worked to “Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.” - Action Plan on Base Erosion and Profit Shifting, Page 23, OECD, 2013.

The measures agreed under Action 14 sought to strengthen the effectiveness and efficiency of the process by minimizing the risks of uncertainty and unintended double taxation to ensure consistent and appropriate implementation of tax treaty provisions.

Through the final report of this Action, a significant number of countries agreed to change their approach to the resolution of disputes concerning tax treaties. Their commitment on this issue represents a minimum standard, which will ensure that:

- The obligations of tax treaties in relation to MAP are fully implemented in good faith, and that cases of MAP are resolved in a timely manner (on average 24 months).
- Implementation of administrative processes that promote the prevention and timely resolution of disputes, such as guidelines for taxpayers on the requirements to access MAP.
- Taxpayers will have access to MAP when eligible.

Being Action 14 a minimum standard of BEPS, the implementation of the aforementioned commitments is monitored to ensure that all countries involved in the project will meet these standards.

---

28 Miscellaneous Tax Regulations 2018, Rule 2.1.32.
29 Cfr. Income Tax Law, Article 5, fifteenth paragraph.
Through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the "MLI") developed under Action 15 of the BEPS project, compliance with this standard will be facilitated as the subscribing countries can incorporate these -and other- measures into their existing treaties via an amendment to the relevant articles. That is, the MLI will allow for modifications to existing agreements between countries, thereby avoiding lengthy bilateral negotiations and eliminating the procedural burden of signing and ratifying protocols to the treaties.

4.3.9. Conclusion

The MAP article is essential for the proper operation of double taxation treaties because it facilitates solutions to cases of taxation that is not in accordance with the treaty, as well as resolving disparities in their implementation and interpretation. The tax authorities must apply this article in good faith in order to fulfill the objective of the double taxation treaties and to prevent tax evasion or tax avoidance.

It is also important to note that as part of the implementation of the minimum standard of BEPS Action 14, countries that are part of this project should incorporate at least the first three paragraphs of Article 25 of the OECD Model (subject to allowed variations). Of particular interest is the second sentence of paragraph 2 of Article 25 of the OECD Model, which states that MAP agreements shall be implemented notwithstanding any time limits in the domestic law of the Contracting States. According to the final report of Action 14, countries that cannot incorporate this provision must be willing to accept alternative provisions that limit the time during which adjustments can be made under Article 7 (Business Profits) and Article 9 (Associated Enterprises).

One of the main challenges in the framework of BEPS Action 14 is the inclusion of mandatory binding arbitration as a means to ensure the resolution of MAP cases. This mechanism gives legal certainty to taxpayers regarding instances where they consider that a measure not in accordance with the convention was applied to them. It also encourages competent authorities to avoid postponing the discussion of the case, in order to avoid the arbitration. Notwithstanding the above, most of the countries participating in the BEPS project have chosen not to include this measure arguing sovereignty (i.e. they are unable to accept panel arbitration rulings on issues of domestic taxation), inexperience, lack of confidence in the impartiality of arbitrators, costs, and potential difficulties in finding specialists who can be appointed as arbitrators. It should be noted that the arbitration provisions incorporated as part of the Multilateral Instrument provide great flexibility with respect to the cases that may be subject to arbitration, by allowing countries a reserve mechanism to exclude certain cases from its purview.
4.4. Condiment 4: Alternative mechanisms for dispute resolution between taxpayers and tax authorities

4.4.1. Background

Prior to the contentious stages that the taxpayers and tax administrations may reach, there arises a need for more tolerant administrative and judicial positions that allow taxpayers and tax administrations to seek technical solutions by consensus. Attempting to work out their differences in an atmosphere of cooperation and transparency under the principles of flexibility and promptness with the intention of helping taxpayers comply with their tax obligations in order to achieve expeditious tax collection. Moreover, these measures are especially appropriate in the international tax and transfer pricing context given the complexity, subjectivity and extensive analysis of facts and circumstances that is required.

Such procedures (for example, mediation) have been selected to be part of the “Cocktail” of measures for managing cases involving transfer pricing manipulation and problems arising from international experiences, where determining adjustments creates a high level of disputes that leave the Tax Administration in a vulnerable position when defining adjustments and collecting them. This situation is aggravated in countries where courts do not have an adequate degree of specialization in the field.

Mexico and India are two reference points on these procedures. In both, the experience has been useful and has shown positive results. However, it is essential to have a minimal implementation structure for ensuring institutional capacity for proper operation.

4.4.2. The Mexican case

In Mexico, the mediation system consists of a "conclusive agreement", a concept which arose from a previously established system of complaints to the Mexican Ombudsman ("Prodecon" - Office for the Defense of Taxpayers). The Prodecon aims to identify and investigate actions by the federal tax authorities that could potentially violate the rights of taxpayers. The overall intention being that the authorities desist from any such violations and restore the taxpayers their fundamental rights.

This procedure originated from the presentation of formal complaints by taxpayers, sent in various forms; verbal, written, by email, or through Prodecon’s internet portal. This resulted in non-binding public recommendations for the Tax Authority, suggesting corrective measures to restore the rights of taxpayers.

The aforementioned complaint system was found to be an effective means for direct communication between the tax authority and the taxpayers as it was impartial, flexible and fast. This improved the
probability of reaching mutual consensus and allowed both parties to be part of a roundtable discussion regarding potential violations to taxpayer rights. The tax authority took these points into consideration, desisted from the infringing acts, and reinstated taxpayer rights, all thanks to the presence and protection of the Prodecon. Nevertheless, the system was not perfect. The conclusions reached from the given feedback (the complaints) required a character\(^{31}\) with more resemblance of "mediation", as explained below.

### 4.4.3. The problem

From the point of view of the regulatory authorities, the complaint system started as an effective means of self-control and a way to resolve non-judicial aspects. However, Prodecon found that the regulatory authority's flexibility and openness to dialogue was contrary to the audit procedures that usually entail specified time restrictions and a statute of limitations. Thus, the tax authority first concluded its audit and then analyzed the petition from the complaint. Furthermore, the non-binding nature of the recommendations being presented at the end of the complaint procedure, lead to inefficiency. Thus, it was necessary to implement an alternative form of dialogue that would be available for the duration of the audit (with the support of the Prodecon as an intermediary).\(^{32}\)

### 4.4.4. Justification

In accordance with the initiative that led to the Conclusive Agreements being adopted, the purpose of these efforts is to ease the burden for taxpayers. The legislation provides for a supplementary tax return to be used in order to facilitate the taxpayers’ capacity to fulfill their tax obligations. Conclusive Agreements were proposed as an alternative means of reaching consensus during an audit, with the institutional participation of the Prodecon acting as a facilitator and witness throughout. Taking into consideration these objectives, it was established that Conclusive Agreements are definitive and do not allow for a legal remedy or modification under a mutual agreement procedure, thereby only taking effect for the taxpayers involved, without generating legal precedents\(^{33}\).

There is an international trend for implementing alternative means of dispute resolution in tax matters. These mechanisms have already been applied in various countries, where they grew to become a cornerstone of the tax system\(^{34}\) as they provide for better service by tax administrations and human rights defenders. These mechanisms recognize that for improved compliance, not only is the application of the tax law important, but also it is necessary to emphasize the role of facilitators that pay service to the taxpayers. Thus, similar procedures apply in countries like Italy, India, Spain, USA, France, Australia, New Zealand and the UK.\(^{35}\)

---


32 Idem.

33 cfr. Parliamentary Gazette, n. 3857-C, 8 September 2013, pp. CX, CXI.

34 CUADRA RAMIREZ, José Guillermo, Medios alternativos de resolución de conflictos como solución complementaria de administración de justicia, Mexico, SCJN, p. 14, quoted by BERNAL Ladron de Guevara, Diana, et.al ., Acuerdos Conclusivos Primer medio alternativo de solución de controversias en auditorías fiscales, Series of Notebooks of the Office of the Taxpayer Advocate, n. XIV, Prodecon, Mexico, February 2014, p. 7.

4.4.5. Regulatory aspects

Conclusive Agreements became part of the Mexican tax system in 2014, consisting of the following characteristics:

- A Conclusive Agreement may be requested by a taxpayer when they have been subjected to an audit (either desktop or field) and consider the authority’s assessment incorrect by some action or omission. The request must be submitted as soon as the action or omission becomes known, before the notification of the amount of unpaid taxes.\(^{36}\)
- A request starts with the submission of a written document that states the acts or omissions being appealed to by the taxpayer, specifying the treatment that should be given according to the taxpayer’s opinion, and attaching whatever documentation they deemed necessary.
- Consequently, a reconciliation process takes place between the taxpayer and the reviewing authority. During which, the Prodecon serves as an intermediary entity facilitating communication between the taxpayer and the authority, using discussion groups to better reach a consensus, and suspending the audit expiration dates during this process. Furthermore, the Prodecon attests that the agreements follow the tax rules and respect the rights of the taxpayer.\(^{37}\)
- After discussions, Prodecon requires that the reviewing authority, in a maximum period of 20 days, reveal whether or not it will accept the terms of the Conclusive Agreement. If refused, they will express their motives and present the terms under which the adoption of the agreement or non-agreement could proceed.
- After acknowledging receipt of the response from the Tax Authority, Prodecon has a period of 20 days to complete the process and notify the taxpayer. In the case of signing a Conclusive Agreement, it must be signed by the taxpayer, the Tax Authority and the Prodecon.

If a Conclusive Agreement is signed it does not constitute a precedent, it will not be possible to challenge it, and the conclusions reached are binding. An additional advantage obtained from a Conclusive Agreement is the right to waive the taxpayers’ total fines due.

The impossibility for recourse after the conclusion of these agreements, from the perspective of the authority, is a feature that facilitates their conclusion. This feature is known in advance by taxpayers and is expressly stated in the Mexican law. Additionally, the resolution of the agreement cannot be changed under a mutual agreement procedure, as stated in item 2.6 of Action 14 of the BEPS Project; it is valid to limit the scope of the MAP in respect to the issues resolved through such procedures.

\(^{36}\) c.f. Art. 69-C and art. 42, fr. II, III and XI of the CFF
\(^{37}\) BERNAL Ladron de Guevara, Diana, et.al, Acuerdos Conclusivos Primer medio alternativo de solución de controversias en auditorías fiscales, Oh. Cit., P. 27.
\(^{38}\) Cfr. art. 69- H CFF.
The impact of these measures on tax collection are as follows:

- The tax authority estimates it has raised about $19,000 million pesos in taxes resulting from the subscription of approximately 2,000 Conclusive Agreements from their inception in 2014 through mid-2017\textsuperscript{39}.
- Currently, 5,700 Conclusive Agreement processes are pending resolution.

4.4.6. The case of India

In India there is a mediation procedure similar to the Conclusive Agreements of Mexico, called Income Tax Settlement Commission which consists of a quasi-judicial body that hears matters from taxpayers who exceed a certain amount of Indian Rupees\textsuperscript{40} (1 million or 5 million), depending on certain criteria.

Through this forum, taxpayers may reveal before the commission an amount of income that has not previously been declared. The taxpayer and tax department specify certain terms in order to facilitate a mutual agreement and avoid contentious tax disputes.

Taxpayers must submit a request to apply for this procedure, the tax department will conduct a preliminary evaluation of the case and decide whether to proceed with the Commission. Subsequently, if the case is accepted, the tax department will have a certain time period during which to investigate the matter. Meanwhile, the taxpayer has the opportunity to raise objections against the department.

After analyzing the position of both parties (tax authority and taxpayer), the Commission decides on the matter in question and determines the final basis for applying the tax. This element is important as it differs from the Mexican case where the solution arises from an agreement between the parties.

In India, there is always a conclusion of the case which implies a greater commitment by the taxpayer when deciding to pursue this process. The process takes 18 months to be completed and the decision of the Commission is final and binding for both the taxpayer and the tax department.


Consulted on 18/12/2017
4.4.7. Examples of proposal (generic / specific)

<table>
<thead>
<tr>
<th>Topic</th>
<th>Alternatives</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consequences</td>
<td>Option 1: final resolution in all cases. Option 2: final resolution conditional on an agreement.</td>
<td>Option 2 could generate greater motivation by the taxpayer to access the procedure as it is under no obligation to accept a solution when it does not reach a mutual agreement.</td>
</tr>
<tr>
<td>Deadline for completion of the procedure</td>
<td>Option 1: a time limit is established under which the subject to be treated must be resolved. Option 2: no time limit is set.</td>
<td>Option 1 generates greater legal certainty for both parties, since a time limit for resolution and fulfillment of obligations is known. Notwithstanding the above, the country that incorporates this type of process must evaluate the advantages and disadvantages of establishing a deadline and if so what it would be.</td>
</tr>
<tr>
<td>Characteristics of the unrelated party</td>
<td>Option 1: facilitator, mediator, conciliator or intermediary. Option 2: arbitrator or ruling officer.</td>
<td>Option 1 provides more confidence and security to the taxpayer if they do not reach an initial understanding and believe they can continue to discuss the tax adjustment in other instances. The characteristics of the unrelated party must be evaluated by each country that incorporates this type of process.</td>
</tr>
<tr>
<td>Statute of limitations / expiration of obligations / rights</td>
<td>Suspension of time limits.</td>
<td>This requirement is advisable to ensure the normal development of the process without affecting the terms established in the regulations.</td>
</tr>
<tr>
<td>Sanctions</td>
<td>Decrease or reduction of penalties.</td>
<td>This serves as an incentive for taxpayers to request the process.</td>
</tr>
</tbody>
</table>

4.4.8. Example of legislative proposal:

**Article 1.** When taxpayers are subject to an investigation and they do not agree with the proceeding results, they may decide to request an alternative means of dispute resolution. This alternative shall be definitive in regards to the disputed fact or omission.

Taxpayers may request this alternative at any time from the start of the investigation until receiving the notification of the amount of unpaid taxes due, so long as the tax authority has already made their assessment regarding the infringement on the tax provisions.

**Article 2.** The taxpayer who opts for these alternative mediation procedures, will do so via a facilitator. The request must describe the acts or omissions in dispute, specifying the treatment that, in their opinion, should be attributed to them. Also, they should include any documentation that is deemed necessary.

Upon receiving the request, the facilitator will ask the reviewing authority to indicate whether or not they accept the terms proposed for the resolution of the case, within a defined time period. Otherwise, indicate the reason why it was not accepted, and the terms under which the adoption of the resolution would proceed.

Should the reviewing authority fail to respond to the aforementioned request, it would merit the application of penalties.
Article 3. After acknowledging receipt of the response from the tax authority, the facilitator will have a defined time period to conclude the process and notify the parties involved. When concluding the process, the resolution must be signed by the taxpayer and the reviewing authority as well as the facilitator.

To encourage a resolution, the facilitator may convene meetings and workshops, promoting at all times the issue of consensual resolution between authority and taxpayer.

Article 4. The resolution process suspends deadlines, from the time the taxpayer submits the request to the facilitator until the reviewing authority is notified of the termination of the proceedings.

Article 5. The taxpayer who has signed a resolution is entitled, on one occasion, to reduced penalties. Tax authorities shall take into account the resolution’s reach when deciding the amount of the reduction. The aforementioned entitlement does not guarantee a refund or compensation.

Article 6. The resolutions reached and signed by the taxpayer and the authority may not be appealed through any means of defense; when facts or material omissions of the resolution are the basis for the actions of the authority, they shall not give rise to any disputes. The referenced resolutions will only have effect between the parties and will not generate any precedents.

The tax authorities cannot ignore the facts or omissions described in the resolution, unless it is established that these were falsehoods\(^\text{41}\).

For optimal implementation, certain minimum conditions are necessary. Furthermore, the facilitator must be able to handle the process, this requires: a high degree of specialization in taxation that allows them to verify that the actions of the tax authority comply with regulations; facilitate resolutions when the rights of the taxpayer are under threat; and adjust the terms of proposed resolutions to facilitate a conclusion.

The facilitator must demonstrate their ability to bring the parties together, encouraging the conclusion of an agreement in good faith while promoting respect and fairness to taxpayers\(^\text{42}\). Upon being appointed facilitator, they should ensure independence, impartiality and objectivity toward the involved parties and their interests.

Moreover, if an arbitrator is considered in place of a facilitator, as in the case of India, they must also display the characteristics described above. Neutrality should be given special consideration given that the arbitrator’s decision is final and may not necessarily reflect the will of the parties.

In conclusion, these measures are favorable for guaranteeing the rights of taxpayers in cases where there may be a potential breach of tax obligations. As well as, strengthening the tax authorities’ efforts

---


\(^{42}\) BERNAL LADRON DE GUEVARA, & al., Acuerdos Conclusivos Primer medio alternativo de solución de controversias en auditorías fiscales, Ob. Cit., P. 21.
for implementing complex and subjective international taxation systems, specifically to do with the control and assessment of transfer pricing.

This process allows for earlier conclusion of disputes, reducing the workload and the costs borne by the treasury. Similarly, the need for expensive litigations or further control processes is minimized.

**4.5. Condiment 5: Sanctioning system to enhance compliance with the transfer pricing regime**

**4.5.1. Background**

This section analyzes elements for an effective sanctioning regime that enables the tax administration to attain sufficient, relevant and reliable information for effective risk assessment and for releasing low risk taxpayers from excessive administrative burdens. The objective is not on the quantity of information but the quality; having information that focuses on risky situations that threaten the tax base. Meanwhile, inciting an adequate perception of risk in the taxpayers, which motivates them to document and estimate the transfer prices correctly.

According to information found in the CIAT database on transfer pricing in Latin America and the Caribbean\(^43\), transfer pricing manipulation has become one of the biggest non-compliance risks amongst taxpayers who carry out international or domestic transactions with related parties. One reason could be the increase in operations between subsidiaries, these are not necessarily exclusive to large multinational companies, however, large companies do concentrate the vast majority of related-party operations which represent the highest risk of transfer mispricing. The risk is also high in developing and low-income countries, where natural resources are the pillars of the economy, and tax administrations face numerous control challenges.

Thus, to promote voluntary compliance in taxpayers with international operations, we need appropriate rules that allow the tax authorities to carry out effective control, according to their capabilities, that also respect taxpayer rights. There should be a balance between the tax administration's cost of managing the regime and the taxpayer's cost of compliance. Similarly, sanctions play a critical role to balance out incentives and encourage positive compliance in the transfer pricing regime. The treatment accorded to the taxpayer must be consistent with their behavior, imposing appropriate sanctions for those who don't comply and providing facilities to those who demonstrate low risk in their behavior.

In this scenario of multinational corporations, significant and complex transactions, and difficult to obtain information, the challenge is to identify the quantitative and qualitative information from both sides of the transaction\(^44\). It is necessary to identify the group to which it belongs, to deploy an effective risk model as well as design adequate sanctions to encourage voluntary compliance. The application of the sanctions corresponds to the severity of the omission and risks involved. For example, some cases of non-compliance to be considered in relation to large taxpayers are:

\(^{43}\) You can view the Database Transfer Pricing CIAT at the following link: https://www.ciat.org/transfer-pricing/?lang=en

\(^{44}\) The application of qualitative and quantitative preliminary information from both sides of the international transaction is crucial as the analysis of transfer pricing are technically bilateral analysis, specifically in what concerns the choice of pricing method most appropriate transfer and the analyzed part of the transaction, as noted.
- Penalties for failure to pay taxes.
- Penalties associated with failure to submit documents or statements.
- Penalties associated with the failure to update data in the established time. For example, these can be set as an amount of late penalty days in their presentation.
- Penalties for incomplete or incorrect / inaccurate information, which aim to sanction mistakes. In some countries, recidivism in committing errors empowers the Tax Administration to suspend the tax registry. Within this group of sanctions, it has been noted that tax administrations sanction more severely omissions or errors made by taxpayers on transaction with special or preferential regimes (Example: tax havens).
- Penalties for resistance, obstruction, or refusal to comply with the actions of the Tax Administration.
- Procedural penalties for fraud, which fall within the scope of criminal law, where tax administrations detect fraudulent registries of nonexistent companies that become an instrument of fraud by issuing false invoices, simulating operations conferring entitlement to tax benefits. It is desirable that criminal laws have defined the crime of tax fraud to apply in these cases.

Given the impact on tax base erosion that results from the improper handling of transfer pricing transactions, some countries have introduced a special regime of sanctions applicable to subjects carrying out such operations. For example, according to the CIAT transfer pricing database\(^45\), updated to March 2018, 11 of the 19 countries representing Latin America and the Caribbean have special sanctioning regimes. In all cases, these special regimes are stricter than the general sanctioning regimes.

<table>
<thead>
<tr>
<th>Countries</th>
<th>General sanctioning system</th>
<th>Sanctioning system for international transfer pricing operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Bolivia</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Costa Rica</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Ecuador</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>El Salvador</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Guatemala</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Honduras</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Jamaica</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Nicaragua</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Panama</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Paraguay</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>X 1/</td>
<td></td>
</tr>
<tr>
<td>Uruguay</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

1/ The sanction regime is exclusive in terms of formal measures, but in terms of material restrictions the general sanction regime is followed.

\(^{45}\) The CIAT Database of Transfer Pricing can be consulted at: [https://www.ciat.org/precios-transferencia/](https://www.ciat.org/precios-transferencia/)
In the case of non-compliance, it may be necessary to have a special regime of sanctions for transactions with related parties. However, if the general sanctioning regime works properly and enforces the fulfilment of taxpayer obligations, it might be unnecessary to create a different exclusive regime.

The most advanced experience (i.e. the United Kingdom) also promotes compliance through other actions such as the early disclosure of tax planning structures with the tax administration. As part of these initiatives, the tax administration provides their opinion on the compliance risks that the presented plan could trigger, maintaining close communication with the taxpayer and generating certainty in advance to avoiding penalties and future litigation. This practice is in line with the recommendations of the Action 12 of the BEPS Action Plan.

To better understand these special regimes, the following table provides information on the penalties for formal infractions, as found in 4 of these 12 special sanctioning regimes:

<table>
<thead>
<tr>
<th>Countries</th>
<th>Failure to submit return / technical study of transfer pricing</th>
<th>Incorrect filing of statement / technical study of transfer pricing</th>
<th>Omission of information on declarations or technical studies transfer pricing</th>
<th>No preservation of documents</th>
<th>No presentation in terms of reporting obligations related to transfer pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>10 to 50 annual tax units ($5,219,880 to 26.099400)</td>
<td>10 to 50 annual tax units ($5,219,880 to 26.099400)</td>
<td>10 to 50 annual tax units ($5,219,880 to 26.099400)</td>
<td>Not Available</td>
<td>10 to 50 annual tax units ($5,219,880 to 26.099,400)</td>
</tr>
<tr>
<td>Colombia</td>
<td>Informative documentation: 4% -6% of the value of undocumented transactions</td>
<td>Informative report: 1% -4% of the total value of transactions corrected 1% of the value of the transaction for which inconsistent information was provided.</td>
<td>The penalty is set on the value of the operation omitted and is only 2%</td>
<td>Not Available</td>
<td>Informative report: 0.05% -0.2% per month or fraction</td>
</tr>
<tr>
<td>Mexico</td>
<td>US $ 1,380 to US $ 4150 per unidentified operation</td>
<td>Not Available</td>
<td>US $ 61,000 to US $ 122.010</td>
<td>No deduction on payments to related parties</td>
<td>US $ 140,540 to US $ 200.090 for not presenting the Master file, Local file and country-by-country reporting.</td>
</tr>
</tbody>
</table>

Moreover, the special sanctions for material infractions adopted by the 7 countries previously analyzed are as follows:

<table>
<thead>
<tr>
<th>Countries</th>
<th>Substantive violations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Tax omission - adjustable fine of (1) one to (4) times the tax ceased to pay or withhold. Adjustable fine of two (2) up to ten (10) times the amount of the evaded tax.</td>
</tr>
<tr>
<td>El Salvador</td>
<td>25% -50% of the tax liability.</td>
</tr>
<tr>
<td>Honduras</td>
<td>15% penalty, calculated on the amount of the adjustment by the Tax Administration.</td>
</tr>
<tr>
<td>Paraguay</td>
<td>50% of the tax omitted. In the case of fraud, it is subjected to a fine of between one (1) to three (3) times the amounts of tax defrauded.</td>
</tr>
<tr>
<td>Peru</td>
<td>50% of the tax omitted.</td>
</tr>
<tr>
<td>Venezuela</td>
<td>100% to 300% of tax omitted.</td>
</tr>
<tr>
<td>Mexico</td>
<td>15% -27.5% of the tax omitted, provided the taxpayer has complied with the presentation according to information regime. Otherwise, the general rule applies 30% to 55% of the omitted tax.</td>
</tr>
</tbody>
</table>
The common denominator in the design of sanctions for substantive violation lies in the definition of a fine that represents a significant value whose calculation basis is the omitted tax, leaving in some cases a range that enables the appropriate penalty depending on the seriousness of the case.

It is common today that tax administrations consider mechanisms for remission of penalties, however they must be seriously evaluated since in the absence of a tax culture, taxpayers do not have incentives to comply positively and correctly their tax obligations. If a behavior of avoidance or tax evasion were detected, the only consequence would be to have to pay the taxes originally due. This creates the perfect setting for tax planning in the complex and subjective sphere of international taxation and transfer pricing scenario.

With regard to certain developed economies, the penalty regimes applicable to transfer prices adjustments follow a general trend, they usually do not determine an absolute amount as a penalty, but as a percentage of transfer prices adjustments, as shown in the following table, which contains information updated to 2016:

<table>
<thead>
<tr>
<th>Country</th>
<th>Penalty Regimes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Under the current legislative framework, the sanctions regime in Australia is as follows: i) 50% of the evaded tax for transfer pricing agreements concluded with the sole or primary purpose of allowing a taxpayer to avoid taxes or pay fewer taxes; and (ii) 25% of the evaded tax for other transfer pricing arrangements. The penalties referred to may be reduced from 50% to 25% and 25% to 10% tax credit, when the taxpayer has a reasonable and sustainable position. It is considered that the taxpayer has a reasonable and sustainable position when he prepared the transfer pricing documentation in accordance with the requirements of the law.</td>
</tr>
<tr>
<td>France</td>
<td>From 1 January 2010, companies subject to documentation requirements for transfer pricing are subject to a fine for each audited financial year, to the highest amount between: (i) 0.5% of the amount of the unpaid operations or documented incorrectly; or ii) 5% of the amount determined in relation to the same operations, with a minimum of 10,000 Euros. In case of bad faith, sanctions of 40% of the tax reassessment may be applied, which can reach 80% in cases of fraud and 150% in other specific cases. There is no provision on reduction of fines.</td>
</tr>
<tr>
<td>Italy</td>
<td>Italy applies ordinary penalties in an amount of 100% to 200% of the additional tax determined, increased by one third of the unpaid tax and applicable interest if taxable income is derived from foreign sources. From 2000, under certain circumstances criminal penalties also may apply. The taxpayer could avoid administrative sanctions in the case of transfer pricing adjustments, if the taxpayer prepares and quickly provide documentation to the transfer pricing tax auditors. Taxpayers are obliged to inform the tax authorities in advance about the existence of “appropriate” transfer pricing documentation. Penalties with respect to transfer pricing adjustment can be reduced in circumstances where the taxpayer accepts the transfer pricing adjustment and amendment of the tax return within a specified period.</td>
</tr>
<tr>
<td>Netherlands</td>
<td>The general rules of fines are also applicable to transfer pricing. The fine can be up to 100% in case of fraud or bad faith. Penalties may be reduced or forgiven if the documentation reflects a justifiable position.</td>
</tr>
<tr>
<td>New Zealand</td>
<td>The general rules of fines are also applicable to transfer pricing. A fine of 220% is applicable for not taking reasonable care or taking an unjustifiable tax position. A fine of 40% is charged for gross negligence. Interest is chargeable on any outstanding tax. Reduction of fines is possible when the documentation shows that the taxpayer: (i) exercised reasonable care in the preparation of documentation; or (ii) adopted an acceptable interpretation of the law. Fines can be reduced to 100% in pre-audit situations.</td>
</tr>
<tr>
<td>United States</td>
<td>A transfer pricing fine from 20% to 40% of the additional tax assessed derived from an adjustment can be imposed. Transfer pricing fines will not be imposed if the method of transfer pricing was reasonably selected and applied, if the documentation was sufficient and prepared simultaneously with the tax return, and was provided to the tax authorities within 30 days from the request.</td>
</tr>
</tbody>
</table>
Regardless of the design of sanctions to confront formal or substantive omissions, it is important to consider other non-monetary sanctions that may contribute to motivate voluntary compliance. In some cases, the effect of these sanctions may be significantly more effective than financial penalties. Given the high cost that compliance with the transfer pricing regime represent to taxpayers and their resistance to comply with the reporting requirements, such sanctions could play a key role in encouraging compliance.

Non-financial penalties allow noncompliant taxpayers to react quickly to their application -after due process- properly fulfilling their formal obligations to prevent damage to the business that they generate. For its part, the tax administration must arbitrate the means to lift sanctions as soon as possible once the compliance can be verified. With respect to material breaches, the non-financial penalty also has a significant effect, but its application usually depends on a longer process than the one involving formal offenses.

Each country should consider in which cases to apply the sanction, the severity of the penalty and the impact it could generate, to avoid significantly affecting key economic sectors for the country, for example, in times of crisis.

An example of a non-financial penalty would be to block or deactivate registration or tax certificate of a particular taxpayer, which disables their daily operations. This procedure stemming from a widespread and recurrent failure to tax obligations, can be defined as a precautionary measure by which the tax administration restricts the operation of a taxpayer when they fail to meet the compliance standards. For example, in the case of outstanding payments that are overdue by more than a certain period, when more than a certain number of returns have been omitted, failure to submit required information directly from the tax administration, etc.

When a registration or tax certificate is blocked by this procedure, the taxpayer could not perform procedures such as invoicing authorization, processing applications for refund/compensation, and import /export. For example, in Colombia and some other Latin American countries, tax benefits and costs or deductions would not proceed, as well as those costs or deductions where the taxpayer appears as supplier or service provider in refund procedures. It is noteworthy that blocking the registration or tax identification number does not relieve the taxpayer from their formal and substantive duties with the tax administration.

In Spain, this measure is known as “revocation of the tax identification number” which revokes the registration or tax identification when specific aspects have emerged, such as: lack of activity or corporate purpose declared, no development of the activity at the stated address, failure to provide the definitive tax identification document, taxpayer declared as non-located or provisionally deregistered. The revocation is published in the gazette after a hearing with the person concerned. On the side of the tax administration, this means automatic deregistration of traders and exporters, non-issuance of tax certificates to contract with the State and suspension of tax services. Externally, it means preventing new registries in the public record, being blocked in the commercial register and the freezing of bank accounts.
A similar measure derives from taxpayers who have ceased filing returns. This inactivity in the registry may have similar consequences as that of a blockade but is based solely on non-filing. The taxpayer is required to reactivate by updating his data when he presents the request to the tax authorities. This practice may even serve a second purpose, since they have detected cases where inactive registration numbers are fraudulently used.

In the hopes of establishing direct contact with the taxpayers, some tax administrations have chosen to block the access to their websites, for taxpayers with a specific status such as those who have not filed for a certain time, or whose residency is unknown. In the case of Mexico, the rule states that the ability to provide invoices will be revoked, and the taxpayer’s registration or tax identification blocked, when the tax administration detects the following situations:

- The taxpayer fails to present three or more consecutive declarations or six non-consecutive, prior to request from the authority for non-compliance.
- During the administrative procedure for recovery of a tax credit, they do not locate the taxpayer or he disappears.
- In the exercise of their powers of verification, the authorities detect that the taxpayer cannot be located, he disappears during the procedure or they detect that the tax receipts issued were used to cover nonexistent, simulated or unlawful operations.
- Even without exercising their powers of verification, authorities detect the existence of one or more offenses, from a behavior carried out by the taxpayer who is the certification holder.

In this regard, we recommend to use such measures according to the needs and reality of the jurisdiction that requires them and that the regulation include the prevention of tax evasion, avoiding to affect taxpayers with minor breaches on low-risk behavior for which the tax authorities may apply other measures. In addition, if the measure implemented is the disqualification from registration or tax identification, it is recommended that the tax administration promptly inform taxpayers of this event and offer flexible mechanisms for reactivating quickly the registration, once the noncompliance is corrected.

It should be noted that the application of financial penalties should not necessarily exclude the possibility of concurrent non-financial administrative sanctions. In addition, all sanctions should be applied ensuring the right to hearing, and equity in the norm.

The use of non-financial penalties by the authorities should provide pre-established limits and equally effective revocation mechanisms that allow authorities to revoke the penalty if the taxpayer demonstrates compliance with the relevant obligation. In the case of transfer pricing, given its subjective nature, in case of material breaches, non-financial penalties should be applied when there is an existing debt not paid to the treasury. In the case of formal infringements, both financial and non-financial, concerning the veracity of the information contained in the system, the application of sanctions could be more complex if the tax authorities do not know how to prove it.

To this end, we recommend reviewing the CIAT Model Tax Code, which in Title IV “Offenses and Tax Penalties” provides recommendations on how to design an adequate and modern sanctioning system. In addition, for administrative purposes related to the management of formal and substantive
obligations, it is recommended to revise the CIAT Manual on Collection and Recovery\(^4\), which presents a compilation of Ibero-American good practices within this field.

### 4.5.2. Examples of the proposal (generic/specific)

A sanctioning regime must respect the principles of legality, criminality, subjective responsibility, proportionality and non-concurrence of sanctions or double jeopardy. The critical element of the sanctioning regime proposed for taxpayers operating within the international tax and transfer pricing sphere, lies in identifying taxpayer behaviors that are unusual or undesirable, and in defining responsibilities and severity of sanctions. With the ultimate goal that sanctions must have a significant impact among the most representative segment of large taxpayers.

<table>
<thead>
<tr>
<th>Concepts</th>
<th>Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope of the proposal:</td>
<td>Any breach of substantive/ material or formal tax rules, by commission or omission constitute a tax offense, defined in the legal rules. The existence of concealment or use of fraudulent means are the basic criteria for distinguishing the severity of the offenses (minor, serious or very serious). The mere breach of a substantive or formal obligation does not involve the commission of an “illegal” tax, but it depends on their classification as such.</td>
</tr>
<tr>
<td>Formal breaches to consider:</td>
<td>Generally speaking, the most common offenses related to formal transfer pricing obligations are: Prepare and maintain accounting books, records and any other documentation requested by the Tax Administration. Information reporting. Facilitate the process of control by the tax authorities. Report and appear before the Tax Administration.</td>
</tr>
<tr>
<td>Substantive/ material: breaches</td>
<td>Substantive / common material offenses relating to transfer pricing obligations derive from the following conduct: Skip filing, self-determination or declaration for the administrative liquidation of the tax. This offense is set when the required statements do not present the full information required for the Tax Administration determines the amount of tax due. The basis of the sanction could be constituted by the amount determined by the Tax Administration office. Inaccurate filing, self-determination or statements necessary for the administrative liquidation. This offense is set when taxpayers fail to enter within the legally established periods their returns by filing inaccurate, self-determinations, or erroneous information, or by filing inaccurate declarations.</td>
</tr>
<tr>
<td>Forms of fraud, that the normative should consider</td>
<td>Examples of events which, if realized, would configure fraud: Declare figures or deliberately false information or omitting circumstances that influence the determination of the tax liability. Present statements in which facts or false amounts or nonexistent operations, or where whole or in part operations, revenue, income, products, goods or any other information that affects the determination of the tax liability included are omitted. Carrying separate accounts that referred to the same activity and tax year, do not let know the real situation of the company; register entries, records or false amounts. Use of false or falsified invoices or documents. Use people or intervening entities when the offender, in order to conceal his identity, has displayed the name of a third party, with or without their consent, ownership of property or rights, obtaining income or capital gains or performing operations with tax significance of the tax obligation arises, breach constitutes infringement to be punished.</td>
</tr>
</tbody>
</table>

\(^4\) The CIAT Manual on Collection and Recovery can be recovered at the following link: [https://biblioteca.ciat.org/opac/book/5509](https://biblioteca.ciat.org/opac/book/5509)
### Types of sanctions:

They can be divided between principal and accessory, can both be concurrent:

- **Examples of major penalties:**
  - **Fine:** may be proportional or fixed amount. Implementation is considered appropriate amounts proportional to the value of transactions. This avoids the obsolescence of values and can adequately justify the impact of the fine on operations subject to the fine.
  - Confiscation of the material effects of the offense or object used to commit.
  - Temporary closure of establishment. According to the international doctrine, closing it should not be concurrent with monetary fines.
  - **Examples of accessory penalties:**
    - Suspending authorization of activities.
    - No access to public subsidies / tax credit, disqualification from participating in public tenders and loss of right to enjoy benefits or tax incentives for a period commensurate with the seriousness of the offense.
    - Suspension of registration or tax certificate of contributors, which depending on the procedures can affect the performance of procedures or vital operations to the taxpayer (bill, import / export, banking, etc.)
    - Others.

It is important to consider the principle of “non-duplication”, which states that it is not possible to punish the same facts with a criminal and an administrative penalty, which would mean the inability to cumulate a custodial sentence with a monetary fine.

### Reduction of penalties:

A trend of modern tax laws reward a compensatory behavior of the offender. In this sense, importance is given to the role of voluntary compliance, which is characterized by having a favorable treatment that consists of solving non-compliance, without prior action of the Tax Administration. Given the subjectivity of the “transfer pricing” issue, the fair application of sanctions may be complex. In certain cases, it is advisable to consider reductions in penalties based on proper compliance by taxpayers after notification of the infraction.

### Taxpayers excepted from the standard:

All standard including sanctions should consider assumptions under which the subjects are exempted from liability, although there was default from the objective point of view. For example: accident, cases arising under state of necessity, force majeure, error of law or prohibition, errors or indeed, malfunction of computer systems, among others.

### Graduation criteria:

It is not advisable to define a fixed amount of penalty, as situations that may occur are varied, as are the characteristics of taxpayers. The amount of sanctions must fall within a range and consequently a criterion for graduation. For example, in cases of recidivism (when sanctioned by a judgment or final decision commits a new illicit the same type in a given period) and recurrence (when the accused commits a new illegal act of the same type, without a conviction for judgment or a final decision within a certain period).

### Subjective responsibility:

Control of transfer pricing requires a detailed level of information on the functions, assets and risks involved in related transactions. The personnel working in some financial area external to tax areas, which often give evidence/ information, is not necessarily part of the tax planning. For this reason, it is important to define precisely who bears the responsibility for such information.

In the case of legal entities and communities or economic units, the subjective responsibility should be considered when it is found that, within its internal organization, the duty of care that would have prevented the offense was omitted, without determining the specific responsibilities of its officers, directors, trustees, curators, trustees and other individuals involved, and without prejudice to them. Entities or authorities and employers in general should be responsible for the financial penalties for tax offenses committed by their subsidiaries on their performance as such as their failure in their duty to watch over them, which would have prevented the offense, without prejudice of the personal responsibility of the persons named as participants.

### Joint and several liability of subjects involved in the commission of the offense:

The causative partners should be jointly and severally liable for their actions. These would be, for example, accomplices and instigators, third parties to facilitate their fault or willful infringement and /or those who for their own benefit or that of a third party carry out actions to commit an offense. For example, practitioners, consultants and tax intermediaries should be subject to a significant penalty when they participate in the design, planning or implementing acts, contracts or businesses, constituting abuse or simulation.

Recent trends in comparative law are in line to link the sanction professional fees, either to a daily fine since it offers an alternative to abusive tax planning until it is discovered, or the very amount of the tax debt avoided by the customer or the fine applied to it. This sanction should be accompanied by a general policy regarding tax advisors to avoid this type of behavior.

---

48 Consider that in cases of tax abuse, certain sanctions could not proceed “a priori”, because they are cases in which there is no illegality. In these cases, before applying an anti-abuse clause, the legal disposition taken by the taxpayer would be lawful.
The following proposal is based on the CIAT Model Tax Code and the experience of countries with special sanction regimes for cases involving breaches in the field of international taxation and transfer pricing. In addition, a proposal that empowers the tax authorities to impose non-financial penalties is added.

It is worth noting that the approach proposed is to ensure compliance with the formal and material requirements, mainly by multinational companies, aware that the field under study is much broader; concerned countries should implement improvements to the sanctioning regime, while observing other aspects that configure the general regime and deserve attention.

The CIAT Model Tax Code, updated in May 2015, represents a tool to consider as a starting point in designing a sanctioning regime adapted to the needs of each jurisdiction. Further examined below:

<table>
<thead>
<tr>
<th>Article of Title IV of the CIAT Tax Code</th>
<th>Topic</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>159</td>
<td>Causing agents or collaborators.</td>
<td>Not available.</td>
</tr>
<tr>
<td>160</td>
<td>Participation of professionals in the commission of tax offenses.</td>
<td>Not available.</td>
</tr>
<tr>
<td>161</td>
<td>Subjective responsibility.</td>
<td>Not available.</td>
</tr>
<tr>
<td>162</td>
<td>Exculpatory of responsibility.</td>
<td>Not available.</td>
</tr>
<tr>
<td>163</td>
<td>Joint and several liability of subjects involved in the commission of the offense.</td>
<td>Not available.</td>
</tr>
<tr>
<td>Numeral 2 of Article 165</td>
<td>Types of sanctions. Accessory.</td>
<td>This article provides examples of additional penalties, non-financial. These examples could add other cases, such as disabling the tax identification number, which may result in the inability to invoice and import/export, and others. It also can consider preventive freezing of bank accounts, the publication of tax offenders’ names, or other actions. The CIAT Collection and Recovery Manual provides additional examples.</td>
</tr>
<tr>
<td>166</td>
<td>Graduation of sanctions: determination rules.</td>
<td>Not available.</td>
</tr>
<tr>
<td>167</td>
<td>Graduation criteria.</td>
<td>Not available.</td>
</tr>
<tr>
<td>168</td>
<td>Reduction of sanctions.</td>
<td>Not available.</td>
</tr>
<tr>
<td>169</td>
<td>Interest on penalties.</td>
<td>Not available.</td>
</tr>
<tr>
<td>170</td>
<td>Materials violations.</td>
<td>Not available.</td>
</tr>
<tr>
<td>171</td>
<td>Material offenses by omission, inaccuracy, misapplication, or obtaining refunds or compensation.</td>
<td>Material violations described in Article 171 shall be punished with a monetary fine that represents a percentage of the adjusted amount (or base defined for the purpose)49.</td>
</tr>
</tbody>
</table>

---

49 Observe paragraph 2 of Article 173 of the Tax Code of CIAT. Sanctions may apply.
Formal offenses related to the obligation to issue and carry or keep receipts.

Offenses concerning formal obligation to keep books and accounting and tax records.

Formal offenses related to the obligation to declare.

Offenses concerning formal obligation to allow control.

Offenses concerning formal obligation to inform and appear.

In cases of formal violations related to compliance with information systems by subjects bound to the regime of transfer pricing and the obligation to cooperate with the control actions of the Tax Administration, it is recommended to consider monetary fines, setting a lower limit and an upper limit that allows appropriate graduation according to the severity of the behavior. Given the size of subjects that are usually required to transfer pricing (multinational companies) and the amount of their transactions regimes, the lower limit should be significant enough to encourage compliance. Clearly, the significance of the amount of the fine reflects the size of the business in each country.\(^{50}\)

Minimum conditions for achieving the optimal implementation of these elements:

- Regulatory aspects of legal status:
  - Clearly define the obligations and the taxpayers involved.
  - Defining the offenses explicitly in a legal framework. Regulatory and administrative rules whose violation will constitute an infraction.
  - Clearly define the sanctions and enforcement mechanism (e.g. procedures, graduation, etc.).
- Procedures for identifying breaches relating to the submission of information and any inconsistencies in the content.
- To have adequate computer systems that can implement the aforementioned procedures, receiving and processing of information, and identify failures in a timely manner.
- To have access to sufficient information that can corroborate that reported by the taxpayer, with the aim of identifying inconsistencies.
- To have a robust and modern sanctioning regime, that could be the base for a more burdensome special regime - if necessary- for the taxpayers subject to the transfer-pricing regime.
- To have tax procedures that permit timely and equitable application of sanctions, as well as, in the case of non-monetary sanctions, the possibility to lift sanctions upon verification of compliance by the taxpayer.
- To have a pre-defined multi-level sanctioning system, designed according to the seriousness of the facts, and which reduces arbitrary criteria or unfair decisions by officials.
- Having the possibility of reducing sanctions for compliance efforts in well-defined cases.
- To have personnel trained to implement control methods, identifying violations and sanctions.
- To use adequate control and monitoring procedures, after the application of sanctions.
- To rely on cooperative compliance initiatives, avoiding aggressive behavior by tax intermediaries/tax advisors and businesses.

\(^{50}\) Article 175 of the CIAT Model Tax Code addresses formal offenses relating to the registration process. This article was not considered, understanding that the agents operating in the area under study generally meet these obligations; this does not represent a significant risk for the purposes of transfer pricing.
Bibliographic references


▶ Compliance Management of Large Business. (2009) OECD.


▶ Corporate Loss Utilization through Aggressive Tax Planning. (2011) OECD


▶ Internal Revenue Manuals, Part 4, Chapter 69, Section 2, United States.

▶ International Tax Review. (18 December 2017) *India: How to resolve disputes in India.*


▶ Making Dispute Resolution More Effective - MAP Peer Review Report, United Kingdom (Stage 1), OECD, 2017, p. eleven.
of measures for the control of harmful transfer pricing manipulation, focused within the context of low income and developing countries


- OECD project and the G-20 on the erosion of the tax base and Benefit Transfer. Ensure that the results of transfer prices are in line with the creation of value. ACTION 8 to 10 - Final Reports 2015. OECD (2015). Paris.

- Prodecon (18 December 2017). The figure of the “complaint” or “claim”. Recovered from


- Sánchez, A. (31 de mayo de 2017) Recupera SAT 19 mil mdp vía acuerdos ,Reforma online.


- Taxation (International and Other Provisions) Act 2010, sections 124 and 125, UK.


- Working with Large Business. (2013) HM Revenue
