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Transfer Pricing Rules in the BRICS World: A Shifting Balance in Global Taxation Governance?

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Abstract

The rise of the BRICS (Brazil, Russia, India, China and South Africa) as major emerging powers has challenged existing important structures in the global economy. For this reason, there is an expectation that this restructuring may also occur in the international tax regime. In this respect, transfer pricing is one potential area for cooperation between the BRICS, which have faced challenges in applying the existing international standard – the traditional arm's length approach as established by the OECD – in practice. Therefore, this thesis investigates the differences between the transfer pricing regulations of the BRICS and those of the OECD, examining the potential for cooperation between these countries and their impact on the international tax debate. The author concludes that the substantial differences among the BRICS prevent them from developing a unified and cohesive transfer pricing policy. However, the BRICS have demonstrated an ability to individually influence the international transfer pricing regime.

Keywords

Transfer Pricing, Arm's Length Principle, BRICS, International Taxation, OECD, Cooperation, Law.

Dedication

This thesis is dedicated to my mother, Rozangela Gossler, and to my father, Vanderlei Gossler, who have supported and encouraged me all the way since the beginning of my studies. I also dedicate this thesis to my husband, Tiago Souza, for his remarkable patience and unwavering love over the course of my research.

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List of Abbreviations

ALP	Arm's Length Principle
BEPS	Base Erosion and Profit Shifting
BFRO	Brazilian Federal Revenue Office
BRIC	Brazil, Russia, India and China
BRICS	Brazil, Russia, India, China and South Africa
CUP	Comparable Uncontrolled Price
FDI	Foreign Direct Investment
FIE	Foreign-Invested Enterprise
GAAR	General Anti-Avoidance Rule
G20	Group of Twenty
GDP	Gross Domestic Product
GNP	Gross National Product
IMF	International Monetary Fund
ITD	International Tax Dialogue
LSA	Location-Specific Advantage
MNE	Multinational Enterprises
OECD	Organization for Economic Co-operation and Development
SARS	South African Revenue Service
SAT	State Administration of Taxation

TNMM	Transactional Net Margin Method
WTO	World Trade Organization
UN	United Nations

Chapter 1

1 Introduction

Globalization has given rise to a great number of multinational enterprises[1] (MNEs), which have the capacity to place their businesses and activities anywhere in the world. Through advances in technology, transportation and communications, companies operating their business abroad may choose to do so by collaborating with independent enterprises or with associated enterprises. In the first case, as the independent enterprises carry on their business in their own interests by trying to maximise profits, transaction prices are determined by market forces[2]. However, in the second circumstance, given the connections between the companies and, consequently, the absence of market forces in their relations, their intra-group transaction prices may deviate from what would have been negotiated between independent parties.

Transactions within MNEs groups currently account for a significant volume of global trade: there is evidence that more than 30 per cent of all international transactions consist of intra-group transactions[3]. This means that a growing number of the existing international transactions are no longer completely ruled by market forces, but by the interests of MNE groups. For these reasons, establishing the appropriate price – the "transfer price" – for intra-group transfers of goods, services and intangibles becomes an important global issue. In the international tax area, transfer pricing assumes particular relevance as it determines

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[1] For the purposes of this thesis, the adopted concept of multinational enterprises is the one established by Lorraine Eden, who defines MNEs as "two or more firms under common control, with a common pool of resources and common goals, where the units of enterprise are located in more than one country". Lorraine Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 2000) at 126.

[2] The Oxford Dictionary of Economics provides the following definition for market forces: "the forces of supply and demand, that determine equilibrium quantities and prices in markets. These are contrasted with the government and monetary authorities, which are able to some extent to influence market forces". John Black, Nigar Hashimzade and Gareth Myles. "market forces." In *A Dictionary of Economics*. Oxford University Press, 2012.

[3] Department of Economic & Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013) at 1 [UN Practical Manual].

the income of each entity of the MNE group, influencing the tax base of the countries where these entities are residents. This happens because, although business is increasingly global and unlimited by national borders, taxation of MNE's profits continues to be based on the domestic laws of each country[4], which use the independent enterprise approach[5]. Therefore, if the pricing of intra-firm transactions is not effectively regulated, MNE's profits can be shifted to low or no tax jurisdictions, minimizing taxes and harmfully affecting the revenues of the countries where the real economic activities occur.

The Organization for Economic Co-operation and Development (OECD)[6] has led efforts to create measures to regulate transfer pricing matters. In its Model Tax Convention on Income and on Capital[7] (the "OECD Model Treaty"), the organization establishes the Arm's Length Principle (ALP) as the international standard to determine the reasonable transfer price for international intra-group transactions. Nevertheless, Article 9 of the OECD Model Treaty does not specify the methods for determining the arm's length prices and, when necessary, reallocating profits. A detailed application of the principle is provided by the OECD Transfer Pricing Guidelines, which, although not considered a formal source of law, may have influences on customary norms and general principles of law. In this sense, the OECD defines itself as a "market leader in developing standards and guidelines in the core of International Taxation, such as the Model Tax Convention and Transfer Pricing Guidelines (…) These standards are applied on a global basis"[8].

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[4] John Henshall, *Global Transfer Pricing: Principles and Practice.* 2nd ed (Haywards Heath: Bloomsbury Professional, 2013) at 3.

[5] The independent enterprise approach recognizes the separate legal identity of corporations, even when they are owned or controlled by the same group or person. Jinyan Li, Arthur Cockfield & J. Scott Wilkie, *International Taxation in Canada,* 3rd ed (Markham: LexisNexis Canada) at 27.

[6] The OECD is an advisory organization for economic cooperation established in 1961. According to Article 5 of the organization's convention, the OECD can take decisions that are binding on all member countries, make recommendations, enter into agreements with members, non-members countries and international organizations. OECD, Convention on the Organisation for Economic Co-operation and Development (Paris: 14 December 1960).

[7] OECD, Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital (Full Version)* (2014) [OECD Model Tax Convention].

[8] OECD, Centre for Tax Policy and Administration, *Focus on Africa,* online: Centre for Tax Policy and Administration < http://www.oecd.org/ctp/40998413.pdf>.

Considering that membership to the OECD is generally limited to developed countries, it is important to investigate the role and limitations of its standards and governance methods on a worldwide scale. With regard to OECD Member States, there is a well-defined expectation of compliance with the OECD's Transfer Pricing Guidelines[9]; however, the influence and scope of this instrument in non-member countries are not so clear, notwithstanding the OECD's argument that it represents "internationally agreed principles and provides valid guidelines for the application of the arm's length principle"[10].

In this regard, the economic rise of emerging countries such as Brazil, Russia, India, China and South Africa (BRICS) – none of them members of the OECD – may represent a challenge to the narrative that international tax law, particularly as it is defined by the OECD, has reached international consensus. The economic performance and the growth of the BRICS countries in the last decade has remodeled important structures in the global economy. Thus, there is an expectation that this remodelling may also occur in the international tax regime, in which the BRICS institutionalization and closer cooperation may counterbalance the current dominant powers and contribute to redefining the existing system. The area of transfer pricing seems to be promising in this respect as the BRICS countries transfer pricing laws and practices present significant deviations from the OECD traditional approach.

Therefore, this thesis will compare the BRICS transfer pricing practices in order to identify the differences between each of them and between them and the international transfer pricing standards established by the OECD. To the extent that these differences are identified, this thesis will analyze their impact on the BRICS collective effect on the existing transfer pricing system.

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[9] In its "Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises", Amendment C (2016)79, the OECD instructs its Committee on Fiscal Affairs to monitor the implementation of the Transfer Pricing Guidelines as amended in cooperation with the authorities of Member countries. OECD, *Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises* (2016), online: OECD < http://webnet.oecd.org/oecdacts/Instruments>.

[10] OECD, Committee on Fiscal Affairs, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2014) [OECD Transfer Pricing Guidelines].

1.1 Research Objectives

This thesis has two main objectives. The first objective is to provide a comprehensive analysis of the existing international transfer pricing regime and of the BRICS countries transfer pricing laws. According to this research objective, this thesis will examine if there are differences between the transfer pricing regulations of the OECD and those of the BRICS countries and, to the extent that there are differences, this thesis will study their impacts on the international transfer pricing regime. The second objective is to analyze the potential for cooperation among the BRICS countries regarding their international transfer pricing policies.

1.2 Methodology

In developing the research, this thesis will employ a comparative methodology between the tax systems of Brazil, Russia, India, China and South Africa concerning the treatment given by these countries to transfer pricing issues as well as the convergences and divergences among each of them, and in regards to the international standards established by the OECD. According to the research objectives that guide this thesis, it will be firstly necessary to diagnose what subjects and issues will be relevant for the comparison between the legal systems.

Therefore, in order to establish the international standard on transfer pricing and how it has evolved, this thesis will analyze relevant documents produced by the OECD regarding the application of the ALP as an international principle to regulate transfer pricing. Then, the transfer pricing laws[11] and double taxation treaties currently in force in the BRICS countries will be examined, limiting the scope of this analysis to Article 9 provisions of tax treaties, which specifically deal with transfer pricing. Considering the importance of the

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[11] The study of laws integrating the legal systems of countries with such a cultural divergence, geographic distance and linguistic variation limits the access to the information of the BRICS. For these reasons, data collection for this thesis will be based on materials available on the World Wide Web through international organizations, governments and institutions websites in which translated primary legal sources are available. Additionally, this thesis will rely on secondary sources, such as government documents, books, journals and periodicals.

positions and practices of the tax authorities in transfer pricing issues, special focus will be directed to an examination of the BRICS representatives participation in international organizations and initiatives.

1.3 Organization of Thesis

Apart from this introductory chapter and from the conclusion chapter, this thesis has four main chapters. Chapter 2 will provide insight into the existing international transfer pricing regime, examining the ALP and its relevant sources, such as the OECD Transfer Pricing Guidelines. Chapter 3 will set the stage for the subsequent study of the BRICS transfer pricing rules, providing and overall analysis of these countries and explaining why they may represent challenges to the international tax regime. Chapter 4 will individually examine the transfer pricing laws of the BRICS countries. This chapter will describe important factors such as the historical development of the BRICS transfer pricing regulations, their current transfer pricing methods and their challenges and peculiarities in applying the arm's length principle. Chapter 5 will focus on the potential for cooperation between the BRICS and discuss these countries influences on the international transfer pricing regime.

Chapter 2

2 Transfer Pricing Concepts and International Standards

Transfer pricing is one of the most difficult challenges in international taxation. As governments strive to preserve their tax bases in an increasingly integrated global economy, establishing appropriate prices for related party cross-border transactions has become a complex issue for taxpayers and tax administrations. The issue of transfer pricing is relevant not only because of its complexity but also because it usually involves large sums of taxes. Transfer pricing rules were developed to address problems related to the mispricing of related party transactions. In this respect, the ALP is the international standard included in Article 9 of the OECD Model Treaty and UN Model Treaty, and applied by several domestic legislations around the world.

This chapter offers an overview of the transfer pricing issue, which involves its conceptualization, the ALP and other relevant international guidelines regulating the matter. The objective of this chapter is to establish what are the international standards regarding transfer pricing and how the standards operate in a global context. An understanding of these international transfer pricing standards is fundamental in order to compare them with and comprehend their influences on the BRICS transfer pricing practices, which will be described in Chapter 4.

2.1 Transfer Pricing

Transfer pricing is the appropriate pricing of cross-border transactions between related parties[12], i.e., the amount that is charged between associated enterprises in their transfers of goods, services or intangibles[13]. One simple way of understanding this concept and its

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[12] Eden, *supra* note 1 at 2.

[13] Providing a broader definition for transfer pricing, the International Bureau of Fiscal Documentation (IBFD) International Tax Glossary describes it as “the area of tax law and economics that is concerned with ensuring that prices charged between associated enterprises for the transfer of goods, services and intangible property accord with the arm’s length principle”. Julie Glabush, *IBFD International Tax Glossary*, 7th ed (IBFD, 2015).

implications in international tax law is to imagine the global profits of a Multinational Enterprise ("MNE") as a pie that needs to be divided, in a principled and fair manner, between the different countries involved[14]. As modern MNEs are generally structured with the parent company controlling directly or indirectly its subsidiaries, it can be extremely complex to appropriately allocate profits among members of a multinational group[15].

The main concern is that these intra-group prices may be different from the prices that would have been agreed between two unrelated parties operating at arm's length. This difference, from a fiscal perspective, affects the amount of taxable income of the associated enterprises involved in the transactions and hence the level of corporate income tax paid in each country[16]. For instance, if the parent company of an MNE is resident in a high tax jurisdiction and has a subsidiary in another country with a lower tax rate, the parent may have an incentive to be over-charged in its transactions with its subsidiary, shifting profits to a low tax jurisdiction in order to reduce the overall tax liability of the group[17]. In this case, when the parent company pays above normal market prices to its subsidiary, it may appear to be in financial difficulty; even though the MNE group as a whole is probably achieving good profit margins. After all, although MNEs usually carry on their activities through different corporations – treated by law as separate from each other and from their owners – they usually operate as a single business in economic and financial respects[18]. In the example above, the pricing manipulation is problematic to the country where the parent

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[14] Henshall, *supra* note 4 at 3.

[15] Reuven Avi-Yonah, *Advanced Introduction to International Tax Law* (Northampton: Edward Elgar Publishing, 2015) at 28 [Avi-Yonah, "Advanced Introduction to International Tax Law"].

[16] Jérôme Monsenego, *Introduction to Transfer Pricing* (The Netherlands: Kluwer Law International, 2015) at 3.

[17] The United Nations Practical Manual on Transfer Pricing provides the following example to illustrate transfer pricing issues: "A profitable computer group in Country A buys "solid state drives" from its own subsidiary in Country B. The price the parent company in Country A pays its subsidiary company in Country B (the "transfer price") will determinate how much profit the Country B unit reports and how much local tax it pays. If the parent pays the subsidiary a price that is lower than the appropriate arm's length price, the Country B unit may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed computer is sold". UN Practical Manual, *supra* note 3 at 1.

[18] Li, Cockfield & Wilkie, *supra* note 18 at 105.

company is resident, which will not have the expected profits to tax as most of the income will be allocated to the subsidiary company, resident in a country with lower taxes.

Therefore, transfer pricing assumes particular importance when the tax rates of the jurisdictions involved in intra-group transactions are different, since MNEs have a genuine interest in shifting profits through their transfer prices to low-tax countries[19]. In this respect, the manipulation of transfer prices can cause two main negative consequences. First, it may generate a harmful tax competition among countries because, as MNEs have the incentive to increase their after-tax profits by allocating their taxable income to low-tax jurisdictions, countries may progressively reduce their tax rates in order to attract MNEs, resulting in what some have called a 'race to the bottom'[20]. Second, since international transfer pricing manipulation is a strategy only available for MNEs, it also provides them a disproportionate advantage in relation to their domestic counterparts.

This manipulation of transfer prices has led governments and international organizations to create ways of controlling transfer pricing under domestic and international tax law. Since the United Kingdom implemented its first transfer pricing regulation in 1915, countries have been exploring ways in which the manipulation of transfer prices and its aforementioned consequences can be minimized[21]. The ultimate result is a broad international consensus that transfer prices have to follow the "arm's length" standard, which comprises a hypothetical analysis of how the related enterprises would have negotiated if they were independent from each other.

2.2 The Arm's Length Principle

The Arm's Length Principle ("ALP") – incorporated into the domestic law of approximately 100 countries[22] – is codified by Article 9 of the OECD Model Treaty, which

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[19] *Ibid*.
[20] Eduardo Baistrocchi, "The Transfer Pricing Problem" in Eduardo Baistrocchi and Ian Roxan, eds, Resolving Transfer Pricing Disputes (Cambridge: Cambridge University Press, 2015) 10 at 11 [Baistrocchi, "The Transfer Pricing Problem"].
[21] *Ibid*.
[22] UN Practical Manual, *supra* note 3 at 31.

is the framework for bilateral tax treaties between OECD members and many non-member governments, as follows:

> Article 9 "Associated Enterprises": 1. Where: *a)* an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or *b)* the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly[23].

According to Article 9 of the OECD Model Treaty, also incorporated in the UN Model Tax Convention, profits may be reallocated when conditions in commercial and financial transactions between related enterprises are different from those which would have been made between independent enterprises[25]. The underlying assumption is that independent parties performing a business transaction always seek to maximize their own profits and, through this negotiation process, a fair profit – proportional to the functions performed,

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[2323] OECD Model Tax Convention, *supra* note 7.

[25] Article 9 "Associated Enterprises": 1. Where: (*a*) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or (*b*) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. Department of Economic & Social Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York: United Nations, 2011) [UN Model Convention].

assets employed and risks assumed – is achieved by each enterprise[26]. Therefore, the ALP establishes that "the division of income among companies within a commonly controlled group should be based on estimates of how the income would be divided if the commonly controlled companies were instead unrelated companies, acting with respect to one another at arm's length"[27]. Consequently, in order to determine the reasonable transfer price, it is necessary to compare intra-group transactions to transactions between unrelated entities[28].

The OECD argues that the ALP is the preferred basis for pricing related-party transactions because it provides a more equal treatment for tax purposes between associated and independent enterprises; avoiding the creation of tax advantages or disadvantages that would otherwise distort the competitive positions of each type of entity[29]. The OECD, nonetheless, recognizes some problems in the application of the ALP, particularly when there are no readily available comparable transactions, when relevant comparable data is difficult to find or when the MNE's transaction would not be entered into by independent enterprises[30]. In this respect, Jeffrey Owens, a former official of the OECD, also recognizes a number of problems in applying the ALP, especially because of the absence of comparable transactions and because of the burden it creates for taxpayers and tax administrations[31].

These difficulties arise mainly because MNEs perform their businesses in a different way from independent enterprises in terms of the allocation of risks and structure of

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[26] Henshall, *supra* note 4 at 5.
[27] Avi-Yonah, "Advanced Introduction to International Tax Law" *supra* note 15 at 28.
[28] "The role of the ALP is to compare an intra-firm transaction with a crucial element, a comparable from the open market. The ALP assumes that there will always be an available comparable. Thus, if a given intra-firm transaction is inconsistent with the comparable, tax authorities are generally empowered to adjust the relevant transfer price in order to achieve consistency with that comparable". Baistrocchi, "The Transfer Pricing Problem" *supra* note 20 at 12.
[29] OECD Transfer Pricing Guidelines *supra* note 8.
[30] *Ibid*.
[31] Despite of the difficulties in its application, the author believes that the arm's length principle "will survive as the principle on which the necessary international consensus is based". Jeffrey Owens, "Should the arm's Length Principle Retire?" (2005) 12 *International Transfer Pricing Journal* 99.

transactions[32]. Indeed, in multinational transactions, "parties are not 'independent' economic actors even though they have separate legal existences, and do not really bargain with each other in the sense typical for parties that have genuinely independent, and accordingly adverse or competitive interests"[33]. This makes the assumption of establishing an objective price by comparing MNEs with independent enterprises somewhat artificial[34]. However, despite these problems, the OECD concludes that the ALP is still better than any other approach[35] so far presented[36].

The theory underlying the ALP is based on market forces: according to the supply and demand of a certain good or service, the market forces will usually result in a price that is acceptable to both parties at a given point in time[37]. Following this theory, when the prices paid for international transactions between independent parties are acceptable to both parties, there is an assumption that their income, as well as their resulting income taxes, will also be acceptable to the tax administrations of the countries where their business activities are located[38]. From a theoretical perspective, the ALP is an essentially neutral standard, as it is applied in transactions between associated enterprises regardless of their country of residence. There are, nevertheless, arguments against the applicability of the ALP in developing and emerging countries, especially with respect to the absence of comparable transactions, which will be further explored in the following chapters.

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[32] John Neighbour and Jeffrey Owens, "Transfer Pricing in the New Millennium: Will the Arm's Length Principle Survive?" (2002) 10:4 *George Mason Law Review* 951 at 954.
[33] Li, Cockfield & Wilkie, *supra* note 5 at 110.
[34] *Ibid*.
[35] The ALP is usually contrasted with *unitary* or *formulary apportionment* methods, under which a formula – e.g., based on each party's assets, payroll or sales – is used to allocate the entire profit of a MNE among its constituent entities. The main distinction between the ALP and formulary apportionment is that, while the latter starts with treating the entire affiliated group as one unitary enterprise, the ALP treat each entity in the group as a separate taxpayer, who hypothetically deals with each of the other MNE's entities at arm's length. Reuven Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" (1995) 15:1 *Virginia Tax Review* 89 at 92.
[36] OECD Transfer Pricing Guidelines, *supra* note 10.
[37] Monsenego, *supra* note 16 at 16.
[38] "Most countries consider that the arm's length price, determined by the market forces, is the fairest way to set prices between associated enterprises and ultimately divide the tax base of multinational enterprises". *Ibid* at 17.

2.2.1 The OECD Transfer Pricing Guidelines

Although the ALP concept provided in Article 9 is straightforward, its application in practice is much more complex. First, it is necessary to ascertain whether or not prices and, consequently, taxable profits have been influenced by the connection between the parties and, second, if so, how these profits should be recalculated to achieve the appropriate transfer price[39]. In this context, the OECD has been active[40] in recommending how to correctly assess arm's length pricing by producing its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[41], referred in this thesis as the "OECD Transfer Pricing Guidelines". The OECD Transfer Pricing Guidelines are the "most comprehensive model of legal regulation of transfer pricing to date since the inception of corporate income tax systems at the beginning of the twentieth century"[42].

Since neither Article 9 of the OECD Model Treaty nor Article 9 of the UN Model Treaty provide specific procedures for determining arm's length prices or allocating profits, the OECD Transfer Pricing Guidelines provide guidance to MNEs and tax administrations in the application of the ALP. The guidelines represent a revision and compilation of previous transfer pricing reports published by the OECD Committee on Fiscal Affairs and focus on helping "tax administrations (of both OECD member countries and non-member countries) and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimizing conflict among tax administrations and between tax administrations and MNEs"[43].

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[39] Henshall, *supra* note 4 at 11.
[40] According to Allison Christians, "rich countries have long sought to overcome tax jurisdiction gaps and overlaps by engaging in consensus building over nonbinding soft law norms via the Organization for Economic Co-operation and Development (OECD)". Allison Christians, "BEPS and the New International Tax Order" (2016) 6 *Brigham Young University Law Review* 1603.
[41] OECD Transfer Pricing Guidelines, *supra* note 10.
[42] Baistrocchi, "The Transfer Pricing Problem" *supra* note 20 at 17.
[43] OECD Transfer Pricing Guidelines, *supra* note 10 at para 15.

2.2.1.1 Transfer Pricing Methods

The OECD Transfer Pricing Guidelines stipulate five methods for assessing the appropriate transfer price in transactions between associated enterprises. The *traditional transactional pricing methods* are: a) the comparable uncontrolled price (CUP) method; b) the resale price method; and c) the cost plus method. The *transactional profit methods* are: a) the profit split method; and b) the transactional net margin method[44].

Under the CUP method, there is a comparison between the price charged for property or services in a controlled transaction and the price charged for property or services in a comparable uncontrolled transaction in comparable circumstances[45]. If this assessment demonstrates a difference between the two prices, there may be an indication that the intra-group transaction price is not at arm's length[46]. The application of this method is indicated for cases in which the associated enterprise buys or sells a product or service and there are comparable non-arm's length transactions in similar quantities and similar terms[47].

The resale price methodology involves the subtraction of a gross profit margin from the price that would have been sold to an independent enterprise. The OECD Transfer Pricing Guidelines describe the application of this method as follows:

> The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (resale price) is then reduced by an appropriate gross margin on this price ("resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other

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[44] *Ibid.*
[45] *Ibid* at 63.
[46] *Ibid.*
[47] Li, Cockfield & Wilkie, *supra* note 18 at 122.

> costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises[48].

The cost-plus method begins with the costs incurred by the supplier of property or services in a controlled transaction with a related purchaser. Then, an appropriate mark-up – calculated based on similar and comparable transactions – is added to remunerate the supplier for its functions, assets used and risks assumed[49].

Under the transactional profit split method, the total taxable income between the related enterprises is allocated to each party in accordance with its contribution to the profit[50]. This methodology is suitable to situations where the roles of the associated enterprises in an international transaction are so interconnected that it becomes very difficult to evaluate them in a separate fashion[51]. The transactional net margin method has a similar application to the profit split method: the difference is that, while the latter is applied to all participants in the intra-group transaction, the former is applied to one participant, by comparing the "net profit margins derived from a transaction involving related parties with net profit margins realized by unrelated parties from similar transactions[52]".

2.2.1.2 Legal Status of the OECD Transfer Pricing Guidelines

The OECD Transfer Pricing Guidelines are the international standard adopted by member and some non-members countries of the OECD in their domestic legislation and double tax conventions[53]. In this context, some scholars argue that the OECD Guidelines are the main legal source of an *international transfer pricing regime*, which is one of the

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48 OECD Transfer Pricing Guidelines, *supra* note 10 at 65.
49 Henshall, *supra* note 4 at 28.
50 Li, Cockfield & Wilkie, *supra* note 18 at 125.
51 Henshall, *supra* note 4 at 29.
52 Li, Cockfield & Wilkie, *supra* note 5 at 127.
53 Calderón, "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law?" (2007) 35:1 *Intertax* 4.

fundamental structures of an *international tax regime*[54]. According to this conception, there is an international understanding that these guidelines are the agreed interpretation of the ALP established in Article 9 in regards to the application of tax treaties that follow the OECD Model Treaty[55].

The application of the ALP and the OECD Transfer Pricing Guidelines has also expanded into the legal systems of countries that are not members of the OECD. There is a trend towards the reshaping of domestic transfer pricing rules in order to align them with the standards established in the OECD Transfer Pricing Guidelines. This process is significantly influenced by the negotiation of a great number of treaties according to Article 9 of the OECD Model Treaty[56]. In other words, an effective application of Article 9 may demand a coordinated interpretation in line with the OECD Guidelines, as explained by José Calderón:

> The Transfer Pricing Guidelines have been used to uniform, harmonize or to even "standardize" the configuration, interpretation and application of the arm's length principle and all the legislation on transfer pricing at an international level. The OECD soon noticed that the only way to eliminate the serious conflicts that can arise from an asymmetrical interpretation or application of this principle by the different states was through the articulation of guidelines that would shape the arm's length principle in a uniformed and internationally agreed form. That is to say, through an instrument of *soft law*, flexible and dynamic as the Guidelines are[58].

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[54] Scholars like Avi-Yonah argue that an international tax regime (ITR) exists, which is embodied in both the tax treaty network and domestic law, and that it forms a significant part of customary international law. The same position is adopted by Richard Vann, who observes an international consensus in the structure and content of tax treaties in a way that no country, except possibly the United States, can depart substantially from the ITR and its tax norms. See Avi-Yonah, "Advanced Introduction to International Tax Law", *supra* note 15 and Richard Vann, "International Aspects of Income Tax" in Victor Thuronyi, ed, Tax Law Design and Drafting (International Monetary Fund, 1998).

[55] Calderón, supra note 53 at 10.

[56] *Ibid*.

[58] *Ibid* at 14.

In this context, a *soft law*[59] approach to the OECD Transfer Pricing Guidelines seems to offer a third way between describing these rules as "law" – which would mean that states are legally bound by it – and describing them as "not law at all" – which would overlook the evidence that countries do comply with the rules, frequently against their self-interest[60]. After all, the mere fact that recommendations from international organizations are not legally binding does not mean that they have no effect because a legal obligation is just one of the reasons for complying with a rule, particularly in international law, where sanctions are often illusory[61]. Indeed, Hugh Ault, examining the role of OECD's commentaries in the interpretation of tax treaties, affirms that, although treaty parties are free to deviate from the guidance suggested by the organization, the presumption is that their interpretation represents the intention of the parties[62].

It is important to emphasize, nonetheless, that although the OECD Transfer Pricing Guidelines are broadly relied on, there are still different interpretations regarding transfer pricing issues from MNEs and countries' tax administrations. Despite intending to represent internationally agreed principles, the OECD Transfer Pricing Guidelines are not fully accepted by all countries, particularly by those developing and emerging countries that are not members of the organization, as evidenced by the following comment of China in the UN Practical Manual:

> The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Transfer Pricing Guidelines) have been the

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[59] "Soft law is most commonly defined to include hortatory, rather than legally binding, obligations. The focus of this definition is usually on whether or not something that looks like a legal obligation in some ways (e.g., it is a written exchange of promises between states) nevertheless falls short of what is required to formally bind states". Andrew Guzman & Timothy Meyer, "International Soft Law" (2010) 2:1 *Journal of Legal Analysis* 171 at 172.
[60] Allison Christians, "Hard Law, Soft Law, and International Taxation" (2007) 25:2 *Wisconsin International Law Journal* 325.
[61] Frank Engelen, "Some Observations on the Legal Statues of the Commentaries on the OECD Model" (2006) 60:3 *Bulletin for International Taxations* 105.
[62] The author used the framework of the Vienna Convention on the Law of Treaties, especially in its Articles 31 and 32, to suggest that the Commentaries represent a default setting for the treaties based on the OECD Model. Hugh Ault, "The role of the OECD commentaries in the interpretation of tax treaties" in Herbert Albert and Kees van Raad, eds, Essays on International Taxation (Devender: Kluwer Law and Taxation Publishers, 1993) 61.

> "gold standard" for tax administrations and taxpayers to apply the "arm's length principle" for the valuation, for tax purposes, of cross-border transactions between related parties for much of the period since the original version of the guidelines was first issued in 1995. As the world economy becomes increasingly globalized, transfer pricing is an issue faced not only by developed countries, but is increasingly a critical matter for developing countries. Such nations face a set of unique issues that have not been addressed, or at least not sufficiently or practically addressed by the OECD Guidelines. Therefore, while much of the OECD guidelines may still be applicable to developing countries, the UN Practical Manual should put a special focus on offering practical solutions to issues faced by developing countries[63].

In order to create a more balanced relationship between developed and developing countries in terms of transfer pricing regulations and interpretations, the UN Committee of Experts on International Cooperation in Tax Matters has published a manual specifically for developing countries, further analyzed in the next section.

2.2.2 The UN Practical Manual

The United Nations Practical Manual on Transfer Pricing for Developing Countries (the "UN Practical Manual") – whose first version was approved by the UN Tax Committee on October 2012 and launched publicly in the Economic and Social Council Chamber of the United Nations on May 2013 – is intended to be a "living document", to be modified and updated, based on the OECD's Guidelines and on the ALP[64]. The UN Practical Manual, thus, was drafted "as a response to the need, often expressed by developing countries, for clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises (MNEs)"[66].

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[63] UN Practical Manual *supra* note 3 at 374-375.
[64] David Spencer, "BRICS, BEPS and the U.N. Transfer Pricing Manual (Part 1)" (2013) 24:5 *Journal of International Taxation* 28 at 37 [Spencer, "BRICS, BEPS and the UN Manual Part 1"].
[66] UN Practical Manual *supra* note 3 at VI.

On April 2017, the United Nations Committee of Experts in International Cooperation in Tax Matters released a revised UN Practical Manual. The revised Manual was drafted alongside the OECD/Group of Twenty (G20) Action Plan on Base Erosion and Profit Shifting (BEPS) to reflect the developments in the area of transfer pricing analysis and administration since the Manual's first edition, especially regarding developments in developing countries[67].

Having representatives of Brazil, India, China and South Africa – four of the five BRICS[68] – participating in the development of the document, the UN Practical Manual evidences the growing importance of the BRICS in the area of international taxation. In Parts A through C, the Manual often follows the OECD Transfer Pricing Guidelines, reflecting the operation of Article 9 of the UN Model Treaty and the ALP embodied in it[69]. The significant difference of the Manual is in Part D, where Brazil, China, India, Mexico and South Africa individually described their viewpoints and experiences in dealing with transfer pricing. These country practices, nonetheless, do not necessarily reflect the UN Subcommittee's views on transfer pricing as it was stated in the forewords to both the 2013 and 2017 UN Practical Manual editions:

> While consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not be reached, and it follows that specific views expressed in this Manual should not be ascribed to any particular persons involved in its drafting. [Part D] is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was

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[67] *Ibid*.
[68] Russia does not have a representative member in the U.N. Committee of Experts on International Cooperation in Tax Matters and, for this reason, the views of the country are not highlighted in Chapter 10 of the Transfer Pricing Manual.
[69] The UN Manual is divided in four parts. Part A refers to transfer pricing in a global environment; Part B explores the arm's length principle, providing guidance on principle and policy aspects; Part C relates to the practical implementation of a transfer pricing system in developing countries; and Part D contains country's transfer pricing practices. UN Practical Manual *supra* note 3 at VI-V.

> not considered feasible or appropriate to seek a consensus on how such country practices were described. [Part D] should be read with that difference in mind[70].

Although not reflecting an official position from the United Nations, the countries' practices exposed in Part D of the UN Practical Manual demonstrate some common challenges and themes in the area of transfer pricing between the BRICS countries. China, India and South Africa, for instance, used the document to emphasize the importance of considering location-specific advantages ("LSAs") in the determination of the arm's length prices of the companies resident in its territories. The UN Practical Manual also reveals some unique approaches, such as the Brazilian transfer pricing system, which does not rely on comparable transactions but rather on predetermined margins to achieve the adequate transfer price[71].

2.3 The Base Erosion and Profit Shifting (BEPS) Action Plan

Following the financial crisis of 2008 – when many countries faced high levels of public debt and pressure to generate more tax revenue – governments across the world became much more vocal about their concerns regarding international tax avoidance schemes, acknowledging how traditional tax policies and principles have not kept pace with the advances in cross-border trade generated by the rise of information and communication technology[72]. Since 2008, media reports and the empirical literature[73] have also highlighted how highly profitable MNEs appeared to pay comparatively little income taxes in the countries where their income was effectively earned. In this respect, although some authors

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[70] *Ibid* at V.
[71] Spencer, "BRICS, BEPS and the UN Manual Part 1", *supra* note 65 at 37.
[72] Joy Hail, "An overview of the OECD Action Plan on BEPS" (2016) 94:2 *Taxes: The tax Magazine* 47.
[73] Dhammika Dharmapala, "What do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature" (2014) 35:4 *Fiscal Studies* 421.

argue that the impact of BEPS on tax revenues is only modest in magnitude[74], there is significant evidence that MNEs arrange their affairs in a tax-sensitive manner and usually report higher profit rates in low-tax jurisdictions than in high-tax jurisdictions, from which it is possible to infer that BEPS is a relevant problem[75].

Therefore, in 2013, following the political G20 mandate[76], the OECD published the Base Erosion and Profit Shifting ("BEPS") Report[77] and its Action Plan[78]. According to the OECD, BEPS refers to tax avoidance schemes that manipulate gaps and differences in tax regulations to artificially shift profits to low or no-tax jurisdictions[79]. In this respect, considering the common awareness that governments are losing substantial corporate tax revenue because of MNE's strategies aimed at shifting profits to countries where they are subject to more favourable tax treatments[80], the BEPS Report recognizes and openly

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[74] James Hines Jr. argues that "it appears that even a complete solution to the problem of BEPS, were one available and implementable, would have little direct impact on government finances" and that "the level of concern expressed about the problem of BEPS is inconsistent with the implications of the available statistical evidence". James Hines Jr, "Policy Forum: How Serious Is the Problem of Base Erosion and Profit Shifting?" (2014) 62:2 *Canadian Tax Journal* 443 at 444.
[75] *Ibid* at 443-444.
[76] The "need to prevent base erosion and profit shifting" was explicitly referred in the G20 meeting in Mexico in 2012 in the meeting's final declaration. G20 Information Centre, "G20 Leaders Declaration, Los Cabos, Mexico, June 19, 2012" (2012) *University of Toronto*, online: < http://www.g20.utoronto.ca/2012/2012-0619-loscabos.html>. In the 2013 G20 meeting in Russia, the G20 Leaders endorsed the BEPS project, declaring that "in a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes more than ever a priority. Tax avoidance, harmful practices and aggressive tax planning have to be tackled. (…) We fully endorse the ambitious and comprehensive Action Plan – originated in the OECD – aimed at addressing base erosion and profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created". G20 Information Centre, "G20 Leaders Declaration, St. Petersburg, Russia, September 6, 2013" (2013) *University of Toronto*, online: < http://www.g20.utoronto.ca/2013/2013-0906-declaration.html>.
[77] Organization for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013) [OECD, "Addressing BEPS"].
[78] *Ibid*.
[79] Organization for Economic Co-operation and Development, "Base Erosion and Profit Shifting", online: <http://www.oecd.org/tax/beps/>.
[80] According to David Spencer, "this increased attention and the inherent challenge of dealing comprehensively with such a complex subject has encouraged a perception that the domestic and international rules on the taxation of cross-border profits are now broken and taxes are only paid

discusses the weaknesses in the international tax architecture designed by the OECD and by its member-countries[81].

The BEPS Action Plan calls for essential changes in the existent tax system mechanisms as well as the adoption of new 'consensus-based' approaches designed to prevent base erosion and profit shifting[82]. Thus, the Action Plan establishes the following fifteen actions that, when implemented internationally and domestically, will have an impact on current tax avoidance issues.

1. Address the tax challenges arising from the digital economy.
2. Neutralize the effect of hybrid mismatch arrangements.
3. Strengthen CFC rules.
4. Limit base erosion through interest deductions and other financial payments such as insurance arrangements and derivatives.
5. Improve transparency and ensure transactions have substance.
6. Prevent tax treaty abuse.
7. Prevent artificial avoidance through permanent establishments.
8. Prevent BEPS created by moving intangible assets among group members.
9. Prevent BEPS created by allocating risk or excessive capital to group members.
10. Prevent BEPS created through high-risk transactions that would not occur between unrelated parties.
11. Establish methodologies to collect and analyze data on BEPS.

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by the naive. Multinational enterprises (MNEs) are being accused of do dodging taxes worldwide, and in particular in developing countries, where tax revenue is critical to foster long term development". David Spencer, "OECD BEPS Project: Transfer Pricing" (2013) 24:11 *Journal of International Taxation* 23.

[81] *Ibid*.

[82] Organization for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013) at 13 [OECD, "Action Plan on BEPS"].

12. Require taxpayers to disclose aggressive tax planning arrangements.
13. Re-examine documentation requirements.
14. Make dispute resolution through the mutual agreement procedure more effective.
15. Develop a multilateral instrument under tax and public international law to enable jurisdictions to implement measures to combat BEPS[83].

After two years of work within the OECD and after public consultation, the BEPS final reports on the actions were published in October 2015[84]. In February 2016, during the G20 meeting in China, the group leaders endorsed the BEPS final reports, supporting a consistent implementation of the BEPS package[85].

One of the typical profit shifting opportunities generated by the interaction of international and domestic taxation rules is in the area of transfer pricing. One fundamental assumption of the arm's length standard is that the more extensive are the functions, assets and risks of one party in a transaction, the greater this party is expected to be remunerated and *vice versa*[86]. According to this logic, MNEs have the incentive to shift their functions, assets and risks to jurisdictions where they will receive a more favourable tax treatment. Although central functions may be difficult to be shifted, the risks and the ownership of intangible assets may be more easily contractually allocated to low-tax jurisdictions[87]. This shifting of income through such transfer pricing arrangements – particularly those related to risks – was not effectively regulated in the OECD Transfer Pricing Guidelines, which "are perceived by some as putting too much emphasis on legal structures (as reflected, for

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[83] *Ibid*.
[84] Organization for Economic Co-operation and Development, "BEPS Final Reports" online: < http://www.oecd.org/ctp/beps-2015-final-reports.htm>.
[85] G20 Information Centre, "Communiqué, G20 Finance Ministers and Central Bank Governors Meeting, Shangai, February 27, 2016" (2016) *University of Toronto*, online: < http://www.g20.utoronto.ca/2016/160227-finance-en.html >.
[86] OECD, "Addressing BEPS" *supra* note 77 at 42.
[87] *Ibid*.

example, in contractual risk allocations) rather than on the underlying reality of the economically integrated group”[88], contributing to BEPS.

In this sense, the BEPS Action Plan demands improvements in the current transfer pricing rules[89] in order to “put more emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits”. The OECD's principal recommendations regarding transfer pricing are for countries to: a) revise allocation rules to attribute risks to related parties according to their control and financial capacity; b) revise allocation rules to avoid that the legal ownership of intangibles represents the only determinant of the source of their income; c) revise allocation rules to attribute value to associate enterprises performing important functions and; d) limit non-controlling companies to risk-free return on financial transactions[90]. Overall, it is possible to observe that transfer pricing and the ALP constitute the basis of a number of actions developed by the OECD under the BEPS project, being one fundamental aspect in avoiding base erosion and profit shifting.

2.4 Conclusion

Transfer pricing, which refers to the appropriate allocation of global profits between group members of MNEs, is an extremely complex issue, affecting governments and taxpayers from across the world. In order to address this issue, the ALP attempts to ensure that an appropriate price is charged between related parties in their cross-border transactions. However, notwithstanding the widespread adoption of this principle, its application remains challenging when there are no comparable transactions available, especially in the

[88] *Ibid* at 43.
[89] “In many instances, the existing transfer pricing rules, based on the arm’s length principle, effectively and efficiently allocate the income of multinationals among taxing jurisdictions. In other instances, however, multinationals have been able to use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it into low-tax environments. This most often results from transfers of intangibles and other mobile assets for less than full value, the over-capitalization of lowly taxed group companies and from contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties”. OECD, “Action Plan on BEPS” *supra* note 77 at 19-20.
[90] Christians, *supra* note 37.

cases of developing and emerging countries. There are two important legal sources in the international transfer pricing area that provide recommendations on the application of the ALP: the OECD Transfer Pricing Guidelines and the UN Practical Manual. The first, although recognized by some scholars and countries as a representation of internationally agreed principles, is increasingly questioned by developing and emerging countries. The latter, on the other hand, attempts to provide specific guidance for developing countries in dealing with transfer pricing. None of these two seem to effectively and globally addressed the issue of transfer pricing, which, among other factors, motivated the creation of the OECD/G20 BEPS initiative in 2013.

This new international tax and transfer pricing stage started with the BEPS initiative marks the beginning of the participation of more countries in creating international transfer pricing standards. Among these countries, one influential group is formed by the BRICS (Brazil, Russia, India, China and South Africa), which is examined in the following chapter.

Chapter 3

3 The BRICS Countries

The acronym BRICs was formulated by Jim O'Neill, former chief economist of Goldman Sachs, in a paper written in 2001 where the author proposed that, considering their economic performance in the 1990s, Brazil, Russia, India and China could be the drivers of the world economic growth in the next decade[91]. O'Neill's reason for grouping together these countries was that they were all experiencing fast economic growth and becoming important emerging economic powers[92].

Following the global economic crisis of 2007-2008, while the world suffered a severe slow-down in its economy, the BRICs countries engaged in a rapid recovery[93]. According to Goldman Sachs, the consequences of the 2008 crisis essentially enhanced the relevance of the rise of the BRICs countries[94]. Indeed, the growth in the domestic demand among the BRICs had a significant role in achieving global economic recovery, especially considering the need of developed countries for new export markets in face of the decreased demand in their domestic economies[95].

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[91] Jim O'Neill, "Building Better Global Economic BRICs" (2001) Paper no. 66 *Goldman Sachs Global Economics.*

[92] The BRICS are considered to be emerging economies, a term used to describe economies that "first […] are regional economic powerhouses with large populations, large resource bases and large markets. Their economic success will spur development in the countries around them; but if they experience an economic crisis, they can bring their neighbors down with them. Second, they are transitional societies that are undertaking domestic economic and political reforms. They adopt open-door policies to replace their traditional state interventionist policies that failed to produce sustainable economic growth. Third, they are the world's fastest growing economies, contributing to a great deal of the world's explosive growth of trade". Chuan Li, "What are Emerging Markets?" *The University of Iowa Center for International Finance and Development,* online: <http://www.mrshultz.com/webpages/emergingmarkets.shtml>.

[93] However, Goldman Sachs reports caution that, although the BRICs have emerged as major players in the international economic order, "living standards in the BRICs continue to lag far behind the developed world", particularly considering that none of the BRICs "have yet to break into even the top 50 richest economies in terms of PPP-based GDP per capita". Dominic Wilson, Constantin Burgi and Stacy Carlson, "BRICs Monthly" (2011) 11:6 *Goldman Sachs Global Economics, Commodities and Strategy Research* 1 at 3.

[94] *Ibid* at 2.

[95] *Ibid*.

More than a decade after the formulation of the acronym BRICs, the discussion over the real possibility of a change of roles in the global economy, as predicted by O'Neill, gains new chapters every day. The BRICs – now BRICS with the inclusion of South Africa membership in 2011[96] – continue to promote the rapprochement between its members. Also, in recent years, there has been a dramatic growth in the importance of emerging countries in the global economic development and, consequently, the BRICS countries may affect the current international taxation scenario.

This chapter discusses how and why the BRICS may be viewed as a globally influential group in the international tax area. The objective is to provide an overall perspective of the BRICS as individual countries – analyzing their main differences and similarities – and as an institution, establishing a framework for understanding the way in which they present challenges for the international transfer pricing regime.

3.1 Globalization and the BRICS

The BRICs countries (Brazil, Russia, India and China) were not grouped together because of natural, historical, cultural, political or linguistic reasons. It is an economic concept that connect these countries as "the choice of Brazil, Russia, India and China is nothing but a focus on the four emerging markets with the largest GDP (at purchasing power parity) and on their four big populations becoming more productive"[97]. The grouping of these countries represents a transformation in the international order, in which "the world's economic center of gravity has moved towards the east and south, from OECD members to emerging economies […] This realignment of the world economy […] represents a structural change of historical significance"[98].

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[96] In December 2010, based on mutual consent, South Africa received an official invitation from the BRICs members to become a member of the group. South Africa Ministry of International Relations and Cooperation, "About BRICS", BRICS, online: <http://www.brics5.co.za/about-brics/>.
[97] Francesca Beausang, *Globalization and the BRICs: Why the BRICs Will Not Rule the World for Long* (New York: Palgrave Macmillan, 2012) 2.
[98] Organization for Economic Co-operation and Development, *Perspectives on Global Development 2010: Shifting Wealth* (Paris: OECD Development Centre, 2010) at 15.

One important similarity among the BRICS economic development is the fact that, over the last three decades, these countries adopted decisive policies towards opening up their economies to the international market. Brazil, following a long period of military dictatorship, has, since the beginning of the 1990s, extended the opening of its internal market to imports, stabilized its economy and experienced significant improvements in its trade balance. Concurrently, Russia, after the end of the communist system – which had been in place since 1917 – began to substitute its economic model focused on domestic production for a system with greater international trade openness[99]. India, in response to the country's low rates of development as well as inflation problems since the 1960s, also started its commercial opening in the early 1990s. Some scholars argue that this change was fundamental for India to reach the levels of growth the country has been experiencing since the first decade of this century[100]. China, having restructured and expanded private participation in national economic activity since 1978, experienced an unprecedented rural exodus in the 1990s, resulting in millions of people moving to cities in search for jobs in the large private enterprises established in Shanghai and Beijing[101]. At this point, the Chinese government promoted the gradual opening of its market to foreign companies and investors, also seeking better access to western markets. South Africa, after its democratic reform in 1994, moved away from international isolation towards greater integration with the world economy, beginning to attract capital inflows and to reduce its restrictions on capital outflows[102].

The 1990s was a decade when all BRICs economies were restructured according to a new world reality, which was being opened to new players through what was then called globalization. Unsurprisingly, the opening up of these countries' economies to

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[99] Anatoly Zhuplev, "Economic Internationalization of Russia: Roots, Trends, and Scenarios" (2008) 29:1 *International Political Science Review / Revue internationale de science politique*.
[100] Chanchal Sharma, "A Discursive Dominance Theory of Economic Reforms Sustainability: The Case of India" (2011) 10:2 *India Review.*
[101] Sun Sheng Han and Clifton Pannell, "The Geography of Privatization in China, 1978-1996" (1999) 75:3 *Economic Geography* 272 at 279.
[102] Yashvir Algu and Kenneth Creamer, "Evaluating South Africa's Open Economy" (2017) 85:2 *South African Journal of Economics* 196.

international trade forced their enterprises, governments and institutions to adapt themselves in order to improve their insertion to the global market. This is a fundamental aspect in understanding why the BRICS, in that period, took the initiative to develop or update, among other things, domestic transfer pricing provisions.

The accelerated pace of globalization is also leading to a “rebalancing of economic influence, with political power shifting from the West to the East”[103]. In this context, the BRICS, where new consumer markets are opening up and where a middle class is emerging, also arise as significant sources of foreign direct investment, especially into developing countries[104].

3.2 Overall Perspective

The BRICS countries account for about one fourth of the world’s Gross National Product (GNP), their population corresponds to 40% of the world’s total and, together, they occupy more than 25% of the world’s land area[105]. The economies of these countries vary considerably[106]: China is a strong manufacturer and service provider, being the most populous country in the world, the second largest economy (after the United States of America) in terms of Gross Domestic Product (GDP) and occupying the second largest land area (after Russia); India is a leading country in the service supply category, being the 10th largest economy in the world; Russia and Brazil are relevant raw material suppliers,

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103 This rebalancing is supported by significant changes in GDP rankings: “China […] has overtaken Brazil, Japan and the United Kingdom”, for example. However, it is not realistic to foresee that, in the near future, China will outpace the United States in terms of political, military or economic power. Jeffrey Owens, “The BRICS: An Overall Perspective” in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 353 at 355 [Owens, “The BRICS: An Overall Perspective”].

104 *Ibid* at 356.

105 Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 5.

106 According to Jeffrey Owens, GDP, GDP per capita and GDP growth rates of the BRICS countries demonstrate how these countries diverge in the size of their economies. According to the author, due to these differences, although the BRICS seek a greater influence in the global debate, it has been difficult for them to coordinate positions in the tax area. See Owens, “The BRICS: An Overall Perspective” *supra* note 103 at 353.

although Brazil is also a provider of manufactured goods and services and; South Africa – the most recent BRICS member – has a smaller economy[107], serving as a strategic African partner in the group[108].

Essentially, the main political and economic common characteristic between the BRICS is that they are all rapidly emerging economies, most of them having had direct experiences as colonies under European imperialism[109]. On the other hand, one of the main dissimilarities among these countries is the division existent between the democratic members of the group (Brazil, India and South Africa) and Russia and China[110]. The inclusion of South Africa in the BRICS, some authors argue, has also created more difficulties in developing a collective BRICS identity, since the African country is a democracy with close relations to Western economies and it is supposed to represent all 54 diverse nations of Africa[111], having less common causes with Brazil, Russia, India and China.

Regardless of the differences between their tax systems and international tax policies, the BRICS countries share common aspects that are important for the contemporary international tax policy debate. First, all of them see themselves as emerging and developing powers, as explained by Niall Duggan:

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[107] South Africa is the largest economy in Africa and its economy holds the 33rd place in the world GDP ranking. In terms of population, it is the 25th largest country in the world. However, compared to the other BRICS, South Africa has a much smaller economy: Its GDP is only a third of Brazil's and Russia's GDP and a tiny portion of China's and India's GDP. Niall Duggan, "BRICS and the Evolution of a New Agenda Within Global Governance" in Marek Rewizorski, ed, *The European Union and the BRICS* (Switzerland: Springer, 2015) 11 at 16.
[108] According to Niall Duggan, "South Africa's claims for membership were driven and justified by political rather than economic factors. South Africa, as Africa's only member of the G20, is an important political actor among developing nations. South Africa itself was attempting to gain greater influence in global affairs. Increased influence in global governance is one of the most important aspects of BRICS membership. As Africa is the continent with the largest number of developing states, its largest economy, South Africa, was seen by the BRIC states as a representative of the entire continent". *Ibid*.
[109] John Kirton, "Explaining the BRICS Summit Solid, Strengthening Success" (2015) 10:2 *International Organizations Research Journal* 1 at 9.
[110] *Ibid*.
[111] Duggan, *supra* note 102 at 16-17.

> The BRICS have developed a large network of interactions and have institutionalised areas of cooperation. The basis for the development of these interactions has been a common self-identity as an emerging and developing power. Within this self-identity is a commonly held perception that the current system of global governance does not represent the interests of emerging powers and that without reform or the development of an alternative system, emerging powers would fail to develop fully[112].

Besides that, all the BRICS countries have been capital importers – and consequently source-based countries – that are progressively becoming capital exporters and assuming residence country roles[113]. This duality is revealed by the BRICS countries tax treaty history, which reflects a path of increasing economic power and decreasing dependence on attracting foreign investments[114]. According to Diane Ring, "this duality is important in shaping their influence on the OECD, their ability to act as a unified group and their likelihood of representing the interests of developing groups outside the BRICS group"[115].

The necessity of the BRICS countries in improving their domestic tax laws and tax treaty networks – essentially because of their unique position as emerging economies – is also one commonality between them. This mutual necessity reflects in the interest these countries have in cooperating with each other:

> There are significant differences in [the BRICS] economic position, as reflected in their tax treaty policy. There are, however, also commonalities, such as rapidly growing economies which require major public investments in education and infrastructure to continue realizing the planned growth for the benefit of more groups among their large – and often, still very poor –

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[112] *Ibid* at 22.
[113] Diane Ring explains that the BRICS countries connect two economic realities: one where outside investment is still the most defining economic feature, and another ne where tax policy decisions are also base on the ability to invest abroad. Diane Ring, "Institutional Aspects" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 469.
[114] *Ibid* at 475.
[115] *Ibid* at 471.

> populations. Thus, there is a shared interest in improving domestic and international tax law and treaties so as to facilitate such growth, as well as in capacity building within tax administrations to effectively deal with more complicated tax rules and to achieve the needed increase in government revenue. In view of this, there is no doubt a shared interest for the BRICS countries to exchange experiences and to support each other in these areas[116].

Therefore, although it is not clear whether the BRICS countries could act as an unified group, the way their economies have developed over time may give rise to common interests and understandings regarding international tax policies, which may be different from the perspectives of OECD countries[117]. The main concern is that, if the BRICS dissonant positions from the OECD are the principal link between them, then it will always be easier for them to merely express their opposition to 'Western' policies and institutions than to develop a cohesive international tax policy agenda or concrete proposals on reforming the existing system.

3.3 The Tax Systems of the BRICS: Similarities and Differences

The tax systems of the BRICS, reflecting their economic, political and social characteristics, have considerable differences between them. Regarding the BRICS countries' tax burdens, for instance, it is possible to note a significant dissimilarity between India, which has the lowest tax burden of approximately 12% of GDP and Brazil, which has the highest tax burden of around 38% of the GDP. In general, the BRICS tax burdens are below the OECD average level, except for Brazil and South Africa[118]. The tax structures

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[116] Jan J.P. de Goede, "The BRICS Countries in the Context of the Work on the UN Model" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 421 at 442-443.
[117] Eva Eberhartinger and Matthias Petutschnig, "The Dissenting Opinion of BRICS Practitioners on the BEPS Agenda" (2017) 32 *Australian Tax Forum* 1 at 7.
[118] Owens, "The BRICS: An Overall Perspective" *supra* note 103 at 357.

of the BRICS countries are also contrasting: Brazil gives greater importance to taxes on consumption, while Russia and South Africa rely more heavily on taxes on income and profits[119].

These dissimilarities can be attributed mainly to the different economic roles played by each of the BRICS countries in the global market. In terms of foreign direct investment, for example, China is a major FDI recipient whereas India receives smaller amounts[120], which may influence the variations in how these countries deal with the competitiveness of their tax systems. The level of informality is also notably different in the BRICS countries – India has the largest informal economy between them and Russia has the smallest[121] – affecting the range of their tax bases as well as the level of simplicity and practicability of their tax systems.

One similarity between the BRICS countries in their tax systems is that all five countries are more likely to prioritize source-taxation than more developed countries, where the OECD Model Tax Treaty is usually strictly followed. According to Kim Brooks:

> They [the BRICS] stake this ground in different ways in negotiating their bilateral tax treaties: sometimes by raising the threshold for the taxation of business income, sometimes by negotiating to increase the amount of income that might be allocated to a permanent establishment, sometimes by pushing for higher withholding tax rates on interest returns, often by trying to explicitly ensure that technical services may be taxed at sources, and usually by preserving source taxation of other income[122].

Nevertheless, comparing the BRICS countries' present international tax policies to the policies they had in the past – before 2001, when the Goldman Sachs' paper grouped them

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[119] *Ibid*.
[120] *Ibid* at 359.
[121] *Ibid*.
[122] Kim Brooks, "International Tax Policy: The Counter-Story Presented by the BRICS" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 447 at 466.

– it is possible to note that all of them are advancing towards reducing taxation at source[123]. The extent of this reduction varies between the BRICS countries because, since each one of them has reached a different stage of development in becoming a capital exporting country, their tax policies are also different. In this sense, while China and India encourage its resident companies to invest abroad, Brazil still sees itself as a capital importing country and Russia, until recently, saw the possibility of investing abroad with suspicion[124].

3.4 BRICS Institutional Aspects

Economic power does not always convert to influence in international politics; however, in the case of the BRICS, it is possible to see how these countries are being able to transform their economic potential into political influence in some areas of international governance. All the BRICS countries are currently members of relevant international institutions, such as the UN, the World Trade Organization and the G20, being active participants in their meetings and initiatives. In parallel, the BRICS have also been growing their international influence as a pluralistic summit institution.

Thus, this section studies the institutional aspects of the BRICS in the international tax and transfer pricing arena, analyzing its performance as a group and its interaction and influence among new institutions and initiatives, namely the International Tax Dialogue, the Global Forum on Transparency and Exchange of Information for Tax Purposes and the G20[125].

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[123] Monica Gomez, "Brazil, China (People's Rep.), India, Russia: The BRICs: Tax Treaty Policy Regarding Dividends" (2012) 66:8 *Bulletin for International Taxation.*
[124] *Ibid*.
[125] According to F. Afredo Prats, these initiatives – which have appeared in the international tax landscape to promote greater cooperation – compete to the UN to develop globally accepted international tax standards and, for this reason, "force the BRICS to disseminate and articulate their positions on tax policy issues in these new forums". F. Alfredo García Prats, "Impact of the Position of the BRICS on the UN Model Convention" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 393 at 395.

3.4.1 The BRICS as a Group

The BRICS are a group of countries that seek to strengthen the relations of its members among themselves and, at the same time, to exert an international influence on matters where they have a common interest. In 2006, Brazil, Russia, India and China held – in parallel to a UN General Assembly meeting in New York – their first meeting as the group BRIC. Nevertheless, the group's first joint document was only published after the First Ministerial Meeting of the BRICs held in Russia in 2008. In this communiqué, the BRICs representatives declared the need for a more democratic international system, including through the expansion of the UN Security Council and incorporation of Brazil and India as permanent members[126]. In this first communiqué, it is already possible to observe the BRICs intention of transforming global governance in favour of a greater sharing in the decision-making process of global matters.

In 2009, the BRICs had another meeting, in which the group's main discussion was the 2008 financial crisis and its repercussions in the world economy. Although the crisis had originated in developed countries, its effects were also suffered in a greater extent by poorer nations[127]. For this reason, the BRICs reiterated the discussion during the G20 meeting in April 2009, emphasizing the need for the international system to improve on: a) democratic and transparent decision-making in international financial organizations; b) implementation of a more solid legal basis; c) compatibility between activities of national regulatory institutions and international standards-setting bodies; and d) strengthening risk management and supervisory practices[128].

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[126] BRICS Information Centre, "BRICs Foreign Affairs Minister's Meeting Joint Communiqué" (2008) *University of Toronto*, online: <http://www.g20.utoronto.ca/2012/2012-0619-loscabos.html>.
[127] BRICS Information Centre, "Joint Statement of the BRIC Countries' Leaders, Yekaterinburg, Russia, June 16, 2009" (2009) *University of Toronto*, online: < http://www.brics.utoronto.ca/docs/090616-leaders.html>.
[128] G20 Information Centre, "G20 London Summit" (2009) *University of Toronto,* online: < http://www.g20.utoronto.ca/2009/2009communique0402-br.html>.

In 2010, the BRICs meeting occurred in Brazil and the countries' representatives continued to address the 2008 economic crisis in their final communiqué, resonating the previous year's discussion on the management and participation of emerging and developing nations in the Bretton Woods institutions (The International Monetary Fund and the World Bank)[129]. In 2011, in their annual meeting held in China, the BRICS were joined by South Africa. In this meeting communiqué, the BRICS emphasized the need to coordinate their multilateral agendas, both in economic matters as well as in the areas of international security and human rights protection[130].

In 2012, the BRICS annual meeting took place in India, where, essentially, all the commitments made during the other meeting were reaffirmed[131]. The 2013 BRICS summit was one of the most productive meetings of the group. The BRICS investigated the feasibility of establishing a Development Bank focused on financing infrastructure projects in emerging countries, with an initial quota of $ 100 billion USD. In this meeting, the BRICS Development Banks signed the "Multilateral Agreement on Cooperation and Co-financing for Sustainable Development" and the "Multilateral Agreement on Infrastructure and Co-financing for Africa”[132].

With respect to tax cooperation, in 2012, BRICS finance ministers and central bank governors held a meeting in the United States, in which they agreed to develop a cooperative approach on international taxation, transfer pricing, exchange of information, tax evasion and tax avoidance matters[133]. This lead to a first meeting, occurred in 2013,

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[129] BRICS Information Centre, “2nd BRIC Summit of Heads of State and Government: Joint Statement, Brasília, April 15, 2010” (2010) *University of Toronto*, online: < http://www.brics.utoronto.ca/docs/100415-leaders.html>.

[130] BRICS Information Centre, “BRICS Reports” (2011) *University of Toronto*, online: < http://www.brics.utoronto.ca/reports/index.html>.

[131] BRICS Information Centre, “Fourth BRICS Sumit: Delhi Declaration, New Delhi, March 29, 2012” (2012) *University of Toronto*, online: <http://www.brics.utoronto.ca/docs/120329-delhi-declaration.html>.

[132] BRICS Information Centre, “Statement by BRICS Leaders on the Establishment of the BRICS-Led Development Bank” (2013) *University of Toronto*, online: < http://www.brics.utoronto.ca/docs/130327-brics-bank.html>.

[133] South Africa Ministry of International Relations and Cooperation, “First Meeting of Finance

between the BRICS heads of revenue, during which they deliberated on issues of common concern regarding tax administration, international taxation, transfer pricing, cross-border tax evasion and tax dispute mechanisms[134]. One of the identified areas of tax policy and tax administration for extending the BRICS mutual cooperation was "contributing to the "development of international standards on international taxation and transfer pricing taking into account the aspirations of developing countries in general and BRICS countries in particular"[135]. According to David Spencer, the choice of the words "international standards on transfer pricing" was not coincidental, as the OECD claims that the ALP and its guidelines are both the "international standard"[136].

A multilateral cooperation approach was also deliberated in this meeting, as stated by the BRICS heads of revenue in their 2013 communiqué:

> We also agree to establish a central point of contact in each of the BRICS Countries for coordination of issues relating to taxation. The central points of contacts will identify issues of common interest in areas of International Taxation and Transfer Pricing and will develop a common response, interact and meet regularly, including pre-meeting before important multilateral meetings. The agreed common response of the BRICS countries would be communicated to international organisations engaged in development of standards on International Taxation and Transfer Pricing[137].

Ministers", BRICS, online: <http://brics5.co.za/about-brics/sectorial-declaration/financial-ministers-meeting/first-meeting-of-finance-ministers//>.

[134] BRICS Information Centre, "Communiqué of BRICS Heads of Revenue Meeting, Delhi, January 18, 2013" (2013) *University of Toronto*, online: <http://www.brics.utoronto.ca/docs/130118-tax.html>.

[135] Further actions include "strengthening the enforcement processes by taking appropriate actions for non-compliance and putting more resources on international cooperation; sharing of best practices and capacity building; sharing of anti-tax evasion and non-compliance practices, including abuse of treaty benefits and shifting of profits by way of complex multi-layered structures; development of a BRICS mechanism to facilitate countering abusive tax avoidance transactions, arrangements, shelters and schemes; promotion of effective exchange of information; any other issues of common interests and concerns related to taxation". *Ibid*.

[136] Spencer, "BRICS, BEPS and the UN Manual Part 1" *supra* note 65.

[137] *Supra* note 129.

In 2015, the BRICS heads of revenue met again to discuss potential areas of cooperation in reaching a "globally fair and modern tax system"[138]. In this regard, the BRICS representatives welcomed the final package of Base Erosion and Profit Shifting (BEPS) Action Plan measures, acknowledging transfer pricing as one of the areas of priority[139].

3.4.1.1 The Debate Regarding the BRICS Performance as an International Institution

There is a continuing discussion regarding the BRICS performance as a group, particularly about how and why their summits occurred and have been developed. Some authors, such as O'Neill, view the BRICS as a group with little importance to its countries or to the global community in general[140]. This school of thought highlights the political and economic differences[141] among the countries and the lack of mutual interests as obstacles to achieving some relevant developments, such as a reform in the UN Security Council, advocated by the group in their 2008 summit[142]. In a similar sense, some authors have the understanding that the BRICS are only one of the many groups of emerging economies that arose in the last decades, with these other groups having more possibilities of providing better global governance and influence because of their more reliable democratic political systems[143].

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[138] BRICS Information Sharing and Exchange Platform, "Communiqué of BRICS Heads of Revenue Meeting" (2015) *BRICS Business Council*, online: < http://www.brics-info.org/communique-of-brics-heads-of-revenue-meeting/>.

[139] *Ibid*.

[140] Jim O'Neill, "Building BRICS: From Conceptual Category to Rising Reality" in Marina Larionova and John. Kirton, eds. *BRICS New Delhi Summit 2012: Stability, Security and Prosperity*. (London: Newsdesk, 2012) 25, online: <http://www.brics.utoronto.ca/ newsdesk/BRICS-2012.pdf> [O'Neill, "Building BRICS: Rising Reality"].

[141] In this respect, some authors emphasize the economic disparities between the BRICS, with China being more powerful than the others, and potential conflicts between China and India. See Amitav Acharya, "Can Asia Lead? Power Ambitions and Global Governance in the Twenty-First Century" (2011) 87:4 *International Affairs* 851.

[142] O'Neill, "Building BRICS: Rising Reality" *supra* note 135.

[143] Stephan Keukeleire and Bas Hooijmaaijers, "The BRICS and Other Emerging Power Alliances and Multilateral Organizations in the Asia-Pacific and the Global South: Challenges for the European Union and its view on Multilateralism" (2014) 52:3 *Journal of Common Market Studies* 582.

Other authors argue that, although the BRICS are increasingly becoming more influential, they are still far from forming a "unified political alliance"[144]. Therefore, even though the BRICS represent a challenge to many aspects of the current international system "functionality, scope, legitimacy and authority", the interests and differences between their members impede that they effectively change the "structural power" of the existing international order[145].

A different position is adopted by Nikonov, who sees the BRICS as an expression of the unified political will of these emerging countries to create a new international institutional balance. For the author, the BRICS act as a developing and emerging country coalition that tries to shift the existing balance of global political influence – which is undemocratic and unipolar, failing to offer opportunities for all countries – from the West to the developing world[146]. Identifying the BRICS similarities as large, emerging post-colonial powers as well as the failure of the G7 in adequately accommodating their power and interests, this school of thought understands the BRICS as competitors to the G8 and G20.

A more moderate view is taken by Kirton[147] and Luckhurst[148] who see the BRICS as a cooperator with the international system and its leading industrialized states. Considering the membership of all BRICS countries in the G20, these authors note the tendency of the BRICS to voice their dissent positions in reasonable and diplomatic terms:

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[144] According to Xing Li, the BRICS "still have a long way to go before they can manage to find the common ground necessary to act as a unified geopolitical alliance". Xing Li, "Introduction: Understanding the Hegemony and the Dialetics of the Emerging World Order" in Xing Li, ed, *The BRICS and Beyond: The International Political Economy of the Emergence of a New Order* (Farnham: Ashgate, 2014) 1.
[145] Xing Li and Oscar Agustín, "Constructing and Conceptualizing 'Interdependent Hegemony' in an Era of the Rise of the BRICS and Beyond" in Xing Li, ed, *The BRICS and Beyond: The International Political Economy of the Emergence of a New Order* (Farnham: Ashgate, 2014) 53.
[146] Vyacheslav Nikonov, "BRICS Represents a Challenge to Western Domination" (2015) *Russkiy Mir Foundation,* online: < http://www.russkiymir.ru/en/publications/140423/>.
[147] John Kirton, "Prospects for the BRICS and G20 summits through China's contribution" (2013) *University of Toronto,* online: < http://www.brics.utoronto.ca/commentary/130322-kirton-peoplesdaily.html>.
[148] Jonathan Luckhurst, "Building Cooperation between the BRICS and Leading Industrialized States" (2013) 4:2 *Latin America Policy* 251 at 264.

> Strategic, political, and economic differences between the BRICS make it unlikely they will constitute an anti-western alliance and try to transform inter- national economic norms, for example, by undermining the United States and other wealthy states. Their preference for enhancing multilateralism in international relations is not a radical new political–economic agenda, but simply intended to gain leverage within existing mechanisms. Increasing incorporation of the BRICS in key institutions and forums such as the WTO, IMF, G20, and FSB indicates that their focus is to become more influential through dialogue and cooperation, not confrontation. Despite occasional evidence from Russia and Brazil that contestation could increase, the Chinese government has consistently prioritized multilateral cooperation and leadership through existing institutions and practices in international and Asian regional contexts. This is a consequence of their appreciation of the nonzero-sum effects of complex interdependence, especially in relations with the United States[149].

3.4.2 The International Tax Dialogue

The International Tax Dialogue (ITD) is an initiative of the European Commission, the Inter-American Development Bank, the International Monetary Fund (IMF), the OECD, the World Bank and the Inter-American Center of Tax Administrations[150]. The ITD organizes periodic global and regional conferences to discuss policy and administration issues, aiming to encourage and facilitate the debate of tax matters among tax officials, regional tax organizations, international organizations and other key stakeholders[151].

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[149] *Ibid*.
[150] The International Tax Dialogue, “International Tax Dialogue”, online: < http://www.itdweb.org>.
[151] *Ibid*.

The ITD has held five global conferences to date, two of them being hosted in BRICS countries[152]. Each of these global conferences were attended by senior representatives from approximately 90 countries, having focused on matters such as "Tax and Intergovernmental Relations", "Tax and Inequality" and "Financial Institutions and Instruments"[153]. This initiative, by promoting the strengthening of cooperation between tax administrations at the global level, expands the opportunity to participate in the international tax debate to more countries, including the BRICS. The ITD, therefore, is one more forum where the BRICS countries can coordinate tax policies, share their best practices and contribute to the development of information tools.

3.4.3 The Platform for Collaboration on Tax

The Platform for Collaboration on Tax (PCT) was launched in April 2016 as a joint effort between the IMF, the OECD, the UN and the World Bank Group[154]. The members of the PCT have regular meetings with representatives from developing countries, regional tax organizations and banks[155]. The PCT aims to intensify the cooperation between these international organizations on tax matters in order to better support governments in addressing the challenges they face in the area of international taxation[156]. Therefore, the Platform provides a framework for:

> 1. Producing concrete joint outputs and deliverables under an agreed work plan, implemented in collaboration by all or selected IOs, and leveraging each institution's own work program and comparative advantage. The outputs may cover a variety of domestic and international tax matters. 2. Strengthening dynamic interactions between standard setting, capacity building and technical assistance (experience and knowledge from capacity

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[152] The five global conferences were held in Italy (2005), Argentina (2007), China (2009), India (2011) and Morocco (2013). *Ibid*.
[153] *Ibid*.
[154] OECD, "Platform for Collaboration on Tax", online: <http://www.oecd.org/ctp/platform-for-collaboration-on-tax.htm>.
[155] *Ibid.*
[156] *Ibid.*

> building work feeding into standard setting and vice-versa, including timing of implementation). 3. Sharing information on activities more systematically, including on country level activities[157].

One of the main activities performed by the PCT is the development of appropriate tools for developing countries regarding international tax matters, including those dealt under the BEPS initiative[158]. Recognizing that the taxation of MNEs covers a number of issues, which affect all countries, the PCT develops toolkits to assist developing countries to address a set of these issues and to protect their tax bases.

In June 2017, the PCT published a toolkit in the area of transfer pricing named "Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses", which specifically addresses how developing countries can overcome the lack of data necessary to apply transfer pricing rules[159].

3.4.4 The Global Forum on Transparency and Exchange of Information

The Global Forum on Transparency and Exchange of Information ("The Global Forum") was formed in the early 2000s as an OECD initiative to address the obstacles to tax compliance created by non-cooperative countries. Originally, the Global Forum members were OECD countries and other countries that had agreed to implement transparency and exchange of information measures. In 2009, the Global Forum was restructured and now has 143 members – including all of the BRICS countries – on equal footing, being the "premier international body for ensuring the implementation of transparency and exchange of information in the tax area"[160].

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[157] International Monetary Fund, "The Platform for Collaboration on Tax: Concept Note", online: < https://www.imf.org/external/np/sec/pr/2016/pdf/pr16176.pdf>.
[158] *Ibid*.
[159] For an analysis of the BRICS countries' influence on the PCT Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses, see Section 5.1.1.
[160] OECD, "Global Forum on Transparency and exchange of Information for Tax Purposes", online: < http://www.oecd.org/tax/transparency/>.

According to F. Alfredo Prats, The Global Forum is an example of institution that represents the new international tax order that is being developed. This new order is based on two principles: a) effective taxation of cross-border income; and b) transparency and cooperation (in order to enable the effective application of the previous principle). For the author, the new international tax order relies on the cooperation of the whole international community and, to achieve this, international consensus is essential[161]. It is in this context that the BRICS may play an important role in helping to conciliate the tax policies and demands of developed and developing countries to achieve global consensus on international tax matters.

3.4.5 The G20

The Group of Twenty Finance Ministers and Central Bank Governors, or G20, is a forum for international cooperation composed by 19 members from the 25 largest national economies plus one member representing the European Union[162]. The current members of the G20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union[163]. The G20 is a pivotal group in the creation of cooperation mechanisms and international standards. Thus, the development of international tax policies is one of the main issues in its political agenda[164].

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[161] Prats, *supra* note 125.

[162] "The 19 countries represented individually are not necessarily the top 19 economies in any given year, and there are additional members beyond that 19+1: the CEOs of the International Monetary Fund, the World Bank, the International Monetary and Finance Committee, the Development Committee of the International Monetary Fund and World Bank, and the European Central Bank. G20 has been a convenient shorthand emphasizing the number of member-states (plus the European Union), and succeeding the G33 and G22 in 1999". Bill Kte'Pi, Encyclopedia of Business in Today's World (2009) sub verbo "G20", online: <http://sk.sagepub.com.proxy1.lib.uwo.ca/reference/businesstoday/n456.xml>.

[163] OECD, "G20 Members", OECD and the G20, online: <http://www.oecd.org/g20/g20-members.htm>.

[164] Prats, *supra* note 125.

The political influence of the BRICS can be observed not only in the group's increasing institutionalization – developed throughout their annual summits – but also in their participation in the G20 summits. The G20 provides an opportunity for the BRICS to "have a leading role in addressing the issues and linking the legitimate demands of developed and developing countries, while recognizing the position of economic drivers and operators"[165]. China, for instance, has been acting as a cautious but always essential and effective global leader in G20 governance, advocating for incremental reforms rather than a radical replacement of the existing institutionalized system and operating in co-leadership with other members, especially the BRICS[166].

Notwithstanding their influential positions as individual countries, according to Kristen Hopewell[167] and Stefan Schrim[168], the BRICS countries have not coherently acted together to create and drive a BRICS agenda in global governance in the context of the G20. However, when there are common interests, the BRICS have a record of coordination, such as when they had a uniform position opposing the bank taxes proposed by the IMF in the 2010 G20 meeting[169]. Their participation in the G20, therefore, may be an indication of the group's choice to operate "inside the system as a loosely coordinated bargaining group"[170], focusing on their common interests and, more regularly, on particular interests of the individual BRICS countries and not counterbalancing current dominant countries and institutions.

3.5 Conclusion

This chapter explored the economic, legal and institutional aspects involved in the establishment of the BRICS as an association between fast-growing emerging countries.

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[165] Prats, *supra* note 125 at 418-419.
[166] John Kirton, *China's G20 Leadership* (New York, Routledge, 2016) at 9.
[167] Kristen Hopewell, "Different paths to power: The rise of Brazil, India and China at the World Trade Organization (2015) 22:2 *Review of International Political Economy* 311.
[168] Stefan Schirm, "Leaders in Need of Followers: Emerging Powers in Global Governance" (2009)16:2 *European Journal of International Relations* 197.
[169] Salman Shaheen, "The Future for BRICS Tax Policy Coordination" (2012) *International Tax Review*.
[170] Pistone and Brauner, *supra* 100 at 4.

The reason for grouping the BRICS countries is not obvious, as their policies and politics diverge; they are not geographically close; their economies do not necessarily supplement each other; and some of their interests diverge. However, they are all large emerging economies who share economic and politic concerns, one of them being the dominance of Western powers over the international tax agenda. This dominance is reflected, in the area of transfer pricing, in the OECD's perceived authority in developing international transfer pricing standards, such as the OECD Transfer Pricing Guidelines, as discussed in Chapter 2. Thus, the next chapter will analyze the transfer pricing rules of the BRICS countries and how they differ from the standard approach established by the OECD and from each other.

Chapter 4

4 Transfer Pricing Rules in the BRICS Countries

Establishing a suitable regulation for transfer pricing issues is extremely important for the BRICS countries as the manipulation of prices by MNEs can be an even more damaging problem for developing and emerging economies[171]. In this sense, considering that the BRICS have developed their international tax policies "with an eye to the approach suggested by the OECD, but not necessarily in conformity with its structures"[172], this chapter discuss the transfer pricing regulations of Brazil, Russia, India, China and South Africa. Each of these countries is analyzed in a separate section, comprehending the historical development of their transfer pricing rules, their current transfer pricing law as well as peculiarities and challenges they face in its application.

4.1 Brazil

> *The legal treatment of transfer pricing in Brazil is a highly complex and relatively new matter which, although demonstrating the concern of adapting itself to the international scenario, has departed significantly from it, giving excessive attention to the preservation of the national tax base, although in disagreement with the arm's length principle itself and with the international parameters*[173].

4.1.1 Introduction

Brazilian transfer pricing legislation was only enacted in 1996, following an important legal reform that moved Brazil's tax system from a territorial system to taxing MNE's

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[171] Transfer pricing is "among the most compelling explanations" for the lack of a correlation between foreign capital flows and poverty alleviation, since the combination of transfer pricing and tax havens has put developing and emerging countries into a very difficult position. Edmund Malesky, "Transfer Pricing and Global Poverty" (2015) *International Studies Review* 669.

[172] Brooks, *supra* note 117 at 447.

[173] Rodrigo Bernardes Braga, "Preços de Transferência: Novas Regras Estão Fora da Realidade Econômica" (2009) *Consultor Jurídico*, online: <http://www.conjur.com.br/2009-jul-01/regras-precos-transferencia-fora-realidade-economica>.

worldwide income, according to a residence-based taxation. The country has received substantial amounts of foreign direct investment (FDI) in the past years and it is considered – as other developing and emerging economies – a capital importing country, since its inward FDI stocks exceed its outward FDI stocks[174]. In this context, considering the increasing importance of foreign income to the Brazilian economy, the development of Brazil's transfer pricing rules was an important stage in preventing the allocation of taxable income abroad. The country's transfer pricing peculiarity, nonetheless, is that Brazilian rules were established with significant deviations from the international standards implemented by the OECD's member countries.

The objective of this section is to review some aspects of the Brazilian transfer pricing regime and to demonstrate how some positions deviating from the OECD Transfer Pricing Guidelines are commonly found in Brazil's transfer pricing law. This section is structured as follows: a) historical background and the development of transfer pricing rules in Brazil; b) transfer pricing regulations in Brazil, in which Brazilian transfer pricing methods for import and export transactions will be analyzed; and c) peculiarities and challenges in Brazil's transfer pricing practices, in which the use of predetermined margins, location-specific advantages and intangible regulations in the country will be reviewed.

4.1.2 Historical Background: The development of Transfer Pricing Rules in Brazil

Until 1995, Brazil adopted a territorial approach[175] regarding the taxation of MNEs, according to which only income earned from sources located inside its territory could be

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[174] Isabel Calich and João Dácio Rolim, "Transfer Pricing Disputes in Brazil" in Eduardo Baistrocchi and Ian Roxan, eds, Resolving Transfer Pricing Disputes (Cambridge: Cambridge University Press, 2015) 519 at 520.

[175] According to the territorial principle, there is a taxation only of the income derived from sources located in the territory of the taxing State, irrespective of other characteristics which may be involved, such as nationality or residence. In order to apply a territorial taxation of MNEs, the criterion for the delimitation of tax jurisdiction used was that of material connection, that is, the effective source of income. Therefore, Brazil only allowed the taxation of the income sources that were originated within its territorial limits. Alberto Xavier, *Direito Tributário Internacional do Brasil* (Rio de Janeiro: Forense, 2010) 20-21.

taxed, excluding any foreign income earned by an enterprise – either directly by performing activities abroad or indirectly through associated enterprises – from liability for Brazilian tax[176]. However, because of the increasing importance of foreign income to the Brazilian economy and to its tax system, in December 1995, Brazil moved to the worldwide taxation of MNEs income with the promulgation of Law no. 9,249, which established the requirement to include profits, income and capital gains earned abroad in the Brazilian tax basis[177]. Thus, Brazil changed its previous position and began to tax not only the income produced inside its territory but also the income produced abroad by resident enterprises.

Following this change in its tax system, Brazil enacted its first transfer pricing legislation (Law no. 9,430)[178] in 1996. Until 1996, the manipulation of prices in transactions between related persons was regulated in Articles 72 and 73 of Law no. 4,506, promulgated in 1964[179]. According to Article 72, transactions could be considered 'disguised distribution of profits' when they involved the sale or acquisition of goods in the domestic market for a notoriously lower or above market value, meaning that the enterprise was acting in the interest of the other related party rather than according to its own interest[180]. In these cases, unless the taxpayer proved that the business was carried out in the interest of the enterprise and under the same conditions in which the enterprise would contract with third parties, a 50% tax rate was applied by Brazilian tax authorities[181]. Although it could be possible to argue that Law 4,506 was enough to prevent international transfer pricing schemes, in

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[176] Calich and Rolim, *supra* note 163 at 523.
[177] Article 25: "Profits, income and capital gains earned abroad shall be included in the determination of the corporate profits corresponding to the balance sheet as of December 31 of each year". *Law 9,249*, Brazil 1995, Article 25.
[178] *Law 9,430*, Brazil 1996.
[179] *Law 4,506*, Brazil 1964.
[180] The original objective of Law 4,506 was to avoid that, using some hypotheses casuistically defined in Article 72, the partner or shareholder (or some other related person) and the company would receive some advantages due to the practice of 'disguised distribution of profit'. *Law 4,506*, Brazil 1964, Article 72.
[181] *Law 4,506*, Brazil 1964, Article 73.

practice, these rules were never substantially applied by Brazilian tax authorities in the context of international transactions between related companies[182].

While Brazil did not develop specific transfer pricing legislation until 1996, the country's double taxation agreement network[183] reproduced the provision contained in paragraph 1 of Article 9 of the OECD and UN Model Conventions. Article 9 established the possibility of an adjustment in the transfer prices of transactions between related companies resident in the contracting countries, according to the arm's length standard. Nonetheless, this treaty provision – even with the domestic regulation regarding 'disguised distribution of profits' – was not considered to be applicable by Brazilian tax authorities without the existence of an internal transfer pricing law that expressly authorized any adjustments. Another relevant aspect regarding Brazilian double taxation agreements is that the country, without exception, did not include the provision contained in paragraph 2 of Article 9, i.e., the country did not commit itself to the obligation of granting the correlative adjustment, revealing the apparent disregard of Brazil for economic double taxation[184].

It was against this background that Law 9,430 introduced a more decisive and precise control regarding international transfer pricing in Brazil. The enactment of the Brazilian transfer pricing legislation aimed to avoid the manipulation of prices by MNEs on imports and exports between associated companies and the consequent allocation of taxable income abroad[185]. Hence, while the OECD's transfer pricing rules have the goal of identifying the

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[182] Ricardo Gregorio, *Arm's Length e Praticabilidade nos Preços de Transferência* (DCL Thesis, Universidade de São Paulo, Faculty of Law, 2010) [unpublished].
[183] Until the enactment of its transfer pricing legislation (Law 9,430) in 1996, Brazil had signed 21 double taxation agreements. This number increased and, currently, Brazil has 28 double taxation agreements in force. Receita Federal do Brasil, *Acordos Internacionais*, online: <*www.receita.fazenda.gov.br*>.
[184] Brazilian disregard for economic double taxation consequences in its transfer pricing adjustments was emphasized when Brazil, acting as an observer non-member country, included an observation in the OECD Model Convention on Income and on Capital Commentaries, in which it reserved the right not to insert paragraph 2 in its conventions. See "OECD Model Tax Convention" *supra* note 23 at 1225.
[185] Calich and Rolim, *supra* note 163 at 525.

price that would have been agreed between independent enterprises[186], Brazilian rules were introduced as mechanisms to control and combat tax avoidance schemes[187], which explains why the transfer pricing legislation in Brazil determines a maximum price for deductible expenses on imports and a minimum profit rate on exports in transactions between associated enterprises[188], as will be discussed below.

4.1.3 Transfer Pricing Rules in Brazil

Transfer pricing is currently regulated in Brazil by Law 9,430 – recently updated by Law 12,715/2012[189] – and other administrative regulations issued by the Brazilian Federal Revenue Office (BFRO)[190], among which, one of the most significant regulations is Normative Instruction no. 243/02[191]. Aiming to deal with tax avoidance through transfer pricing arrangements, these provisions cover transactions between "associated persons", transactions between a Brazilian resident and corporations or individuals resident in low-tax jurisdictions (countries with no income taxes or with income tax rates lower than 20%)[192] and preferential tax regime's transactions[193], irrespective of whether the two parties

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[186] The OECD Transfer Pricing Guidelines argue that "the consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purpose". OECD Transfer Pricing Guidelines *supra* note 10.

[187] According to Heleno Tôrres, at the time of the development of Law 9,430, Brazilian tax authorities had the perception that foreign enterprises operating in Brazil were not officially remitting their profits abroad, which made them believe that the manipulation of prices was the way these enterprises found to remit their profits to its parent companies. Heleno Tôrres, *Direito Tributário Internacional: Planejamento Tributário e Operações Transnacionais* (São Paulo: Revista dos Tribunais, 2001) 165-166.

[188] Calich and Rolim, *supra* note 163 at 525.

[189] Law 9,430/1996 was modified by Law 9,959/2000, Law 10,451/2002, Law 11,727/2008, Provisional Measure 478/2009, and more recently by Law 12,715 of September 2012.

[190] The Brazilian Federal Revenue Office is a specific body, subordinate to the Ministry of Finance, performing essential functions so that the State can fulfill its objectives. It is responsible for the administration of federal taxes, including those incidents on foreign trade, covering a significant part of the country's social contributions. Receita Federal do Brasil, *Institucional*, online: <*www.receita.fazenda.gov.br*>.

[191] *Normative Instruction no. 243,* Brazil 2002.

[192] In order to facilitate the identification – for taxpayers and for tax authorities – of low-tax jurisdictions, these countries are listed in administrative regulations published by the BFRO.

[193] Preferential tax regime's transactions are those performed with persons resident or domiciled abroad benefiting from: a) favored taxation of income earned within or outside its territory; b) tax

qualify as associated enterprises. According to the Brazilian rules, specifically in Articles 18 and 19 of Law no. 9,430, the association between parties acts as an absolute presumption of the transfer price's manipulation[194], i.e., there is an assumption that all intra-group transactions necessarily attribute unreal prices for its goods as a way of shifting profits to other jurisdictions. This assumption goes against OECD's Guidelines understanding, according to which "tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits"[195].

Regarding the transactions covered by Brazilian transfer pricing rules, Law no. 9.430 is applied to goods, services and rights, imported or exported[196]. The idea is to establish a generic definition able to encompass all transactions carried out between related enterprises that involve the payment of a price as compensation for the advantage obtained with the acquisition of ownership of a good, a service or the enjoyment of a right. In this context, goods include tangible and intangible property; services include those provided between related parties (intra-group) and those established in cost-sharing contracts; and rights include different rights to use other parties' properties, which entail different forms of remuneration, such as rents, interest and premiums. Although similar to the international standards, the scope of transactions controlled by Brazilian law has one important peculiarity: transactions involving royalty payments and technology transfers to a foreign country are expressly excluded from transfer pricing rules[197].

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advantages independent of the performance of a substantive economic activity or; c) non-disclosure of information of a corporate, commercial or economic nature. *Law 9,430*, Brazil 1996, Article 24.

[194] According to Article 18 of Law 9,430/1996, all the "costs, expenses and charges related to goods, services and rights, contained in the import or acquisition documents, in operations carried out with a related person, will only be deductible in determining the actual profit up to the amount that does not exceed the price determined through the methods". *Law 9,430,* Brazil 1996, Article 18.

[195] *Supra* 11 at 25.

[196] *Law 9,430,* Brazil 1996, Article 18.

[197] *Law 9,430,* Brazil 1996, Article 18, para 9. These transactions must be registered with the Brazilian Intellectual Property Agency and the Brazilian Central Bank. Alina Miyake and Fernando Tonanni, *Brazil - Corporate Taxation* sec. 7.2, Country Surveys IBFD.

Despite following the ALP[198] and the elementary methodology suggested by the OECD Transfer Pricing Guidelines – Brazil has 32 income tax treaties currently in force and all of them reiterate Article 9 of the OECD Model Treaty's dispositions – Brazilian transfer pricing rules deviate from OECD's conventional methods, which are primarily based on comparison, and adopt *predetermined profit margins*[199]. In this context, it is possible to observe that the Brazilian transfer pricing law created a legal fiction, according to which, if the "price practiced"[200] is higher on imports or lower on exports than the "parameter price"[201], the first must be adjusted in accordance to the latter[202]. In other words, the transfer pricing law establishes limits of maximum prices for import transactions and minimum prices for export transactions[203].

Therefore, there are two main aspects in which Brazilian transfer pricing law departs from OECD Transfer Pricing Guidelines. First, Brazil subjects to a unitary regulation cross-border transactions between related enterprises – exclusive object of most international

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[198] The influence of the OECD and its arm's length principle was expressly recognized in the Explanatory Memorandum following the enactment of Law 9,430/1996, which stated that: "the rules contained in Articles 18 to 24 represent a significant advance in national legislation in face of the relevant process of globalization experienced by contemporary economies. In this specific case, in accordance with the rules adopted in the member countries of the OECD, there is a proposition of norms that allow the regulation of the so called "Transfer Prices" in order to avoid the damaging practice of transferring resources abroad by manipulating prices agreed upon in the importation and exportation of goods, services or rights, in transactions with related persons, residents abroad". Explanatory Memorandum, *Law 9,430,* Brazil 1996.

[199] Luís Schoueri, "Brazil" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 41 at 63 [Schoueri, "Brazil"].

[200] According to Normative Instruction no. 243/02, the price practiced refers to the weighted arithmetic mean of the prices effectively practiced in controlled transactions during the taxation period.

[201] The parameter price, as established by Normative Instruction no. 243/02, is the price calculated according to one of the transfer pricing methods established in the legislation.

[202] Therefore, according to the Brazilian legal fiction, when a normative hypothesis established in the transfer pricing legislation is verified, it must give consequence to the normative prescription contained in taxation law, giving rise to an adjustment. Luís Eduardo Schoueri, *Preços de Transferência no Direito Brasileiro*, 2ed (São Paulo: Dialética, 2006) 73.

[203] Ricardo Mariz de Oliveira, "Métodos de Apuração dos Preços de Transferência no Brasil: Efeitos da Escolha de um Método e Possibilidade de Indicação de Métodos Diversos. Consequências da Falta de Indicaçnao de Métodos" in Luís Eduardo Schoueri, ed, *Tributos e Preços de Transferência* (São Paulo: Dialética, 2009) 156 at 159.

transfer pricing regulations – and cross-border transactions between independent enterprises when one of them is located in countries of favored taxation[204]. The other divergence is that, while the transfer pricing policy adopted on the basis of the OECD recommendations and the US experience is not based on a presumption of artificiality of prices between related enterprises, Brazilian law establishes the automatic prevalence of the "parameter price" – calculated by legally predetermined methods – regardless of an administrative investigation of the case[205].

4.1.3.1 Brazilian Transfer Pricing Methods

As mentioned, "parameter price" is an idea created by Brazilian transfer pricing law to indicate the appropriate transfer price – determined by the methods provided in Law 9,430 – which must be compared with the "practiced price" effectively carried out in controlled transactions during the tax assessment period. The methods provided in Law 9,430 were allegedly inspired by the traditional methods to determine the arm's length price employed in the international discipline of transfer pricing. However, while the focus of traditional international methods is on price comparability (CUP method) or gross margins (cost plus and resale price methods), in Brazil, the comparability is maintained only for CUP-inspired methods. As for the methods inspired by cost plus and resale price, the Brazilian legislator innovated by predetermining the gross margins that should be applied.

Regarding the application of the CUP method, the procedures are similar to the OECD Transfer Pricing Guidelines; however, in regards to the cost plus and the resale price methods, Brazilian law establishes fixed margins for gross profit and mark-up instead of finding and using comparable transactions[206]. In addition, although the approach introduced by Brazilian transfer pricing law encompasses procedures inspired in traditional transaction

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[204] Xavier, *supra* note 164 at 367.
[205] *Ibis* at 368.
[206] UN Practical Manual *supra* note 3 at 358.

methods (CUP, cost plus and resale price methods), it does not prescribe the use of transactional profit methods (profit split and transactional net margin methods)[207].

Brazilian law has designated the methods differently depending on whether they apply to import or export operations[208]. Accordingly, the transfer pricing methods established by the Brazilian law, as well as their corresponding international methods, are analyzed separately below.

4.1.3.1.1 Transfer Pricing Methods for Import Transactions

Brazilian transfer pricing law provides four methods for establishing the price limit for products, services or rights imported by Brazilian resident enterprises.

Inspired by the CUP method, Article 18, Item I of Law no. 9,430 establishes the "Independent Compared Prices" method (*Preços Independentes Comparados - PIC*), according to which the "transfer price is based on the average price of identical or similar products or services in purchase and sale transactions carried out in either the internal or external market under similar payment conditions"[209].

The "Resale Price Less Margin" method (*Preço de Revenda Menos Lucro – PRL*), established in Article 18, Item II of Law 9,430 and inspired by the resale price method, prescribes the determination of the transfer price according to the average resale price of

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[207] Regarding the decision of not allowing the use of profit-based methods or any other transactional methods, it results from the perception that the Brazilian legislator exhaustively stated the possible methods for the transfer pricing control in the law. The Brazilian Federal Revenue Office (BFRO) has already categorically stated its interpretation in this sense, including in cases of transactions with companies located in countries with which Brazil has a double taxation agreement. Receita Federal do Brasil, *Perguntas e Respostas – Pessoa Jurídica – PIR 2009*, online: <*www.receita.fazenda.gov.br*>.
[208] "Despite of the fact that Brazilian methodology basically adopts the three traditional transaction methods, i.e., CUP, RPM, and CPM, the law differentiates between imports and exports operations, by establishing separate sets of rules for imports and exports. It is important because Brazilian methodology adopts fixed margins, which are different for import and export operations" Marcos Aurélio Pereira Valadão, "Transfer Pricing: Arm's Length Principle Versus Worldwide Unitary Taxation' Correlative and Secondary Adjustments, and Domestic Legislation Under Brazilian Methodology" (2017) *Revista Direito Tributário Internacional Atual* 270 at 272.
[209] Miyake and Tonanni, *supra* note 186.

goods, services or rights applied by the importer in transactions with independent parties, less unconditional discounts, taxes, brokerage fees and profit margins[210]. These profit margins are determined in Article 18, para 12 (recently updated by Law no. 12,725 of 2012)[211] and calculated in accordance with the enterprise's industrial sector:

> Article 18, Paragraph 12: The margins referred to in item "d" of section II shall be applied according to the sector of economic activity of the Brazilian legal entity subject to transfer price controls and shall be subject, regardless of having a productive process in Brazil or not, in the following percentages: I - 40% for the sectors of: A) pharma-chemical and pharmaceutical products; B) tobacco products; C) optical, photographic and cinematographic equipment and instruments; D) machines, apparatus and equipment for medical and hospital dental use; E) extraction of oil and natural gas; and F) petroleum products; II - 30% for the sectors of: A) chemical products; B) glass and glass products; C) pulp, paper and paper products; and D) metallurgy; and III - 20% for the other sectors[212].

The third transfer pricing method for import transactions, according to Article 18, Item III of Law 9,430, is the "Production Cost Plus Margin" (*Custo de Produção Mais Lucro - CPL*). As well as its international correspondent method – the cost plus method – this Brazilian procedure bases the transfer price on the average of production cost of identical or similar products, services or rights in the jurisdiction where they were originally produced, increased by taxes paid in such jurisdiction and by a profit margin. The particularity is that, unlike the traditional (non-predetermined) cost plus method, the Brazilian law establishes a fixed profit margin of 20% rather than determining it based on comparables [213] .

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[210] *Law 9,430,* Brazil 1996, Article 18, Item II.
[211] The fixed margin for the PRL method used to be 20%, which was then altered to provide for either 20% or 60% margins, depending on whether the imports were subject to manufacturing in Brazil. In 2012, Law no. 12,725 established different margins for certain specific sectors, but in general maintained 20% as the prescribed margin. UN Practical Manual, *supra* note 3 at 358.
[212] *Law 9,430,* Brazil 1996, Article 18, Para 12.
[213] *Law 9,430,* Brazil 1996, Article 18, Item III.

Finally, Law 12,715 introduced in 2012 the "Quote Price for Imports" method (*Preço sob Cotação da Importação – PCI*), which is mandatorily applicable to import transactions of commodities between related companies. In these cases, Brazilian law determines that the benchmark is the average price of the daily medium quotes of the commodities negotiated in internationally known commodities and future exchanges, adjusted by applicable premiums and other variables. In cases where there is an absence of a trading pricing in commodities and future exchanges, it is permissible to compare prices to those obtained from independent data sources provided by internationally known research institutes. The goal of this new method is to avoid discussions regarding the comparability of transactions between related parties when there is a defined market that sets the price internationally, as it is the case of commodities[214].

A transfer pricing adjustment is required whenever the "practiced price", i.e., the average price paid by the Brazilian importer, exceeds the "parameter price", i.e., the average price determined under transfer pricing methods for import transactions[215]. Nevertheless, if the practiced price paid by the Brazilian importer is less than the parameter price, no tax adjustment is necessary.

4.1.3.1.2 Transfer Pricing Methods for Export Transactions

Regarding export transactions, Brazilian transfer pricing rules determine that, whenever the average sales price of goods, services or rights exported by a Brazilian company in a taxable year corresponds to less than 90% of the average price of the same goods, services or rights sold in the domestic market, the price of the export transactions shall be defined under one of the five methods established by Brazilian law[216], which are detailed below.

The "Comparable Uncontrolled Price for Export Transactions" (*Preço de Venda nas Exportações – PVEs*), described in Article 19, Paragraph 3, Item I of Law 9,430 and based

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[214] Valadão, *supra* note 197 at 276.
[215] As a consequence of the transfer price adjustment, the excess amount paid will be added to the taxable base of the importer. Miyake and Tonanni, *supra* note 186.
[216] *Ibid*.

on the CUP method, establishes the transfer price according to the average price of identical or similar goods, services or rights exported by a Brazilian company to foreign independent parties, under similar payment conditions[217].

Inspired by the resale price method, Brazilian transfer pricing rules created two methods with the application of fixed profit margins: the "Wholesale Price in the Country of Destination Less Profit Margin" method (*Preço de Venda por Atacado no País de Destino Diminuído de Lucro – PVA*) and the "Retail Price in the Country of Destination Less Profit Margin" method (*Preço de Venda a Varejo no País de Destino Diminuído do Lucro – PVV*), described in Article 19, Paragraph 3, Items II and III of Law 9,430 as follows:

> Article 19. Paragraph 3, Item II: Wholesale Price in the Country of Destination Less Profit Margin Method: defined as the average of the selling prices of identical or similar goods in the wholesale market of the country of destination, under similar payment terms, reduced from the taxes included in the price, charged in that country, and a *profit margin of fifteen percent* on the wholesale price;
>
> Article 19. Paragraph 3, Item III: Retail Price in the Country of Destination Less Profit Margin: defined as the average of the selling prices of identical or similar goods in the retail market of the country of destination, under similar payment terms, less the taxes included in the price, charged in that country, and a *profit margin of thirty percent* on the retail sale price[218].

The "Acquisition or Production Cost Plus Taxes and Profit Margin" method (*Custo de Aquisição ou de Produção Mais Tributos e Lucro – CAP*) is based on the cost plus method and establishes the transfer price of a transactions based on the average acquisition or production costs of the exported products, services or rights, increased by taxes and with a 15% profit margin, calculated on costs and taxes[219].

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[217] *Law 9,430,* Brazil 1996, Article 19, Para 3, Item I.
[218] *Law 9,430,* Brazil 1996, Article 19, Para 3, Item II and III.
[219] *Law 9,430,* Brazil 1996, Article 19, Para 3, Item IV.

As well as in the Brazilian transfer pricing rules for import transactions, Law 12,715 has also introduced a “Quota Price” method (*Preço sob Cotação da Exportação – PECEX*) for export transactions. This method is applied in transactions of commodities between related enterprises and its benchmark is the average price of the daily medium quotes of commodities negotiated in internationally known commodities and future exchanges, adjusted by the applicable premiums and other variables. In cases of absence of a trading price in commodities and future exchanges, prices can be compared to those obtained from independent data sources provided by internationally known research institutes.

Regardless of the method adopted[220], if the average price applied by the Brazilian enterprise in its export transactions (“the actual price”) exceeds the average price obtained under the above-mentioned methods (“the parameter price”), no adjustment is required. When the actual price is lower than the parameter price, Brazilian tax authorities are entitled to perform a transfer pricing adjustment and to add the difference in the price to the taxable base[221].

4.1.4 Peculiarities and Challenges in Brazil’s Transfer Pricing Practices

4.1.4.1 The Use of Predetermined Margins and the Arm’s Length Principle: A Practical Approach Regarding the Lack of Comparables and the Complexity Present in the OECD Methodology

As mentioned above, the idea of a comparability analysis – present in all methods developed at the international level – was only maintained in Brazil for CUP inspired methods: the “Independent Compared Prices” (PIC)[222], the “Comparable Uncontrolled

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[220] If more than one method can be applied, Brazilian Law allows the taxpayer to adopt the method which will result in the lower export price. Miyake and Tonanni, *supra* note 186.
[221] *Ibid*.
[222] According to the PIC method, comparable prices should be sought in transactions involving goods, services or rights, identical or similar, made in the Brazilian or other markets under similar payment terms. *Law 9,430,* Brazil 1996, Article 18, Item I.

Price for Export Transactions" (PVE)[223], the "Quota Price for Imports" (PCI) and the "Quota Price for Exports" (PECEX) methods. As for other transfer pricing methods, there is a departure from the international comparability approach as a consequence of the Brazilian legislator's preference for the predetermination of profit margins in fixed percentage values[224]. The following table describes the Brazilian transfer pricing rules in comparison with the international methods, particularly those provided in the OECD Transfer Pricing Guidelines and in the UN Practical Manual:

Table 1 - Brazilian Transfer Pricing Methods and its International Correspondents

BRAZILIAN TRANSFER PRICING METHODS		**INTERNATIONAL CORRESPONDENT METHODS (OECD TP GUIDELINES AND UN TP MANUAL)**
Import Transactions	*Export Transactions*	
Independent Compared Prices (PIC)	Comparable Uncontrolled Price for Export Transactions (PVE)	Comparable Uncontrolled Price (CUP)
Quota Price for Imports (PCI)	Quota Price for Exports (PECEX)	
Resale Price Less Margin (PRL) *20% and other margins*	Wholesale Price in the Country of Destination Less Profit Margin (PVA) *15% margins*	Resale Price Method
	Retail Price in the Country of Destination Less Profit Margin (PVV) *30% margins*	

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[223] In the PVE method, comparable prices should be sought in transactions involving goods, services or rights, identical or similar, made by the company itself to other customers or by another domestic exporter, during the same period and under similar payment terms. *Law 9,430,* Brazil 1996, Article 19, Para 3, Item I.

[224] As explained by Marcos Aurélio Pereira Valadão (Brazilian Member of the UN Committee of Experts on International Cooperation in Tax Matters), "the methodology introduced by the law listed the traditional transaction methods (Cost Plus Method and Resale Price Method) but denied the use of transactional profit methods (the Profit Split Method and Transactional Net Margin Method) and formulary apportionment. Regarding the CUP Method, for export or imports, the law introduced a methodology that is similar to OECD practices. However, with regard to the Cost Plus Method and Resale Price Method, instead of making use of comparable transactions, the law established fixed margins for gross profits and mark-up". UN Practical Manual *supra* note 3 at 358.

<table>
<tr><td>Production Cost Plus Margin (CPL)
20% margins</td><td>Acquisition or Production Cost Plus Taxes and Profit Margin (CAP)
15% margins</td><td>Cost Plus Method</td></tr>
<tr><td colspan="2" rowspan="2">N/A</td><td>Transactional Net Margin Method (TNMM)</td></tr>
<tr><td>Profit Split Method</td></tr>
</table>

The use of predetermined margins in the Brazilian transfer pricing legislation is considered to be a simplified methodology regarding the application of the ALP[225] because such margins substitute the numbers that would be found through the comparability analysis employed in the OECD approach[226]. Since the determination of the profits and margins that independent parties would have in similar transactions is one of the main difficulties of the ALP[227], the Brazilian solution of establishing predetermined margins seems to have recognized that it would not be possible to acquire this information from either taxpayers or tax authorities[228].

In this context, it is possible to maintain that the adoption of predetermined margins represents a "compromise between the arm's length standard and practicability", especially because the use of such margins is not mandatory[229]. Indeed, in order to lessen Brazilian

[225] Although the Brazilian rules may resemble the formulary apportionment system – particularly because of the use of formulas based on predetermined profit and mark up margins – it is important to elucidate that "the Brazilian methodology is indeed a simplification of the traditional transaction methods, and the worldwide unitary taxation are more like a transactional profit split method. Brazil does not adopt transactional profit methods". Valadão, *supra* note 197 at 282.
[226] *Ibid*.
[227] The determination of profits and margins in these cases require extremely complex calculations, extensive market research and considerable market information, which is not always available at reasonable costs. Schoueri, "Brazil" *supra* note 168 at 63.
[228] Indeed, due to a large number of taxpayers and a relatively modest tax administration, practicality seems to be one of the motors of the Brazilian transfer pricing system. One example is that, because of the complexities of the regular tax system, almost 90% of taxpayers choose to apply a simplified taxation approach, in which the taxable profit is established through the application of predetermined margins to the gross income of the taxpayer, without allowing deductions. Schoueri, "Brazil" *supra* note 168 at 78-79.
[229] Schoueri, "Brazil" *supra* note 168 at 63. In the same sense, Marcos Valadão also understands that the Brazilian methodology is a simplification of the traditional arm's length approach, mainly

transfer pricing rules departure from the ALP[230], the legislator created a procedure for changing the predetermined margins in Article 20 and Article 21, Paragraph 2 of Law 9,430, as it follows:

> Art. 20. In special circumstances, the Minister of Finance may change the percentages referred to in Articles 18 and 19, and Items II, III and IV of Paragraph 3.
>
> Art. 21. [...] Paragraph 2. Margins of profit other than those established in Articles 18 and 19 may be admitted, provided that the taxpayer proves them, based on publications, surveys or reports prepared in accordance with the provisions of this article[231].

Some authors have raised severe criticisms concerning the Brazilian system in the presence of so many rules that move the Brazilian transfer pricing law away from the ALP as established by the OECD Guidelines.. In this regard, Paulo Ayres Barreto understands that "the distance between transfer pricing discipline in Brazil and the regime adopted by the OECD member countries is abysmal", concluding that "there was no incorporation [in the Brazilian legal system] of the arm's length standard with the content attributed to it in Comparative Law"[232]. Another Brazilian author, Ricardo Mariz de Oliveira, argues that Law 9,430 did not fully adopt the ALP because the Brazilian legislator "wanted to

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because of the use of fixed margins for the resale price and cost plus methods. Valadão, *supra* note 197 at 271.

[230] If taxpayers were not allowed to demonstrate that independent parties have different profit margins in similar conditions, Brazilian predetermined margins would assume an absolute and mandatory nature, which could lead to arbitrary parameter prices unrelated to the market reality. Therefore, considering that taxpayers are allowed to demonstrate that unrelated enterprises have different margins than those established in the law, it is possible to conclude that Brazilian transfer pricing rules meet the requirements of the arm's length principle and practicability as well. Schoueri, "Brazil" *supra* note 168 at 64.

[231] *Law 9,430,* Brazil 1996, Article 20 and Article 21, Para 2.

[232] Paulo Ayres Barreto, *Imposto sobre a Renda e Preços de Transferência* (São Paulo: Dialética, 2001) 153.

introduce and introduced much stricter rules, closed in their own criteria"[233]. This perception has been internationally supported as well: analyzing Law no. 9,430 after its promulgation, Alejandro Messineo affirmed that there was no general ALP on which Brazilian transfer pricing rules were based. According to the author, Brazilian rules seemed more like a minimum guarantee of revenue and its application would probably result in conflicts with the OECD and the US transfer pricing provisions[234].

The above-mentioned positions are quite insistent in sustaining that Brazilian rules do not completely embody the ALP. These opinions, nevertheless, are not fully accepted by other authors, who recognize practicality as an important element to be considered in establishing a transfer pricing regime. In this context, Alberto Xavier explains that, although the Brazilian methodology can lead to distinct results than the ALP, its characteristics bring more comfort to the taxpayer than the legal insecurity caused by the international methodology[235]. Similarly, Paulo Bento acknowledges that whereas "there is a clear detriment to the consistency of price determination based on the arm's length standard", Brazilian rules allow for "a greater degree of simplicity and certainty in relation to OECD rules"[236].

The understanding that Brazilian rules are compatible with the ALP is also shared by administrative courts[237] in Brazil, according to two important administrative decisions. In

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[233] Ricardo Mariz de Oliveira, *Fundamentos do Imposto de Renda* (São Paulo: Quartier Latin, 2008) 843.
[234] Alejandro Messineo, "Transfer Pricing in Latin America: New Rules in Mexico and Brazil" (1997) *International Transfer Pricing Journal* 47.
[235] Xavier, *supra* note 164 at 390.
[236] The author adds that "the difficulties involved in determining prices based on the arm's length standard, associated with the Brazilian reality of information scarcity in the public domain and lack of resources for the fiscal authorities, lead us to the realization that a system as the one adopted by the OECD, does not seem feasible in Brazil". Paulo Bento, "As Regras Brasileiras de Preços de Transferência e o Princípio — Arm's Length – Uma Análise Multidisciplinar" (2006) 2 *Revista de Direito Tributário Internacional* 103 at 129.
[237] Judicial courts have not been involved in transfer pricing decisions because most cases resulted from administrative procedures conducted by Brazilian tax authorities in which the result was a notice of tax assessment. Therefore, according to the Brazilian administrative procedure, the taxpayer is allowed to present a defence to this notice of assessment, which is judged by an administrative judge. This administrative judge's decision can be reviewed by the Administrative

the first case, regarding a Taxpayer Consultation Procedure in 2001, the administrative court ruled that there is no contradiction between Article 9 of the OECD Model Treaty – which covers transfer pricing procedures – and Articles 18 to 24 of Law no. 9,430 – which introduced transfer pricing rules into Brazilian domestic law[238]. The second case was presented in 2005 and involved enterprises resident in Brazil and Germany and questioned the relationship between Article 9 of the Brazil-Germany double taxation agreement and the transfer pricing methods established in the Brazilian domestic law. In this circumstance, the Administrative Taxpayer's Council decided that "although the Brazilian law's option for specific closed methods allows, in some cases, that the arm's length price is not achieved, there is no conflict between Article 9 of the double taxation agreement with Germany and the domestic legislation"[239], i.e., Brazilian law did not oppose the ALP but rather adapted its methodology and application to the Brazilian tax system.

4.1.4.2 Location-Specific Advantages

As a developing country with an emerging economy, Brazil offers location-specific market features and factors of production that enable MNEs to achieve a superior financial outcome from the provision of the same product or service in comparison with alternative locations[240]. These location-specific advantages (LSAs) can include access to skilled labor, incentives, market premium, access to growing markets and cost savings[241].

Taxpayer's Council. If not satisfied with this decision, the taxpayer can further appeal to the Superior Chamber of Tax Appeals and, after this instance, it is possible to appeal to judicial courts. Most of the transfer pricing cases, in practice, are decided in the administrative courts because it has lower costs to taxpayers and a final decision can be reached in a shorter period of time. Calich and Rolim, *supra* note 163 at 531-532.

[238] Coordenação-Geral de Tributação da Secretaria da Receita Federal do Brasil, 21 September 2000 (2000) Diário Oficial da União (Brazil).

[239] Conselho Administrativo de Recursos Fiscais (2005) No. 16327.001319/2001-17, Diário Oficial da União (Brazil).

[240] Brazil not only offers low cost manufacturing opportunities to MNEs but it also provides market access to an expanding middle class that is willing to pay a premium price for foreign products. Richard Ainsworth, "Transfer Pricing: UN Guidelines Brazil" (2013) *Boston University School of Law Working Paper No. 13-48* at 1.

[241] Although location advantages and location savings are generally common to MNE's operations in developing countries, in practice, according to the typical transfer pricing methods, the location advantages are allocated associated enterprises in developed countries. Martjin Lange and Paul

According to the ALP – whose main goal is determining which conditions would be agreed between independent parties in comparable transactions – LSAs are only taken into account insofar as independent enterprises would consider them when negotiating and determining the prices of their transactions[242]. Under the Brazilian transfer pricing system, on the other hand, the predetermined profit margins may cause the transfer of the value of the LSAs out of Brazil through the transfer price. This happens because, as the fixed margin method is applied regardless of the cost structures of taxpayers, enterprises with low operating costs face lower tax burdens than identical enterprises with high operating costs[243]. Indeed, this is one of the main weaknesses of the predetermined profit margins approach used by Brazil: the fact that some enterprises may be taxed at profit margins – could be higher or lower – that are not compatible with their real profitability[244].

4.1.4.3 Intangibles

Because of the difficulties in applying the traditional transfer pricing methods to intangible properties, Brazilian law provides special rules on royalties and technical assistance paid to foreign related persons[245]. As mentioned before, Brazil's transfer pricing law expressly excluded royalties for the use of patents, trademarks and know-how as well as remuneration for technical, scientific or administrative assistance paid by a Brazilian enterprise to foreign related persons from its scope[246]. The applicable law for these

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Lankhorst, "The Impact of Location Advantages on the Transfer Pricing of Multinationals: On the Chinese Love for European Designer Handbags and Lower Production Costs in India" (2014) *International Transfer Pricing Journal* 223 at 224.

[242] *Ibid*.

[243] UN Practical Manual *supra* note 3 at 371.

[244] *Ibid*.

[245] Before 2013, cross-border intercompany loans that were registered with the Central Bank of Brazil were not subject to the limitations of Law 9,430, i.e., there were no limits in the interest deductions under the transfer pricing system. However, with the promulgation of Law 12,715 in 2012, cross-border loan transactions contracted with related persons, or with persons located in low-tax jurisdictions or privileged tax regimes are now subject to limitations regarding the interest deduction. Miyake and Tonanni, *supra* note 186.

[246] "Article 18. Para 9. The provisions of this article do not apply to cases of royalties and technical, scientific, administrative or similar assistance, which remain subject to the conditions of deductibility contained in the current legislation". *Law 9,430,* Brazil 1996, Article 18, Para 9.

transactions (Income Tax Regulations – Article 355) establishes that only a fixed percentage – determined by the Brazilian Ministry of Finance – can be deducted as expenses for income tax. In relation to royalties, for instance, the percentage is 5% of the related revenue, regardless of the nature of the transaction in analysis[247].

Royalties and technical assistance payments received by a Brazilian enterprise from a foreign related party, on the other hand, are not mentioned in Brazil's transfer pricing regulations. Thus, this foreign-source income is subject to the Brazilian transfer pricing rules for export transactions.

4.1.5 Conclusion

There is a significant gap between Brazilian domestic transfer pricing law and the international transfer pricing standards, particularly those established by the OECD Transfer Pricing Guidelines and the UN Practical Manual. One of the main reasons for this dissimilarity is that, while the OECD transfer pricing approach aims to identify the arm's length price, Brazilian rules, as it is possible to observe from their development process, have the goal of combating schemes of tax avoidance involving the use of transfer prices[248]. The Brazilian concern with tax avoidance explains why the country chooses to establish parameters that determine maximum margins for deductible expenses on imports and minimum margins on export transactions.

The Brazilian system of predetermined margins focuses on simplicity and practicality as it avoids the need for specific comparables, which is one of the main challenges in the application of the ALP, particularly for developing countries. Indeed, according to the international standards, the application of traditional transfer pricing methods requires the

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[247] "Article 355. Sums of royalties related to the exploitation of patents for invention or use of industrial or trademarks and for technical, scientific, administrative or similar assistance may be deducted as operating expenses up to a maximum of 5% of net sales revenue from product manufactured or sold". *Income Tax Regulations,* Brazil 1999, Article 355.

[248] Therefore, the significant deviations in Brazilian transfer pricing law from the international standards were not created in order to attract more foreign direct investment. Instead, these differences exist because Brazilian transfer pricing rules are an instrument to combat tax evasion and avoidance rather than to attract foreign investments. Calich and Rolim, *supra* note 163 at 552.

obtainability of precise and detailed data to empirically establish the gross profit margin of independent enterprises and this type of information is not always available for taxpayers or tax authorities. In this context, it can be argued that the Brazilian system also "stabilized the expectation of taxpayers with respect to their Brazilian tax liability associated with inter-company transactions"[249], applying the same methodology for all enterprises. Because of its emphasis on practicability, transfer pricing law in Brazil developed a system with low compliance costs to taxpayers and to the tax administration as well, liberating the country's scarce human resources to work on other relevant issues.

One of the Brazilian transfer pricing system's main disadvantages is that some enterprises are taxed at different profit margins – higher or lower – than their real profitability[250]. Because the fixed margin method is applied irrespective of the taxpayers' costs, some relevant concepts such as location savings and market premium, present in the Brazilian economy, may be disregarded by the transfer pricing rules. Besides that, the Brazilian approach can cause economic double taxation[251] in cases where there is no access to authorities to negotiate the relief of double taxation, especially considering that Brazil has reservations in its double taxation agreements on clauses to resolve double taxation situations derived from transfer pricing adjustments.

In general, it is possible to observe that Brazilian transfer pricing rules diverge from relevant aspects of transfer pricing control existent in the international standards. In this sense, it is important to note that the OECD Transfer Pricing Guidelines, although authoritative, are not binding in OECD member countries[252]. For this reason, it is permissible for a non-member country, such as Brazil, to develop a transfer pricing regime

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[249] UN Practical Manual *supra* note 3 at 371.
[250] *Ibid*.
[251] In the transfer pricing case, the double taxation is economic rather than juridical because it is not the same taxpayer that is being doubly taxed, but rather the same economic fact that is being doubly taxed in the sphere of property of two different taxpayers.
[252] A *soft law* approach to the OECD Transfer Pricing Guidelines seems to offer the most appropriate description for these rules, since they are not "law" – which would mean that states are legally bound by it – neither "not law at all" – which would overlook the evidence that countries do comply with the rules, frequently against their self-interest. Allison Christians, "Hard Law, Soft Law, and International Taxation" (2007) 25:2 *Wisconsin International Law Journal* 325.

that is quite dissimilar from the international norm. Therefore, although the country, i.e., Brazil, must consider whether it is worth disregarding all the knowledge accumulated over many years of transfer pricing studies within the OECD, care should be taken in simply transposing international recommendations into its domestic legislation.

4.2 Russia

> *The Russian transfer pricing rules and the Russian tax system continue to evolve in response to the increasing integration of Russia into the world economy. (...) It can be expected that the Russian approach will continue to evolve in the future closer to the OECD Transfer Pricing Guidelines. However, the practical implementation will still likely have distinct features of the Russia legal system, and is unlikely to be 100 per cent identical to the approaches suggested by the OECD Transfer Pricing Guidelines*[253].

4.2.1 Introduction

The fall of communism in Russia completely transformed the country's economic and business environment. With the exposure of Russia to the forces of globalization, predetermined regulated prices were replace by free market reforms, foreign trade was opened up and no longer monopolized by the government and a modern tax system was introduced in the country[254].

In this context, transfer pricing assumed a greater importance, the first rules being enacted in 1991, which were replaced by a new transfer pricing law in 2012. This new law represented an attempt to bring Russian transfer pricing rules closer to the OECD Transfer Pricing Guidelines, introducing the ALP – modeled after Article 9 of the OECD Model

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[253] Andrey Shpak, "Transfer Pricing Disputes in the Russian Federation" in Eduardo Baistrocchi and Ian Roxan, eds, Resolving Transfer Pricing Disputes (Cambridge: Cambridge University Press, 2015) 555 at 580.
[254] *Ibid* at 555.

Treaty – into Russian tax law. At that time, Russia was negotiating to become a member of the World Trade Organization (WTO) and of the OECD[255], and compliance with international transfer pricing standards was an important aspect in its accession negotiations, especially with the latter[256].

At present, transfer pricing is one of the most popular topics among tax specialists in Russia, especially considering the major relevance of commodities for the Russian economy[257]. This section covers the following topics: a) historical background of transfer pricing rules in the Russian Federation; b) current transfer pricing rules in Russia; and c) peculiarities and challenges in Russian transfer pricing practice.

4.2.2 Historical Background: The Development of Transfer Pricing Rules in the Russian Federation

Until 1991, when Russia – as part of the Soviet Union – was still a socialist economy, the manipulation of transfer prices was not a concern because, in the Soviet system, prices were controlled by the government and, furthermore, the public finance system was developed to centralize and redistribute all the profits that were not immediately necessary

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[255] The Russian Federation has become a member of WTO in August 2012. Regarding the OECD, Russia has made an official request for the organization's membership in 1996 and, in 2007, the OECD Council at Ministerial level adopted a resolution to open discussions concerning the country's accession. OECD, *The Russian Federation and the OECD*, Organisation for Economic Co-operation and Development online: < *http://www.oecd.org/russia/therussianfederationandtheoecd.htm*>.

[256] During the period Russia was drafting its new transfer pricing rules, the OECD Secretary-General, Angel Gurría, noted that the proposed law would "bring Russia into alignment with the internationally accepted OECD standards, thereby providing more legal certainty, a reduced risk of double taxation and a more investment-friendly business environment for multinational enterprises". In this context, the Secretary-General also affirmed that he was "pleased to see that the Russian Federation is upgrading its legal framework in the area of transfer pricing in order to bring it in line with leading international practice". Evgenia Veter, Henrik Hansen and Rusian Radzhabov, "Russia: New Transfer Pricing Rules" (2011) 18:5 *International Transfer Pricing Journal.*

[257] Alexey Besfamilnyy, "The concept of transfer pricing system in Russian Federation" (2016) 3 *Statistika i Ekonomika* 10 at 10.

for the enterprise[258]. This apparent irrelevance of transfer pricing in the Russian Federation changed with the fall of communism in 1991 and the consequent adoption of a free market economy. Therefore, in December 1991, a Western-inspired tax system was established in Russia, which, among other provisions, introduced in Article 4(1) the possibility to adjust the tax base of companies based on market prices[259]. According to this provision, taxpayers selling products or performing services at prices below cost had to calculate the VAT tax based on the market prices for similar transactions, but never less than the actual cost[260].

One problem with these transfer pricing rules was that they were usually applied without considering the actual circumstances of a transaction, not distinguishing between taxpayers who were manipulating transfer prices for tax purposes and those who, acting in good faith, had to sell below costs because of a damaging market situation[261]. Moreover, tax experts argue that the 1991 Russian tax system as a whole was not efficient, having a great number of isolated laws as well as ambiguous and conflicting provisions[262]. For this reason, in 1999, the Russian Federation developed a new Tax Code, which remains in force today.

4.2.2.1 The Russian Tax Code: Transfer Pricing Rules from 1999 to 2011

The Tax Code represented a codification of the principles existent in the previous Russian tax system and a transition of the country to a tax system based on the rule of law, establishing more precise boundaries for government authorities in determining tax liabilities and interpreting statutes[263]. With respect to transfer pricing, the Tax Code, in its Articles 20 and 40, introduced more comprehensive rules enabling tax authorities to adjust

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[258] Considering that 90% of Russian total government revenue was from payments collected from state-owned enterprises, there was an almost complete government control over transfer prices. Shpak, *supra* note 242 at 557.

[259] *Law no. 1992-1 on Value Added Tax*, Russian Federation 1991, Article 4(1).

[260] *Law no. 1992-1 on Value Added Tax*, Russian Federation 1991, Article 4(1).

[261] Shpak, *supra* note 242 at 558.

[262] Shpak, *supra* note 242 at 558.

[263] The main principles of the Russian tax system included: the obligation for everyone to pay the legally established taxes; no retroactive effect for laws creating new taxes; no discriminatory elements in imposing taxes. *Ibid* at 559.

prices for tax reasons. These rules "were originally intended to be a temporary compromise between rudimentary provisions that existed prior to that (the 'sales below cost' rules) and OECD-type rules"[264]. As a result, although the Tax Code rules were based on the ALP, there were considerable deviations from the OECD Transfer Pricing Guidelines in terms of definitions and procedures.

First of all, the transfer pricing rules of the Tax Code were used by tax authorities as anti-avoidance measures, covering not only transactions between associated parties, but also transactions between unrelated enterprises, under specific circumstances[265]. Article 40.2 authorized the transfer pricing administration to check the proper use of prices in the following circumstances: a) transactions between interdependent persons; b) goods exchange (barter) transactions; c) foreign trade transactions; and d) if there was a fluctuation of more than 20 per cent in the prices practices by the taxpayer for identical or similar goods or services over a short period of time[266].

The scope of transactions covered by the transfer pricing rules effective during this period was also significantly narrower as compared to the OECD Transfer Pricing Guidelines. Only prices referring to payments for products or services were subject to Russian transfer pricing control. Consequently, interest – not being a payment for goods or services – was exempt from transfer pricing rules. Accordingly, Russian courts tended to maintain the idea that prices for intangible property, such as royalty or shares in Russian companies, could not be adjusted for tax purposes[267].

The Tax Code also established a "20 per cent safe-harbor deviation", according to which tax authorities could only adjust the price of controlled transactions for tax purposes if they

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[264] *Ibid* at 560.
[265] In this regard, the transfer pricing rules present in the Russian Tax Code deviated from the OECD Transfer Pricing Guidelines (according to which the main goal is to identify the price that would have been agreed between independent enterprises (see OECD Transfer Pricing Guidelines, *supra* note 8 at 31) and are more similar to the Brazilian rules, which were introduced as mechanisms to reduce tax avoidance schemes.
[266] *Tax Code*, Russian Federation 1999, Article 40(2).
[267] Shpak, *supra* note 242 at 561.

could prove that the price practiced by the taxpayer was different from the market price[268] by more than 20 per cent as prescribed in Article 40(3):

> In the instances envisaged by clause 2 of this Article where the prices of goods, work or services which are applied by the parties to a transaction deviate upwards or downwards by more than 20 per cent against the market price of identical (homogeneous) goods (work and services), the tax authority shall have the right to issue a substantiated decision to charge additional tax and penalties calculated as if the results of that transaction had been assessed on the basis of market prices for the goods, work or services in question[269].

Considering that this 20 per cent 'safe-harbor' was not reproduced in Russian tax treaties[270], there were discussions about which norm should be applied: the treaty provisions or Article 40(3) of the Russian Tax Code. This debate took place because, since the main goal of tax treaties is to ameliorate or eliminate double taxation by limiting countries' tax jurisdictions[271], it could be assumed that the tax authorities could not apply tax treaty rules that are less favourable for the taxpayer than the domestic provisions[272]. Indeed, although Article 9 of the OECD Model Treaty allows the adjustments to the taxable income of associated enterprises when the prices between the two companies differ from those that would have been stipulated between independent companies, the method used for these

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[268] "The market price of a good (work, service) shall be understood to be the price prevailing on the basis of the interaction of supply and demand on the market for identical (or, where these do not exist, homogeneous) goods (work, services) under comparable economic (commercial) conditions". *Tax Code*, Russian Federation 1999, Article 40(4).

[269] *Tax Code*, Russian Federation 1999, Article 40(3).

[270] Russian tax treaties usually follow the OECD Model Treaty, using also some provisions of the UN Model Convention in the treaties with some of its tax partners. Danil Vinnitskiy, "Russia" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 81 at 84.

[271] Rebecca Kysar, "Interpreting Tax Treaties" (2016) 101:4 *Iowa Law Review* 1387 at 1393.

[272] Vinnitskiy, *supra* note 239 at 102.

adjustments needs to be prescribed in the domestic laws of the country in which the transfer pricing changes are made[273].

Only the three traditional transaction transfer pricing methods were allowed to be applied: the comparable uncontrolled price (CUP) method, the resale price method and the cost plus method. These methods were required to be used in the exact order as they were listed and, in order to use the next method, it was necessary to prove that the previous one either was impossible to be applied or did not allow the establishment of a fair market price[274].

4.2.2.2 Post-2012 Transfer Pricing Rules

On July 2011, the Russian Parliament approved a new transfer pricing law in an effort to bring Russian transfer pricing rules closer to the OECD Transfer Pricing Guidelines. This reform, described as the biggest change in Russian tax law since the enactment of the Tax Code, introduced a variety of amendments to Russian tax law, such as the application of the ALP and the removal of the so called "safe-harbor provision" in transfer pricing[275]. As declared by the Russian government, the main purpose of this new law was to combat tax avoidance through the use of transfer prices[276]. This convergence towards OECD's international standards on transfer pricing was enacted in a moment when the Russian economy was not in its greatest position, representing an effort to attract more foreign business and investments to the country[277]. The next section discusses details of these new rules.

4.2.3 Transfer Pricing Rules in the Russian Federation

With effect from January 2012, Russia has included new transfer pricing rules applicable to both domestic and international transactions in Chapters 14.1 to 14.6 (Tax Control) of

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[273] *Ibid* at 103.
[274] *Tax Code*, Russian Federation 1999, Article 40(3).
[275] Aleksei Hanninen, "To what extent business restrucuturing fall within the scope of transfer pricing regulations in Russia" (2015) 43:11 *Intertax* 742 at 743.
[276] Shpak, *supra* note 242 at 563.
[277] "Transfer Pricing Brings Russia onto The World Stage" (2009) 19 *International Tax Review* 20.

the Russian Tax Code[278]. Articles 20 and 40 of the Russian Tax Code continue to be applied regarding transactions, income and expenses reported by taxpayers prior to the entry of the new transfer pricing law into force[279].

4.2.3.1 Arm's Length Principle

The previously accepted 20 per cent safe harbor rule was replaced by a market price/profit range, expanding the extent of transactions between related parties potentially covered by transfer pricing controls:

> As this market price/profit range will serve as a safe harbor, the essence is to establish the lower and upper quartiles as any actual price charged or profitability level achieved by a taxpayer will be deemed to be in line with market values (i.e. arm's length) and therefore will not be subject to adjustment, assuming of course that the tax authorities agree with the taxpayer's general characterization of the related parties, the intercompany transaction and the transfer pricing method and data applied[280].

Regarding the sources of information, the previous rules provided in the Russian Tax Code required the use of "official sources" of information in identifying the market price of a transaction. Although the term "official sources" was not properly defined in the Tax Code, according to court cases and other documents issued by Russian tax authorities, this requirement meant that only Russian data were accepted[281]. The new transfer pricing law, on the other hand, has allowed the use of foreign data in establishing the arm's length price; however, Russia data is still the first priority[282].

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[278] The new transfer pricing rules were introduced by Federal Law no. 227-FZ ("On amendments to certain legislative acts of the Russian Federation relating to the development of the Rules for Price Determination for Taxation Purposes") approved in July 18 2011 and entered into force in January 1 2012.
[279] "Transfer Pricing Brings Russia onto The World Stage" (2009) 19 *International Tax Review* 20.
[280] Veter, Hansen and Radzhabov, *supra* note 245..
[281] *Ibid*.
[282] *Ibid*.

4.2.3.2 Scope of Application of the Transfer Pricing Rules

Russian transfer pricing rules can be applied to transactions between related entities and, under certain circumstances, between unrelated parties as well. Therefore, all cross-border transactions between related parties[283] are covered by transfer pricing rules. Domestic transactions between related parties can only be controlled if the revenues generated in such transactions in a calendar year exceed a certain amount (in 2014, the amount was approximately $33 million; however, lower thresholds are established for mineral extraction and entities using beneficial tax regimes). Other than that, transactions between unrelated parties are only subject to transfer pricing rules when they are made with regard to certain traded commodities or with residents of listed low-tax jurisdiction, both subject to the threshold of $2 million in a calendar year[284]. In this context, Joint Resolution of the Supreme Court no. 9 of June 1999 emphasized that Russian transfer pricing control can only be applied to the four types of transactions expressly listed in the law[285].

Additionally, Russian courts are allowed to consider a transaction controlled, and consequently subject it to transfer pricing control, when the referred transaction does not meet the above-mentioned criteria due to conditions artificially created by taxpayer[286].

4.2.3.3 Transfer Pricing Methods

The new transfer pricing law expands the number of methods used for determining the arm's length price of controlled transactions, allowing five methods to be used by tax authorities and taxpayers: a) comparable uncontrolled price (CUP) method; b) resale price method; c) cost plus method; d) transactional net margin method (TNMM); and e) profit

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[283] "The rules provide an extensive list of what constitutes a "related party", including: a) legal entities if one (in)directly has a participation of 25% in the other; b) an individual and a legal entity if the individual (in)directly has a participation of 25% in the legal entity; c) two legal entities if a third legal entity (in)directly has a participation of 25% in both of them; and d) legal entities where not less than 50% of the directors are appointed by the same individual." Tatiana Kogut, *Russia - Corporate Taxation* sec. 7, Country Surveys IBFD.
[284] *Ibid*.
[285] Shpak, *supra* note 242 at 573.
[286] Veter, Hansen and Radzhabov, *supra* note 245.

split method. In this context, Russian transfer pricing rules followed the methods prescribed in the OECD Transfer Pricing Guidelines. Nevertheless, the new law maintained the notion of hierarchy of methods, treating the CUP method as the preferred methodology, so tax authorities and taxpayers can only choose other methods when the CUP method cannot be applied. The only exception is when a company purchases goods from a related party and resells them to independent parties; in this case, priority is given for the resale price method[287].

4.2.4 Peculiarities and Challenges in Russia's Transfer Pricing Practices

The new Russian transfer pricing rules were designed to bring the country's international taxation practices closer to the standards adopted by the OECD and by other jurisdictions with older and more developed tax systems. In this sense, although the new transfer pricing law is closer to the OECD Transfer Pricing Guidelines – particularly in comparison with the country's previous transfer pricing system – this does not mean that these provisions will be interpreted in the same way as they would be according to the OECD transfer pricing approach. Indeed, Russia is not a member of the OECD and, for this reason, the country is not obliged to follow by the OECD Transfer Pricing Guidelines[288]:

> The current transfer pricing provisions of the Russian Tax Code correspond to the OECD Transfer Pricing Guidelines' provisions to a great extent – at least compared to the previous regulations. As mentioned earlier, the Tax Code's new rules are also widely based on the OECD's Transfer Pricing Guidelines. Nonetheless, Russia is not an OECD Member State, and Russian tax authorities, as well as courts making decisions on tax matters,

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[287] Adam Kosmala, Andrew Joshi, Ilarion Lemetyuynen and Svetlana Stroykova, "Russia: Overview of Russia's new transfer pricing rules" (2012) *International Tax Review*.

[288] Even though Russia is not a member of the OECD, it is influenced by OECD Transfer Pricing Guidelines and other tax treaty models. In December 2007, the Ministry of Finance of the Russian Federation initiated discussions with OECD officials regarding the possibility of Russia becoming an OECD member country. Nevertheless, at present, Russia maintains an observer status in some OECD committees.

> are not obliged to follow the OECD Transfer Pricing Guidelines. Therefore, it should be noted that, while the OECD Transfer Pricing Guidelines may provide interpretive help in situations where the Tax Code's transfer pricing rules are ambiguous and difficult to apply in practice, there is no surety of that the tax authorities would interpret the unclear provisions in accordance with the OECD Transfer Pricing Guidelines[289].

Furthermore, Russia still deviates from the OECD approach in significant ways in its new rules[290]. For instance, the Russian Tax Code subjects, under certain circumstances, cross-border transactions between unrelated persons to transfer pricing controls, treating these transactions as controlled, which is not prescribed in the OECD guidelines and not common in most OECD members. Also, contrary to what is prescribed in the OECD Transfer Pricing Guidelines, Russia transfer pricing law establishes a formal hierarchy in the application of the methods for determining the arm's length price of controlled transactions.

4.2.4.1 Intangibles

The majority of Russia's transfer pricing provisions refer to transactions involving goods, works and services. As a result, some tax experts argue that, according to the interpretation of Russian courts of the terms 'goods, works and services', the new transfer pricing rules do not cover interest, royalties as well as any other transactions involving intangible property:

> According to the Tax Code, transfer pricing regulations are applied only to related party transaction where commodities, services and/or work are being transferred from one related party to another. As interpretation of Russian law and overall judicial discretion in Russia are based on legal norms in essence, it is very difficult to validate an argument according to which

[289] Hanninen, *supra* note 264 at 754.
[290] Kosmala, Joshi, Lemetyuynen and Stroykova, *supra* note 276.

> transfer of intangibles assets would fall within the scope of transfer pricing regulations[291].

On the other hand, there are more generic references in Russia's transfer pricing law that may lead to a different interpretation regarding intangible assets. In this context, the Russian Ministry of Finance has claimed in a published written clarification that "both royalties and interest should also be included in the scope of transfer pricing rules (as well as any other transaction that has an impact on the tax base)"[292]. Although the Ministry of Finance's written clarification is not legally binding but rather informative – taxpayers and tax authorities do not have to follow its arguments – it is a helpful interpretive guideline regarding Russian transfer pricing provisions[293].

Therefore, taxpayers usually comply with the Ministry of Finance's clarifications because it is difficult to forecast when Russian tax authorities will follow this understanding or not.

4.2.5 Conclusion

Russian transfer pricing rules have evolved alongside the country's increasing integration into the world economy. In this respect, it is possible to observe that, in conjunction with Russia's efforts to become a member of the OECD, its transfer pricing rules have also been transformed in order to resemble the practices of more developed jurisdictions and those recommended in the OECD Transfer Pricing Guidelines. Although Russia's new transfer pricing law may minimize the risks of double taxation and reduce the compliance burden for MNEs operating in the country, there are still some peculiarities in its practices, particularly those developed in Russian courts under the Tax Code.

Nonetheless, in comparison with the other BRICS, Russia seems to be the country most aligned with the OECD standards regarding transfer pricing. Indeed, either because its transfer pricing rules are fairly recent and still under development or because of a

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[291] Hanninen, *supra* note 264 at 743.
[292] Shpak, *supra* note 242 at 563.
[293] Hanninen, *supra* note 264 at 745.

compromise with the OECD's standards, Russia was the only country among the BRICS that did not have a representative participating in the UN Committee of Experts on International Cooperation in Tax Matters, which was responsible for the UN Practical Manual on Transfer Pricing for Developing Countries[294].

4.3 India

In the case of Transfer Pricing, although it is governed by domestic legislation of each country, the OECD countries have agreed on a common transfer pricing guidelines known as OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. These guidelines on transfer pricing only reflect the agreements amongst Government of those countries that are members of OECD (developed countries) and accordingly tend to take care of interest of only developed countries. The guidelines do not give right of taxation to source countries accordingly eroding taxing rights of developing countries[295].

4.3.1 Introduction

The increasing participation of MNEs in economic activities in India, due to the country's robust economic growth and consumer base, has given rise to complex challenges in determining the transfer price of transactions between associated enterprises. In light of these difficulties, India introduced in 2001, through Sections 92A to 92F of the Indian Income Tax Act, comprehensive transfer pricing legislation, in which the country established mechanisms for determining reasonable arm's length prices and profits

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[294] In the United Nations Practical Manual on Transfer Pricing for Developing Countries, administrative practices of Brazil, China, India and South Africa as well as its peculiarities regarding transfer pricing interpretations and regulations – particularly in relation to OECD's approaches – are explained by representatives of these countries.

[295] Sanjay Kumar Mishra, Joint Secretary and Permanent Representative of India to the United Nations, in "Letter to the United Nations Conveying Government of India's Views on the Advance Unedited Version of the Report on the Work of the Committee of Experts on International Cooperation in Tax Matters" (2012).

regarding controlled transactions. Since the introduction of this law, transfer pricing has become the most important international tax issue affecting MNEs conducting their business in India[296], especially because, although Indian transfer pricing rules are broadly based on OECD guidelines, they also deviate in some respects.

This section provides an overview on transfer pricing rules in India, focusing on the challenges found by the country in applying the ALP and on the practical solutions it applies. Therefore, this section is structured as follows: a) historical background of Indian transfer pricing rules; b) transfer pricing regulations in India; and c) peculiarities and challenges in India's transfer pricing rules and practices, particularly those concerning comparability analysis, location-specific advantages and intangible assets.

4.3.2 Historical Background

Until 1991, India's economy was highly regulated, having elevated tariffs and a series of exchange controls and obstacles to the process of integration with the world market[297]. Due to the country's economic isolation, although the erosion of its tax base through the manipulation of the prices of goods and services was a possibility, the low number of cross-border transactions made the risk of transfer pricing abuse low[298]. Nevertheless, since 1991, with the liberalization of trade and foreign exchange policy, India has been working on the promotion of foreign investment and technical collaboration in order to grow in productivity and achieve higher international competitiveness through the advantages of

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[296] PwC, "International Transfer Pricing 2015/2016", PwC Network, online: <www.pwc.com/ internationaltp>.

[297] Although India had already been through economic reforms in the 1980s, the 1990s reforms were systematic and systemic, representing a broad acceptance of the idea that entrepreneurs should be given priority over the government in the conduct of economic activity and that economic interventions from the government should be made only with proper justification and not by default. Wanda Tseng and David Cowen, *India's and China's Recent Experience with Reform and Growth* (New York, Palgrave Macmilan, 2005).

[298] Mukesh Butani, "Transfer Pricing Disputes in India" in Eduardo Baistrocchi and Ian Roxan, eds, Resolving Transfer Pricing Disputes (Cambridge: Cambridge University Press, 2015) 584 at 585.

technology and marketing expertise transfers[299]. As the inflow of foreign direct investment to India increased[300], Indian tax authorities became more concerned with the possibilities of transfer pricing abuse generated by the growth in the number of international transactions.

Therefore, in 1999, the Indian government created an Expert Group to study global transfer pricing practices and develop a framework for India's transfer pricing law[301]. The Expert Group considered the laws of several countries and especially the OECD Transfer Pricing Guidelines in drafting recommendations for India's transfer pricing rules[302], which were the basis for the legislation subsequently enacted in 2001. Thus, in April 2001, India's Parliament enacted new provisions to the Indian Income Tax Act from 1961[303], introducing with the "Finance Act" the first legislation establishing India's comprehensive transfer pricing regime. According to the Finance Bill Explanatory Memorandum, the legislation was created to control transfer pricing abuse and to prevent the erosion of Indian tax revenues:

> The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the

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[299] Samir Gandhi, Minal Sharma and Rakesh Alshi, "Transfer Pricing Rules and Practice in India" (2010) 39:7 *Tax Management International Journal* 371.
[300] "The cumulative amount of FDI has amounted to US$153,209 million from August 1991 to March 2011. In the financial year ending 31 March 201, the figure for FDI has been US$20,304 million. Butani, *supra* note 287 at 585.
[301] Gandhi, Sharma and Alshi, *supra* note 288.
[302] Even though India is not a member of the OECD, the Expert Group gave great importance for the OECD Transfer Pricing Guidelines mainly because most of India's trading partners are OECD member-countries. Gandhi, Sharma and Alshi, *supra* note 288.
[303] Before 2001, the Indian Income Tax Act, in its Section 92, contained provisions allowing tax authorities to determine an appropriate transfer price in cases where the tax administrators believed that the prices were not appropriate due to the close connection between the parties. In these cases, the assessing officer was able to estimate the reasonable profit for the Indian resident party. Nonetheless, this provision was not found to be effective in controlling the manipulation of transfer prices and, for this reason, it was replaced by the new provisions that came into effect in 2001. Pradeep Gupta, "Transfer Pricing: Impact of Taxes and Tariffs in India" (2012) 37: 4 *Vikalpa* 29 at 43.

> same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby leading to erosion of tax revenues. With a view to providing a statutory framework which can lead to the computation of reasonable, fair, and equitable profits and tax in India in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income Tax Act[304]

Hence, the legislators' idea behind the Finance Act was to provide a statutory framework that could facilitate the determination of a reasonable, fair and arm's length transfer price for controlled transactions[305].

4.3.3 Transfer Pricing Rules in India

4.3.3.1 The Arm's Length Principle

As mentioned above, the Indian comprehensive transfer pricing legislation was introduced in the form of Chapter X – sections 92 to 92F – of the Indian Income Tax Act. These transfer pricing regulations were further elucidated in rules 10A to 10E of the Indian Income Tax Rules. The Income Tax Act and the Income Tax Rules relate to the determination of income from an international transaction having regard to the arm's length price; the concept of associated enterprise; the concept of information and documents; and other important transfer pricing definitions.

According to Section 92.1, "any income arising from an international transaction shall be computed having regard to the arm's length price"[306]. The Section further specifies that, in

[304] Paragraph 176 of the Budget Speech: 2001 (248) ITR 34 Statues as cited in Har Govind, "Transfer Pricing" (2003) 9:1 *Asia Pacific Tax Bulletin* 14.
[305] Butani, *supra* note 287 at 588.
[306] The Section also clarifies that the allowance for any expense or interest arising from an international transaction shall also be determined according to an arm's length price. *Income Tax Act,* India 1961, Section 92.1.

an international transaction between two or more associated enterprises, when there is a mutual agreement or arrangement for the allocation of any contribution, any cost or expenses in connection with a benefit, service or facility provided to any one of such enterprises, the allocation of costs and expenses shall be established having regard to the arm's length price of such benefit, service or facility[307]. Likewise, the price received for services rendered to associated enterprises must also be determined based on the arm's length standard[308]. From these provisions, it is possible to observe that the foundation for transfer pricing rules in India is the ALP. Accordingly, the Indian transfer pricing assessing officer has extensive powers to establish what is the arm's length price for the above-mentioned transactions and to make adjustments for the computation of income[309].

4.3.3.2 The Concept of Associated Enterprise International Transactions

Section 92A defines that enterprises are "associated enterprises" when one enterprise is controlled by the other or when both enterprises are controlled by a common third person[310]. The concept of control in Indian transfer pricing law is not limited to control through holding shares or voting power, but it is also extended to control through debt, blood relationships and management over a series of components of the business activity performed by the taxpayer, such as power over raw materials, sales and intangibles[311].

Section 92B provides the meaning for "international transaction", which is basically defined as a cross border transaction between associated enterprises regarding any property – tangible or intangible – as well as the provision of services, lending or borrowing of money or any other transaction having a bearing on the profits, income, losses or assets of such enterprises[312]. According to Sub-section (2) of Section 92B, the scope of the definition

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[307] *Income Tax Act,* India 1961, Section 92.2.
[308] *Income Tax Act,* India 1961, Section 92.2.
[309] In cases where the application of the arm's length principle decreases the tax incidence in India, these provisions are not applicable. Gupta, *supra* note 292 at 43-44.
[310] *Income Tax Act,* India 1961, Section 92A.
[311] *Income Tax Act,* India 1961, Section 92A.
[312] *Income Tax Act,* India 1961, Section 92B.

of international transaction is also extended to "deemed to be international transactions", which are transactions between unrelated persons where there is a prior agreement in relation to the transaction between such person and an associated enterprise or when the relevant terms of the transaction are determined by the associated enterprise[313]. Even though no international transactions or industries are excluded from the possibility of a transfer pricing investigation, recently, the focus of Indian transfer pricing officers have been the software development, business process outsourcing banking, telecommunications, pharmaceutical and automobile industries[314].

As transfer pricing provisions are only applied to the general concept of "international transactions", there have been several cases in India discussing the meaning of such expression. Under the decided cases, the common understanding is that two requirements must be met so a transaction is considered an international transaction: first, the transaction must have occurred between associated enterprises and, second, one of the associated enterprises must be non-resident in India[315].

4.3.3.3 Transfer Pricing Methods

The Indian Income Tax Act, in Section 92C, provides six methods for the determination of the arm's length price regarding an international transaction: a) comparable uncontrolled price (CUP) method; b) resale price method; c) cost-plus method; d) profit split method; e) transactional net margin method (TNMM); and f) any other method as may be prescribed[316]. As Indian law does not establish a hierarchy in the selection of the methods, the method that is best suited to the facts and circumstances and that provides the most

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[313] *Income Tax Act,* India 1961, Section 92B.
[314] PwC, "International Transfer Pricing 2015/2016", PwC Network, online: <www.pwc.com/ internationaltp>.
[315] D.P. Sengupta, "India" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 115 at 152.
[316] According to Pradeep Gupta, until 2012, no other method has been prescribed by Indian tax authorities. Gupta, *supra* note 292 at 44.

reliable measure of an arm's length result is the one that should be adopted[317], as prescribed in Section 92C:

> The arm's length price in relation to an international transaction or specified domestic transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely: (*a*) comparable uncontrolled price method; (*b*) resale price method; (*c*) cost plus method; (*d*) profit split method; (*e*) transactional net margin method; (*f*) such other method as may be prescribed by the Board[318].

In addition to the above methods, the taxpayer can establish the arm's length price regarding an international transaction using any other method as long as it takes into account the price that would have been charged or paid for the same or similar uncontrolled transaction, with or between associated enterprises, under similar circumstances[319]. Furthermore, transfer pricing provisions will not be applied when the application of the ALP would result in a downward adjustment in the income taxable in India[320].

4.3.4 Peculiarities and Challenges in India's Transfer Pricing Practices

According to Sanjay Mishra, member of the United Nations Subcommittee on Transfer Pricing, over the past fifteen years, Indian tax authorities have witnessed several challenges in the administration of transfer pricing law, with transfer pricing audits causing numerous

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[317] There have been numerous cases concerning whether the application of a particular method was appropriated to the facts and circumstances of the case; however, both taxpayers and Indian tax authorities seem to have chosen the transnational net margin method (TNMM) as the most suitable, since this is, by far, the most used method. Sengupta, *supra* note 304 at 152.
[318] *Income Tax Act,* India 1961, Section 92C.
[319] Shreyas Shah, *India - Corporate Taxation* sec. 7.2, Country Surveys IBFD.
[320] PwC, "International Transfer Pricing 2015/2016", PwC Network, online: <www.pwc.com/internationaltp>.

disputes and litigation[321]. Services rendered by Indian subsidiaries or Indian branches of multinational companies to its foreign affiliates, for instance, have been thoroughly examined by Indian transfer pricing officers in order to establish the appropriate level of compensation received by the Indian taxpayer[322]. This section focuses on some of these transfer pricing issues and challenges in the implementation of the ALP in India.

4.3.4.1 Challenges Regarding Comparability Analysis and Adjustments

Comparability is a key feature for the Indian Tax Administration in establishing the arm's length price of international transactions[323]. Indian transfer pricing rules provide that an uncontrolled transaction is comparable to an international transaction when the dissimilarities between the two will not substantially affect their prices or profits or when reasonably precise adjustments can be made to eliminate the outcomes of such dissimilarities[324]. To the extent possible, Indian transfer pricing administration maintains that local Indian comparables should be used and generally does not accept the use of foreign comparables[325]. However, due to the increasing market unpredictability and complexity in intra-group international transactions, India has been facing several challenges in its comparability analysis[326], particularly regarding the evaluation of risks.

Since the basis of any comparability analysis, according to Indian transfer pricing administration, consists in a "comparison of functions performed, assets employed and

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321 UN Practical Manual *supra* note 3.

322 In many of these cases, the Indian transfer pricing officer determined that the Indian taxpayer was not compensated according to the arm's length principle and, for this reason, adjustments were necessary. Gandhi, Sharma and Alshi, *supra* note 288.

323 This is a contrary position to the Brazilian approach, where the comparability analysis is basically replaced by predetermined fixed margins. See the Section "Brazil".

324 Gandhi, Sharma and Alshi, *supra* note 288.

325 PwC, "International Transfer Pricing 2015/2016", PwC Network, online: <www.pwc.com/ internationaltp>.

326 The problem of the lack of comparables and the problem of comparability adjustments, according to David Spencer, are some of the main difficulties of developing countries regarding transfer pricing regulations and the application of the arm's length standard. See Spencer, "BRICS, BEPS and the UN Manual Part 1" *supra* note 65 at 38.

risks assumed", the country's practice is to evaluate the risks of an associated enterprise in combination with its functions and assets[327]. Essentially, India's tax authorities understanding is that the effective risks[328] assumed by an Indian subsidiary must be given its due importance in determining the arm's length price of an international transaction.

One central problem experienced by India is that MNEs claim that Indian subsidiaries engaged in contract services – especially in research and development – are "risk-free" entities and, for this reason, are entitled to low cost plus remuneration[329]. In such cases, the Indian Tax Administration does not agree "with the notion that risk can be controlled remotely by the parent company and that the Indian subsidiaries or related party engaged in core functions, such as carrying out research and development activities or providing services are risk free entities"[330]. Indeed, in many circumstances, MNE's core functions of performing research and development activities or providing services are located in India, which involves the making of critical strategic decisions – regarding, for instance, the designing of a product or software or the monitoring of research activities – by the management and employees of Indian subsidiaries[331]. Consequently, the Indian subsidiary has control over the operational activities and other risks, while the parent company has a more limited control over risks remotely located[332].

As the margin earned by the above-mentioned "risk-free" Indian subsidiaries cannot be compared with other independent enterprises' margins – because there would be a

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[327] UN Practical Manual *supra* note 3 at 584.
[328] India's approach to risk adjustments is more focused on the reality of the MNE as an economically integrated group as opposed to the OECD Transfer Pricing Regulations, which seem to give more importance to legal structures, such as contractual risk allocations.
[329] A great number of MNEs have established captive outsourcing units in India that perform services such as research and development, software development, call centres and other outsourced services. These units generally operate on a cost plus mark-up basis, which means that the associated enterprises pay the Indian subsidiaries a "mark-up over the total operating costs incurred by the unit". Butani, *supra* note 287 at 623.
[330] UN Practical Manual *supra* note 3 at 391.
[331] *Ibid* at 584.
[332] *Ibid* at 585.

discrepancy between the risks undertaken by them[333] – economic adjustments to account for the differences in risk profiles are usually necessary. In this context, Indian transfer pricing law require "reasonably accurate comparability adjustments"; nevertheless, "the Indian transfer pricing administration finds it difficult to make risk adjustments in the absence of any reliable, robust and internationally agreed methodology to provide risk adjustment"[334].

Case law involving issues in transfer pricing and enterprises' risks assessment demonstrate how this is a controversial matter in Indian transfer pricing law. In *Li and Fung India Pvt v. CIT*[335], for example, the taxpayer company was resident in India and was a wholly-owned subsidiary of a Mauritius company, providing sourcing services to an associated enterprise. The associated enterprise entered into services contracts with third-party customers and subcontracted the work to the taxpayer, which was remunerated at a cost plus 5 percent mark-up (claiming it was a *low risk* service provider performing limited functions with minimal risks). The Indian tax authorities recommended a transfer pricing adjustment to this transfer price arguing that the Indian subsidiary was a risk bearing entity as well as an independent entrepreneur and, for this reason, it could not be considered a risk-free entity. However, the Court decision considered the transfer pricing adjustment unjustified because, among other reasons, it was not proved that the Indian company assumed significant risks. According to the decision, the Indian subsidiary made no investment in the plant, inventory, working capital nor assumed the risk for manufacturing and exporting goods, merely rendering support services in relation to these exported goods. Therefore, the court sustained that Indian tax authorities must assess the risks on specific facts and not on vague terms, such as 'significant risk', 'functional risk', 'enterprise risk' without material records to establish such conclusions.

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[333] The captive units are expected to continue earning a mark-up over costs regarding the provision of the services. Comparable independent enterprises, on the other hand, undertake a broader set of risks and, for this reason, generally earn super profits or significant losses. Butani, *supra* note 287 at 623.

[333] UN Practical Manual *supra* note 3 at 391.

[334] *Ibid* at 586.

[335] *Li and Fung India Pvt v CIT,* (2013), (Delhi High Court, India).

In another relevant ruling, *Deloitte Consulting India Pvt Ltd v CIT*[336], the Income-Tax Appellate Tribunal (Tribunal) rejected adjustments claimed for lower risk borne by a captive “risk free” service provider. In this case, the Indian subsidiary entered into a software development service agreement with Deloitte Consulting USA to provide software related services. The Indian subsidiary provided a warranty to its parent company to deliver its work free of errors, which according to the Tribunal’s decision amounted to undertaking a broader set of risks. Therefore, there were no differences between the risk profiles of the taxpayer and comparable independent enterprises and, consequently, no economic adjustments were needed.

4.3.4.2 Location-Specific Advantages

India, as a low-cost jurisdiction, provides numerous Location-Specific Advantages (LSAs) to MNEs performing economic activities in the country. These advantages include but are not limited to the availability of a highly skilled, specialized and knowledgeable workforce at a low-cost; lower raw material and infrastructure costs; reasonably priced rental spaces; direct and indirect tax incentives; access and proximity to large and growing local/regional markets; large customer base with increasing spending power, etc[337]. As MNEs are increasingly outsourcing their manufacturing and service functions to captive units in India, LSAs arising from the relatively lowers costs of Indian operations have become a concern for the country’s transfer pricing administration[338].

The main issue regarding LSAs involves their quantification and allocation among the associated enterprises. Under an arm’s length approach, this allocation should be done in accordance to what independent parties would have agreed in comparable circumstances.

[336] *Deloitte Consulting India Pvt Ltd v CIT* (2011), (Mumbai Bench Tribunal, India).
[337] UN Practical Manual *supra* note 3 at 587.
[338] “The Indian tax authorities are increasingly recognizing the concept of location savings and attributing high returns to location savings, particularly in the BPO and IT sectors. During the course of audits, TPOs have been adjusting captive subsidiary income upwards due to location savings. Though the standard markup for captive service providers is normally in the range of cost plus 10%- 16%, in some cases TPOs have been raising the markup to 25%-34% on the grounds that the Indian entity is realizing location savings.” Gandhi, Sharma and Alshi, *supra* note 288.

In this context, the current position of the Indian transfer pricing administration – as stated in the 2017 UN Practical Manual – is that, where comparable uncontrolled transactions are available, the comparability analysis and benchmarking by using the results/profit margins of such local comparable companies will determine the arm's length price of a transaction with a related party in a low-cost jurisdiction[339]. Therefore, on one hand, if reliable local comparables are available, the benefits of LSAs will be properly captured in the arm's length price; on the other hand, if reliable local comparables are not available, the consideration of LSAs' benefits will still be an issue[340].

The above Indian transfer pricing administration's position departs from the previous Indian considerations on the subject in the previous UN Practical Manual version. In the 2013 UN Manual edition, India maintained the view that an arm's length price determined on the basis of local comparables would not adequately allocate LSAs[341] because it would not compute the cost difference between a low-cost country and a high-cost country from where the business operations were relocated. The current Indian views are more aligned with the position advocated in the BEPS Actions 8-10 report as explored in Chapter 5[342].

Even before the revision of its position in the UN Practical Manual, the latest Indian approach was already being applied in judicial cases involving location savings. In *Watson*

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339 UN Practical Manual *supra* note 3 at 587.
340 *Ibid*.
341 In the previous 2013 version of the UN Practical Manual, Indian representatives stated that "Comparability analysis and benchmarking by taking local comparables will determine the price of a transaction with a related party in a low-cost jurisdiction. However, it will not take into account the benefit of location savings which can be computed by taking into account the cost difference between costs in the low-cost country and in the high-cost country from where the business activity was relocated. In view of this, the price determined on the basis of local comparables is not consistent with the arm's length price because any arm's length transaction between two unrelated parties would not be possible without benefiting both parties to the transaction". *Ibid* at 395.
342 There was a more expressive divergence between the previous Indian understanding and the OECD Transfer Pricing Guidelines, which state that the location savings may be shared between related parties on the basis of what independent parties would have negotiated in similar circumstances. In this sense, the OECD approach recommends the use of *local market comparables* in order to establish the arm's length price instead of comparability adjustments for location savings. OECD Transfer Pricing Guidelines *supra* note 8 at para 9149.

Pharma Pvt Ltd v CIT[343], the taxpayer was engaged in contract manufacturing for its associated enterprises and provided them contract research and development services, being compensated on a total operating cost plus arm's length mark-up basis. Indian transfer pricing officers made an adjustment in the taxpayer's profits because of the location savings the associated enterprises had in transferring the referred activities from the United States of America to India. Nonetheless, the Tribunal deleted this location savings adjustment because, in this case, the taxpayer did not have exclusive access to factor leading to LSAs[344] and, consequently, did not have a unique advantage that could generate a super profit arising in the entire supply chain. This way, the Tribunal ruled that, when local market comparables are available and used, specific adjustments for location savings are not required.

4.3.4.3 Intangibles

Transfer pricing of intangibles has been a challenging area for the Indian tax administration because, not only are intangible assets difficult to detect, but they are also rarely traded in the external market, which makes it hard to find reliable comparables in the public domain. Some of the main issues regarding the transfer price of intangible property involve the determination of the arm's length price of royalties, the remuneration for research and development intangibles and the allocation of the cost of development of the market and brand in a new country[345].

With regard to the payment of royalties[346], serious challenges have been encountered in determining the arm's length rate in relation to the price charged for the use of brands and trademarks in certain cases. Indian tax authorities argue that the "royalty rate charged by the MNE should depend upon the cost borne by the subsidiary or related party to promote

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343 *Watson Pharma Pvt Ltd v CIT* (2015), (Mumbai Tribunal, India).

344 According to the decision, the associated enterprises operated in a completely competitive market and, for this reason, the taxpayer did not have exclusive location-specific advantages or unique advantages over its competitors.

345 UN Practical Manual *supra* note 3 at 588.

346 Intangible assets, such as intellectual property, which is owned by one entity and used by another entity, generally requires a royalty payment as a compensation for its use. *Ibid* at 588.

the brand and trademark and to develop customer loyalty for that brand and product"[347]. Indeed, the Indian view is that, in an emerging market such as India, in many cases, the local subsidiary should be entitled to receive an arm's length compensation for the economic ownership of the brand and trademark developed by the subsidiary in the country and for improving the value of the brand and trademark legally owned by the parent company[348].

The Indian transfer pricing administration has also noticed that Indian subsidiaries using the technical know-how of their parent companies have incurred significant costs to customize such know-how and to increase its value. In these cases, in determining the arm's length price of royalties for the use of technical know-how, Indian tax authorities take into consideration the costs of activities – research and development activities, for instance – that have contributed to enhancing the value of the know-how owned by the foreign parent company[349].

Marketing intangibles have also been a focus area for Indian tax authorities, especially because of the unique market characteristics of the country regarding location advantages, market accessibility, large consumer base, market premium, etc. Indian subsidiaries usually have substantial marketing activities – including adding value to brands, trademarks and trade names owned by parent companies as well as creating marketing intangibles such as costumer lists and dealer networks – and the expenditure regarding these marketing functions has been the subject of transfer pricing adjustments in India[350]. These adjustments have been questioned in the judicial instance in India and, while the matter is still not finally decided by the Indian Supreme Court, the decisions of the High Courts and Tribunals have elucidated that: a) the existence of an international transaction regarding any service or

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[347] Intangible assets, such as intellectual property, which is owned by one entity and used by another entity, generally requires a royalty payment as a compensation for its use. *Ibid*.
[348] *Ibid*.
[349] *Ibid* at 589.
[350] According to Indian transfer pricing administration, these functions carried out by Indian subsidiaries, which promoted the brands and developed marketing intangibles for their parent companies outside India, deserve a compensation. *Ibid* at 591.

benefit must be established before transfer pricing provisions can be applied; and b) the mere excessive expenditure of an associated enterprise with advertisement, marketing and promotion is not enough to establish the existence of such a transaction[351].

One noteworthy case is *Maruti Suzuki India Ltd v CIT*[352], in which the taxpayer, who manufactured and sold cars, had a license agreement with its associated enterprise for use of licensed information and a licensed trademark for the manufacture and sale of the products. According to these agreements, the taxpayer paid royalties for the licensed trademarks and for the technology license. The Indian transfer pricing officer made an adjustment by disallowing the royalties paid by the taxpayer and imputing as reimbursement with mark-up on the customized advertising, marketing and promotion expenses incurred in promoting the associated enterprise's brand in India. The Indian court decided in favor of the taxpayer, ruling that the excessive advertisement, sales and promotion expenditure incurred by licensed manufacturers cannot be used as the basis for inferring the existence of an international transaction that could warrant a transfer pricing adjustment.

4.3.5 Conclusion

As it is the case with other emerging economies, India has a relatively recent transfer pricing comprehensive law, which was significantly influenced by the practices and experiences of the OECD[353] and its member countries. Nonetheless, the implementation of transfer pricing rules that were established according to developed countries' realities may not always reflect the necessities and challenges encountered in a country with a different stage of development, such as India. For this reason, India – which has constantly pointed

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[351] *Ibid* at 592.
[352] *Maruti Suzuki India Ltd v CIT* (2015), (Delhi High Court, India).
[353] Although India is not a member of the OECD, it has been invited to participate as an observer in the OECD's Committee on Fiscal Affairs, which is responsible for setting international tax standards, including in the area of transfer pricing. In general, India's tax regulations adopt the OECD principles and follow the OECD guidelines. PwC, "International Transfer Pricing 2015/2016", PwC Network, online: <www.pwc.com/internationaltp>.

out the "unfairness of the extant international order relating to international taxation"[354] – maintains some views contrary to the international standard rules in the area of transfer pricing, particularly regarding issues such as comparability analysis, risks, location savings and intangible property.

Although the Indian transfer pricing law was introduced more than fifteen years ago, it is constantly evolving. Recent transfer pricing audits have brought some controversial issues to light and resulted in a number of disputes between taxpayers and Indian tax authorities. Thus, India currently has a mass of jurisprudence regarding the international taxation of MNEs and, more specifically, transfer pricing. In this context, since the OECD Transfer Pricing Guidelines play a supplementary role in transfer pricing on cases where the Indian legislation is silent[355], in many situations, there is a divergence between the Indian transfer pricing administration – the positions that Indian representatives expressed in the UN Practical Manual, for instance – and the decisions of Indian courts on transfer pricing issues.

4.4 China

> *As the world economy becomes increasingly globalized, transfer pricing is an issue faced not only by developed countries, but is increasingly a critical matter for developing countries. Such nations face a set of unique issues that have not been addressed, or at least not sufficiently or practically addressed by the OECD Guidelines*[356].

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[354] According to D.P. Sengupta, "despite being a populous, poor and fractious democracy for the majority of its independent existence, when negotiating international agreements, India has never been completely dominated by any other party. To borrow an analogy from economics, it has never behaved like a typical price taker". Sengupta, *supra* note 304 at 115.

[355] Indian jurisprudence has a variety of examples in which the courts have endorsed reference to the OECD Transfer Pricing Guidelines and Commentary in interpreting and applying Indian transfer pricing law. Butani, *supra* note 287 at 632.

[356] Tizhong Liao, Deputy Director of the International Taxation Department of the State Administration of Taxaton (People's Republic of China) and Wang Xiaoyue, Director of Anti-

4.4.1 Introduction

China is regarded as a relative "late-comer" in the global transfer pricing area[358], having followed the international tax experience of other countries to create its own transfer pricing system[360]. Today, transfer pricing is one of Chinese tax authorities main focus, especially due to the following factors: 1) the growing relevance of imports and exports as a proportion of China's GDP; 2) the propensity for Chinese affiliates to rely on intellectual property and services provided by foreign-related parties; 3) the institution of rigorous transfer pricing rules in some of China's strategic trading partners; 4) the accession of the country to the World Trade Organization, which resulted in a reduction in its tariff rates and, consequently, created pressure for greater revenues; 5) the inclination for Chinese affiliates to declare operating losses; and 6) policy changes that eliminated some tax incentives for foreign invested enterprises and may motivate MNEs to use transfer pricing strategies to reduce their tax liability in the country[361].

While China has accepted the ALP and OECD Transfer Pricing Guidelines methodologies, its transfer pricing system is still in a process of development. This is because, although China deals with the same transfer pricing problems faced by developed countries, it also encounters particular challenges related to its nature as a developing country with an emerging economy. Therefore, this section will analyze how China applies and reconciles the ALP with its unique national market features as well as the challenges the country faces in employing international transfer pricing regulations in practical situations. In order to understand these concepts, the development of transfer pricing rules in China will be reviewed as well as the current Chinese transfer pricing law.

Avoidance Division of the International Taxation Department of the State Administration of Taxation *in* UN Practical Manual *supra* note 3 at 374.

[358] Only from the 1980s onwards, China began to create its own unique transfer pricing system. Michelle Markham and Yixin Liao, "The Development of Transfer Pricing in China" (2014) 29:4 *Australian Tax Forum* 715.

[360] According to Michele Markham and Yixin Liao, "China's basic transfer pricing principles and methods, including the use of comparable factors and a comparability analysis, are the result of a direct transplantation of the relevant provisions from the OECD TPG". *Ibid* at 742.

[361] Chris Devonshire-Ellis, Andy Scott and Sam Woollard, *Transfer Pricing in China* 2nd ed (Heildelberg: Springer, 2011) at 4-5.

4.4.2 Historical Background

4.4.2.1.1 China's Open Door Policies and Pre-2008 Transfer Pricing Regulations

China has begun opening up to foreign investments in 1979, with the implementation of *kaifang zhengce*[362]: a series of open door policies directed to increasing the country's participation in the world market and promoting technological modernization, especially through the diffusion of foreign technology[363]. As a result, multinational enterprises were allowed to invest in China as joint ventures or wholly-owned subsidiaries[364], thus facilitating foreign investments. Consequently, the country started to experience international transactions of goods, services and intangibles between related enterprises as well as the associated transfer pricing issues.

Following China's opening-up policy, a variety of laws were drafted to regulate foreign investments, including the *Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment*[365], promulgated on September 10, 1980 and the *Income Tax Law applicable to Foreign Enterprises*[366], promulgated in 1981. The former was focused on equity joint ventures composed of a foreign investor and a Chinese partner. The latter was focused on other categories of foreign investments, such as contractual joint ventures, joint explorations and wholly foreign-owned enterprises. Since China's main objective was to attract foreign direct investment (FDI) and the export of

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[362] According to Roger Hayter and Sun Sheng Han, *kaifang zhengce* was formally introduced by the "Act of Joint Venture Enterprises", which regulated principles related to Chinese national sovereignty and international practices of foreign enterprises, permitting the approval of foreign investments if they were beneficial for China. Roger Hayter and Sun Sheng Han, "Reflections on China's Open Policy Towards Foreign Direct Investment" (1997) 32:1 *Regional Studies* 1 at 6-7.

[363] Xiaowen Tian, "China's Open-door Policy in Development Perspective" (1996) 17:1 *Canadian Journal of Development Studies* 75 at 76-78.

[364] Hayter and Han, *supra* note 349 at 9.

[365] *Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment,* People's Republic of China 1980.

[366] *Income Tax Law Applicable to Foreign Enterprises,* People's Republic of China 1981.

Chinese-made products into the international market, both laws contained substantial tax incentives, especially for joint ventures operating with a local equity partner[367].

None of these tax laws established transfer pricing rules, creating a favourable environment for foreign investors to design strategies to reallocate their profits from China to other jurisdictions. Therefore, from the 1980s to the early 1990s, Chinese tax authorities did not challenge transfer pricing practices[368]. The lack of transfer pricing rules and investigations demonstrates how, at that time, rather than being a major concern for Chinese authorities, aggressive transfer pricing was perceived as an inherent part of the new MNE's businesses in the country. In the case of joint ventures, for instance, since the Chinese partners were not experienced in dealing with the world market – due to decades of closed-door policies in China – the foreign partner was usually responsible for selling the products to the international market and for purchasing technology, equipment and materials. This type of arrangement provided the foreign partner with the ability to control the prices of the transactions between the related enterprises[369]. Furthermore, Chinese tax incentive measures encouraged foreign-invested enterprises (FIEs) to export all or greater part of their products[370]. Maintaining low prices for these products made them more competitive in the international market and shifted profits from the Chinese affiliates to its related enterprises overseas.

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[367] According to Jinyan Li, during the 1980s and 1990s, tax incentives in the form of special preferential tax regimes were thriving in China. The author explains that "granting tax preference was a key strategy from political, cultural and economic perspective. Politically, granting tax preferences to FDI sent a clear signal to foreign investors China's desire for their investment. This signaling effect was historically important because China suffered from serious image problems due to its previous hostile policies to foreign investors". Jinyan Li, "The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates" (2007) 8:7 *Florida Tax Review* 670 at 673 [Li, "Rise and Fall of Chinese Tax Incentives"].

[368] *Ibid* at 635.

[369] *Ibid*.

[370] Article 6 of the *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* prescribes that "the State shall, in accordance with the industrial policies, guide the orientation of foreign investment and encourage the establishment of enterprises with foreign investment which adopt advanced technology and equipment and export all or greater part of their products". *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises,* People's Republic of China 1991, Article 6.

By the end of the 1980s, three quarters of the FIEs operating in China were reporting tax losses, mainly due to transfer pricing[371]. Besides representing a potential loss of tax revenue for the country, transfer pricing also caused a loss of profit to the Chinese partner – usually state-owned enterprises – in the joint venture[372]. In response, the National People's Congress enacted in April 1991 the *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* (the "ITEF"), introducing in its Article 13 the first Chinese transfer pricing legislation[373]. Article 13 established the ALP[374] as the Chinese standard to define the appropriate transfer price in transactions between FIEs and their associated enterprises.

In June 1991, the *Rules for the Implementation of the* ITEF[375] were promulgated. These rules, in its Chapter IV (Dealings between Associated Enterprises), detailed the application of Article 13 of the ITEF. Subsequently, the State Administration of Taxation (SAT)[376] published a circular entitled *The Implementation Measures for the Tax Administration of*

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371 Jinyan Li, "Transfer Pricing Disputes in China" in Eduardo Baistrocchi and Ian Roxan, eds, Resolving Transfer Pricing Disputes (Cambridge: Cambridge University Press, 2015) 2012 at 637 [Li, "Transfer Pricing Disputes in China"].
372 *Ibid* at 638.
373 Article 13 of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises provides that the payment or receipt of charges or fees in business transactions between an enterprise with foreign investment, or an establishment or a place set up in China by a foreign enterprise to engage in production or business operations, and its associated enterprises, shall be made in the same manner as the payment or receipt of charges or fees in business transactions between independent enterprises. Where the payment or receipt of charges or fees is not made in the same manner as in business transactions between independent enterprises and results in a reduction of the taxable income, the tax authorities shall have the right to make reasonable adjustments. *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises,* People's Republic of China 1991, Article 13.
374 The establishment of the arm's length principle in China was not seen as a surprise: the country had been following international tax norms, with the necessary modifications to suit local conditions and the principle had already been included in a great number of Chinese tax treaties, being viewed as "the only realistic solution to the transfer pricing problem". Li, "Transfer Pricing Disputes in China" *supra* note 358 at 638.
375 *Rules for the Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises,* People's republic of China 1991.
376 The State Administration of Taxation (SAT) is the primary tax authority in China. It consists in a ministry-level organization that regulates taxation from a strategic, regulatory and oversight perspective. Inside the SAT, there is the International Tax Department, which controls anti-tax evasion. Devonshire-Ellis, Scott and Woollard, *supra* note 348 at 2.

Transactions between Associated Enterprises in 1992 as well as a series of comprehensive operative measures to implement the general transfer pricing rules[377]. During this period, considered the "second stage of development for Chinese transfer pricing legislation"[378], China progressively created a comprehensive transfer pricing system, formed by tax laws, administrative regulations and departmental rules.

4.4.2.2 The 2008 Enterprise Income Law

After China's accession to the WTO in 2001[379], Chinese internal markets were opened to goods produced by FIEs and Chinese companies were encouraged to invest overseas[380]. This increase in the integration between China and the global economy intensified the complexity of transfer pricing issues in the country. China's accession to the WTO has also resulted in a reduction in the country's tariff rates, creating concerns about raising revenues for the country. In this context, transfer pricing issues have become one of China's SAT main focus, particularly because of the tendency for Chinese subsidiaries of MNEs to rely on intellectual property and services provided by overseas related parties, as well as to declare operating losses: over 50% of enterprises' losses in China in 2011 were generated by foreign owned enterprises[381].

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[377] These included the *Implementing Measures of the State Administration of Taxation for the Tax Administration of Business Transactions between Associated Enterprises* (Guoshuifa [1992] No.237), 1992, *Notice on Several Specific Issues in the Implementation of the Implementing Measures of the State Administration of Taxation for the Tax Administration of Business Transactions between Associated Enterprises* (Guoshuifa [1992] No. 242), 1992, the *Administrative Regulations on the Taxation of Business Transactions between Associated Enterprises* (Guoshuifa [1998] No. 59) 1998, *Notice of the State Administration of Taxation on Distributing the (Trial) Implementing Rules for Negotiated Pricing for the Transactions Among Associated Enterprises* (Guoshuifa [2004] No. 118), 2004 and *Rules for the Administration of Business Transactions between A liated Enterprises* (Guoshuifa [2004] No.143) 2004. Markham and Liao, *supra* note 346 at 718.
[378] *Ibid*.
[379] World Trade Organization, "Accessions: China", online: World Trade Organization <https://www.wto.org/english/thewto_e/acc_e/a1_chine_e.htm>
[380] In order to be formally admitted to the WTO, China had to follow concession commitments related to market access to goods, foreign trade liberalization and tariff barrier reduction under GATT. Ling-Ling He and Razeen Sappideen, "Reflections on China's WTO Accession Commitments and Their Observance" (2009) 43:4 *Journal of World Trade* 847 at 851.
[381] Devonshire-Ellis, Scott and Woollard, *supra* note 348 at 4-5.

Therefore, a new stage in the development of transfer pricing began in March 2007, with the introduction of the *Enterprise Income Tax Law of the People's Republic of China*[382] (the EIT Law) by the National People's Congress[383]. The EIT Law eliminated most of the previous preferential tax regimes and established a harmonized tax rate of 25 per cent[384], resulting in a substantially higher tax burden to most foreign investors. With the elimination of tax incentives, MNE's tax planning shifted from seeing China "as a low-tax location where it is desirable to recognize profits to a relatively high-tax jurisdiction in which the goal is to minimize taxable profits"[385], turning transfer pricing into an even more relevant issue for the country. This new phase is characterized by a rigorous implementation of the Chinese transfer pricing regulations and strengthening tax investigations of transactions between related enterprises[386]. Since the beginning of this new stage in 2008, the number of enterprises being investigated in China increased annually, which consequently increased the amount of tax collected from MNEs[387].

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[382] *Enterprise Income Tax Law of the People's Republic of China*, People's Republic of China 2007 (hereinafter 'EIT Law').

[383] In November 2007, the *Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law* were published, detailing important transfer pricing rules in its Articles 109 to 115.

[384] Before the new EIT Law, many foreign invested companies were subject to 15 per cent or 24 per cent tax rates, combined with tax holidays to eliminate or reduce by half the applicable tax rate for a certain number of years. Jon Eichelberger and Brendan Kelly, "Tax Planning Strategies in Response to China's Changing Tax Landscape: Issues and Structures to be Considered in a Post-Tax Unification China" (2008) 36:5 *Intertax* 221 at 221.

[385] *Ibid*.

[386] Markham and Liao, *supra* note 346 at 720.

[387] In 2007, China was the eighth most aggressive tax authority in regards to transfer pricing. (Transfer Pricing Week, "Top 10 toughest tax authorities for transfer pricing in 2007" (2007), online: TP Week: <https://www.tpweek.com/articles/top-10-toughest-tax-authorities-for-transfer-pricing-in-2007/arejkape>). Three years later, because of this new severer phase in its transfer pricing investigations, the country was ranked the third most aggressive tax authority in 2010. (Transfer Pricing Week, "Asian Countries Top Aggressive Tax Authorities Poll", (2010), online: TP Week: <https://www.tpweek.com/articles/asian-countries-top-aggressive-tax-authority-poll/arddwcch>.)

4.4.3 Transfer Pricing Regulations in China

4.4.3.1.1 The Arm's Length Principle

Chinese tax treaties commonly follow Article 9 of the OECD Model Treaty concerning the ALP[388]. At present, the main Chinese transfer pricing regulations are the EIT Law (Articles 41 to 44), the *Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law*[389] (Article 109-115), the *Rules for the Implementation of the Law of the People's Republic of China on the Administration of Tax Collection*[390](the "EIT Regulations") (Articles 51-56), administrative regulations and guidelines issued by the SAT and tax treaties. Article 41 of the EIT Law codifies the ALP as follows:

> Article 41. As regards a transaction between an enterprise and its affiliated parties, in case the taxable revenue or income of the enterprise or its affiliated parties reduces by virtue of the failure to conform to the arm's length principle, the tax organ may, through a reasonable method, make an adjustment. As regards the costs of an enterprise and its affiliated parties for jointly developing or accepting intangible assets, or jointly providing or accepting labor services, they shall, when calculating the taxable income amount, apportion them according to the arm's length principle[391].

Thus, enterprises must conduct business transactions with their affiliated parties observing the ALP, which, according to Article 110 of the EIT Regulations, refers to "the principle adopted by unrelated parties in carrying out transactions with each other according to a fair

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[388] China has signed tax treaties with 102 countries and Article 9 of the OECD Model is included in the majority of them. The Chinese treaties that do not include Article 9 are older agreements signed before 1991, such as the ones with Austria, Brazil, Canada, Italy, Japan, Malaysia, Norway, Poland, Spain and Thailand. In new treaties signed after 2007 – replacing older treaties where Article 9 was not included, such as those with Belgium, France, Germany, Singapore, Switzerland and the United Kingdom – Article 9 was incorporated in accordance to the OECD Model.
[389] *Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law*, People's Republic of China 2007.
[390] *Rules for the Implementation of the Law of the People's Republic of China on the Administration of Tax Collection*, People's Republic of China 2002.
[391] EIT Law, Article 41.

price and a normal business practice”[392]. The main goal of transfer pricing rules is to ensure that related parties are pricing their transactions using the ALP, making sure that these transactions have a fair market value price and that the Chinese tax base is protected. In cases where the transactions between related enterprises are not conducted at arm’s length and, as a result, the amount of taxable income in China is reduced, the EIT Law allows Chinese tax authorities to make reasonable adjustments.

4.4.3.2 The Concept of Related Party Transactions

Chinese transfer pricing rules are applied to transactions between related parties or associated parties[393]. The concept of “related parties” is provided in Article 109 of the EIT Regulations, according to which “related parties, as cited in Article 41 of the EIT Law, refer to enterprises, other entities and individuals, which have any of the following relationships with an enterprise: 1) direct or indirect control over such matters as finance, business operations, purchases and sales, etc.; 2) both directly or indirectly controlled by a third party; 3) other relationship due to associated interests”[394]. In regards to the criteria for determining if an enterprise is considered to be related to another enterprise, economic organization or individual, Chinese tax authorities adopt a substance test as opposed to a legalistic and formal approach[395]. Although the scope of the transfer pricing law is broad, comprehending all forms of related party transactions, international transactions are, in

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[392] *Regulations of the People’s Republic of China on the Implementation of the Enterprise Income Tax Law*, People’s Republic of China 2007, Article 110.

[393] The usage of the term “related parties” or “associated parties” in the Chinese transfer pricing legislation corresponds to the use of the term “associated enterprises” in Article 9 of the OECD Model Convention and in Article 9 of the United Nations Model Convention. The different choice of words is important because, in Chinese transfer pricing law, a related party does not have to be an ‘enterprise’: it can be a partnership or an individual. The determination of the relationship is based on a “substance-over-form approach” Li, “Transfer Pricing Disputes in China” *supra* note 358 at 645.

[394] *Regulations of the People’s Republic of China on the Implementation of the Enterprise Income Tax Law*, People’s Republic of China 2007, Article 109.

[395] Li, “Transfer Pricing Disputes in China” *supra* note 358 at 638.

practice, the SAT's main targets of investigation[396]. If the parties of a transaction are not related, even if the transaction involves parties in tax havens, transfer pricing rules are not applied. In this case, the General Anti-Avoidance Rule (GAAR) may be applied.

According to Article 10 of *The Administrative Measures of Special Tax Adjustments* (Circular [2009] No. 2), related party transactions include the following categories: 1) the sale, purchase, transfer and use of tangible property; 2) the transfer and use of intangible property, including providing the right to use licenses as well as industrial property rights; 3) financing, including all types of interest-bearing advances and deferred payments, loans and security; and 4) the provision of services[397]. The focus of early transfer pricing investigations by the SAT was generally on transactions of tangible goods, including selling, purchasing, assigning and leasing tangible property such as buildings, means of transport, machinery, tools and products[398]. Recently, the Chinese revenue authorities have been more concentrated on transactions involving intangible property[399] and the provision of services[400].

4.4.3.3 Transfer Pricing Methods

Under the EIT Law and the EIT Regulations, the transfer pricing methods used to calculate the arm's length price of a transactions include, but are not limited to the internationally recognized methods. Therefore, taxpayers and tax authorities may use the comparable uncontrolled price method (CUP), the resale price method, the cost-plus method, the transactional net margin method (TNMM), the profit split method as well as any "other

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[396] Tianlong Hu and Na Li, "China Tax Treaty and Policy: Developments and Updates" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 181 at 204.

[397] *The Administrative Measures of Special Tax Adjustments, Circular [2009] 2,* People's Republic of China 2009, Article 10.

[398] Markham and Liao, *supra* note 346 at 727.

[399] According to a former SAT official, Shanwu Yuan, Chinese tax authorities believe that foreign parent companies usually overprice intangible property provided to its Chinese related enterprises. K A Bell "China Believes Developed Countries Often Overprice Intangibles, Former Official says" (2014) 22 *Tax Management Transfer Pricing Report* 1506.

[400] UN Practical Manual *supra* note 3 at 374.

reasonable method" to evaluate if the ALP was followed[401]. The definition of other reasonable methods, in this case, seems to be dictated more by the "right outcome", i.e., what the Chinese tax authorities want, rather than the right process or methodology", according to the Chinese "substance-over-form" pragmatic and holistic approach to tax avoidance[402].

China follows the OECD Transfer Pricing Guidelines recommendation with regards to the selection of the most appropriate transfer pricing method – whether it is one of the traditional transaction methods or one of the transactional profit methods – to the circumstances of the case in analysis[403]. Similar to the OECD, Chinese tax authorities have also reviewed their position of recommending a hierarchy between transfer pricing methodologies and currently allow the most reasonable applicable method to be used[404]. Chapter 4 of *Circular [2009] No. 2* provides detailed instructions regarding the selection of the appropriate transfer pricing method, based on the different types of existing transactions and their characteristics[405].

When the taxpayer fails to provide information on its transactions with associated enterprises or provides false or incomplete information, Article 44 of the EIT Law authorizes tax authorities to assess the taxable profit on the taxpayer's income in relation to the related party transaction on a deemed basis[406]. The reason for allowing this power to the SAT – which increases the revenue authorities control in regulating transfer pricing abuses – is the perceived information asymmetry existent between the taxpayer and the Chinese tax authorities[407]. Since this discretion to tax on a deemed basis may damage legitimate interests of taxpayers, the exercise of this power needs to comply with the

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[401] *Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law*, People's Republic of China 2007, Article 111.
[402] Li, "Transfer Pricing Disputes in China", *supra* note 358 at 638-639.
[403] Markham and Liao, *supra* note 346 at 729-730.
[404] The former Detailed Implementing Rules of 1991, in its Article 54, established a hierarchy for the application of transfer pricing methods.
[405] *Supra* note 385.
[406] EIT Law, Article 44.
[407] Markham and Liao, *supra* note 346 at 731.

prescribed procedures defined in Article 115 of the EIT Regulations, which prescribes that the determination of the acceptable transfer price can be assessed: 1) by reference to the profit rate level of identical or similar enterprises; 2) based on the cost of the enterprise plus a reasonable amount of expenses and profit margin; 3) based on a reasonable proportion out of the total profits earned by the related party group; or 4) based on any other reasonable method[408]. Article 115 also establishes that the burden to prove the deemed tax payable lies with the tax authority and that, if the taxpayer does not agree with the result, it may provide opposing evidence[409]. Although these rules limit the power of the SAT, the condition that allows the imposition of taxes on a deemed basis – in cases of false or incomplete information provided by the taxpayer – is considered vague and, consequently, may induce the SAT to skip the need to "collect sufficient information and conduct a careful comparability analysis" and proceed straightforwardly to taxing in accordance to what they deem the taxpayer's income to be[410].

4.4.4 Peculiarities and Challenges in China's Transfer Pricing Practices

During the implementation of transfer pricing rules in China, the ALP was 'transplanted' from Western countries into an extremely different legal culture in China[411]. Although China has unique economic and legal features, years of closed-door policies – resulting in a lack of experience in regulating international transactions – led the country to base great

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[408] *Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law*, People's Republic of China 2007, Article 115.
[409] *Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law*, People's Republic of China 2007, Article 115.
[410] Markham and Liao, *supra* note 346 at 731-732.
[411] Contrary to Western legal culture, which, generally stating, has a system based on the principle of the rule of law and separation of powers (having a judiciary independent of the government and legislature in which, before the court, the taxpayer and the government are equal), China is a socialist country ruled by law, having no separation of powers . Therefore, in the area of taxation, the Chinese Ministry of Finance and the SAT have the power to make, interpret and enforce the laws and the judiciary has little power to interpret the meaning of these laws. For this reason, it is very difficult for the taxpayer in China to disagree with the tax authorities. The result, in transfer pricing, is that there was only one case in China regarding the topic, in which the taxpayer went to the Chinese curt, lost the case and withdrew its appeal. Li, "Transfer Pricing Disputes in China", *supra* note 358 at 641-644.

part of its transfer pricing system on the knowledge and practices from developed countries. In comparison with developed countries, China is still at an early stage of development and, while the transfer pricing problems the country faces may be similar to those encountered by more developed economies, it also has to deal with particular challenges prevalent in developing countries[412].

The ALP, to a large extent, clashes with important elements of Chinese legal and political approaches as explained by Jinyan Li:

> The notion of 'arm's length' is 'foreign' to the Chinese cultural emphasis on 'guanxi' or 'relationships'. In the Chinese culture, 'insiders' are expected to treat each other differently from 'outsiders'. Insiders value the long-term relationship and may not care about immediate cost or benefits. Expecting 'insiders' to behave like strangers in the eyes of law may require a cultural shift. Furthermore, the rules-based application of the arm's length principle is not an easy fit with the Chinese holistic, pragmatic approach to problem-solving. The Chinese approach is exemplified by Deng Xiaoping's famous saying that 'It doesn't matter if a cat is black or white, so long as it catches mice[413].

In this context, important aspects in the Chinese transfer pricing system demonstrate how the Chinese adaptation of the ALP seems to be guided by regarding the principle as "a means to an end, not the end by itself"[414]. For example, while Article 41 of the EIT Law proclaims the ALP as the guiding standard in transfer pricing adjustments, Article 111 of the EIT Regulations prescribes "other reasonable methods" that can be used in establishing the arm's length price of a transaction. There is also the provision of Article 115 of the EIT Regulations, which allows the taxpayer's profit to be assessed on a deemed basis in cases

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[412] China's views on the challenges it has in applying the arm's length principle and transfer pricing methods established by the OECD Guidelines are officially exposed in the UN Practical Manual. UN Practical Manual, *supra* note 3.
[413] Li, "Transfer Pricing Disputes in China", *supra* note 358 at 661.
[414] *Ibid* at 660.

where the taxpayer has failed to provide complete information on transfer pricing. These are some of the Chinese transfer pricing developments that indicate how the ALP, although formally enacted in China within the framework of the OECD Transfer Pricing Guidelines, is applied in substance with respect to country's specific practices.

4.4.4.1 The Issue of Finding Reliable Comparables

The ALP is generally applied by comparing the conditions in transactions between related parties with conditions in transactions between independent parties in order to determine whether the prices of these transactions are different. According to the OECD Transfer Pricing Guidelines, these comparisons are only useful if the economically relevant characteristics of the situations being compared are "sufficiently comparable", i.e., if none of the differences between the situations being compared substantially affects the conditions being examined, such as the price or margin, or if precise adjustments can be made to remove the outcomes of any such differences [415]. In this context, China follows the recommendation made by the OECD Guidelines and requires the performance of a comparability analysis[416] in determining acceptable comparable transactions. Article 22 of the Circular [2009] No. 2, for example, provides that a comparability analysis should consider five factors: characteristics of assets transacted or services provided, functions performed and risks assumed by each party to a transaction, contractual terms and conditions, economic circumstances, and business strategies[417].

As a developing country and an emerging market economy, one of the key challenges for the SAT and taxpayers in applying the ALP is finding reliable and public information on comparables as well as comparable independent transactions which are able to satisfy all

[415] OECD Transfer Pricing Guidelines*, supra* note 8.
[416] The OECD Transfer Pricing Guidelines state that "an analysis of the controlled and uncontrolled transactions, which is referred to as a "comparability analysis", is at the heart of the application of the arm's length principle". *Ibid* at 33.
[417] When determining comparability, the OECD Guidelines establish the same five factors in the analysis: characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies. *Ibid*.

the requirements of the comparability analysis[418]. Developing and emerging countries usually have only a small number of public companies[419] and the information on domestic private companies[420] can be either inadequate or non-existent[421]. For this reason, the amount of publicly available information on domestic companies that can be used for transfer pricing comparability analysis is limited in China[422]. As a result, foreign companies – usually companies in developed countries, where there is a larger number of public companies – need to be used as substitutes to domestic comparables[423]. Because of this lack of information and difficulty in obtaining reliable data, there are no provisions in Chinese transfer pricing rules prohibiting the use of foreign comparables[424]. Therefore, tax authorities and taxpayers are able to select either internal or external comparables according to which of these can provide a better comparability analysis.

China's understanding is that substantial comparability adjustments must be done in order to enable the use of companies in developed countries as comparables for companies in developing countries[425]. These adjustments are necessary to eliminate price or profit

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[418] UN Practical Manual *supra* note 3 at 375.
[419] Particularly in China, the domestic securities market is considered to be in a very initial stage: although more than 1,600 companies have listed in the Chinese domestic stock market since 2000, this is still a small number compared to the size of the country's economy. Carl Walter and Fraser Howie, "Taking Stock of China's Reforms" (2014) *Wall Street Journal,* online: <https://www.wsj.com/articles/walter-and-howie-taking-stock-of-chinas-reforms-1392828606>.
[420] According to Michelle Markham and Yoxon Liao, "it is not easy to get information from Chinese private companies for the purpose of comparability analysis, as these usually keep their information confidential or only disclose minimal information". Markham and Liao, *supra* note 346 at 729.
[421] In 2013, there were only around 2000 public companies in China and the information on private company is lacking or inadequate, limiting the amount of publically available information that can be used for transfer pricing analysis. Besides that, China is a manufacture-based economy with significant vertical simple-function FDI, which makes even more difficult to compare a Chinese manufacturer with a company that has full functions. Tizhong Liao, Deputy Director General of China's State Administration of Taxation's International Taxation Department in Transfer Pricing Week, "SAT'S Liao Tizhong discusses China's transfer pricing position: Part One" (2013), online: TP Week: <https://www.tpweek.com/articles/sats-liao-tizhong-discusses-chinas-transfer-pricing-position-part-one/araejlcu>.
[422] UN Practical Manual *supra* note 3 at 375.
[423] *Ibid* at 376.
[424] Markham and Liao, *supra* note 346 at 728.
[425] UN Practical Manual *supra* note 3 at 376.

differences attributable to different conditions in the market environment of these countries:

> One of the most common adjustments in China is accounting for differences in geographic comparability when applying profit-based transfer pricing methods, such as the Transactional Net Margin Method (TNMM), to determine an arm's length price. For example, when an Asia Pacific set of companies is used to benchmark the transfer prices of a Chinese taxpayer, as often being the case, it often includes companies from both developed countries (such as Japan and Korea), as well as developing countries (such as Indonesia and Vietnam). Generally speaking, the Asia Pacific set is more likely to contain companies from developed countries, due to a greater number of listed companies in those countries and hence there is a greater volume of publicly available financial information[426].

Therefore, China takes the view that there are situations in which geographical market differences between foreign and domestic comparables will require an appropriate adjustment to balance the differences. This approach, nevertheless, can create uncertainties in the Chinese process of establishing the applicable transfer price for a related party transaction, increasing potential tax disputes between authorities and taxpayers[427].

4.4.4.2 Location-Specific Advantages

Location-Specific Advantages (LSAs) are advantages that companies have in their production arising from assets, resource endowments, government policies or other incentives that exist in specific localities[428]. The concept of LSAs, which is not explored in

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[426] *Ibid*.
[427] Markham and Liao, *supra* note 346 at 729.
[428] "For example, household electronics manufacturers invest in China to take advantage of a large pool of well-educated low-cost labour and a well-developed network of suppliers. Likewise, global automotive companies set up joint ventures (JVs) in China to assemble automobiles locally to be close to the market and the customers and to take advantage of lower costs." UN Practical Manual *supra* note 3 at 376.

the 2010 OECD Transfer Pricing Guidelines[429], can refer to "location savings", which are the net costs savings derived by a multinational enterprise when it moves its operations to a low-cost jurisdiction, such as China and other developing countries, which usually offer inexpensive rents, transportation, labour and raw materials[430]. Another concept encompassed in LSAs refers to "market premium", i.e., the additional profit earned by a multinational enterprise that operates in a jurisdiction with unique characteristics that positively impact on the sale and demand of services or products[431].

Tax authorities in China have argued that LSAs – resulting from the country's unique market features – deserve proper recognition and compensation through appropriate transfer prices. In the SAT's view, due to the low cost and higher selling prices found in China, a great number of foreign corporations should have higher profit margins because of location savings and market premiums, particularly in the automotive[432], pharmaceutical and luxury industries[433]. In order to determine LSAs and their impact on transfer pricing, Chinese tax authorities follow a four-step approach: 1) identify the existence of a LSA; 2) determine if the LSA generates additional profits; 3) measure the additional profits

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[429] The OECD Transfer Pricing Guidelines only explore the idea of geographic markets, which can affect comparability analysis, establishing that: "the identification of the relevant market is a factual question. For a number of industries, large regional markets encompassing more than one country may prove to be reasonably homogenous, while for other, differences among domestic markets (or even within domestic markets) are very significant". OECD Transfer Pricing Guidelines, *supra* note 8 at 49.

[430] These countries, however, may also involve higher costs, such as those related to poor infrastructure and to the training costs for hiring less skilled labour. Location savings are only considered when the net reduction in these costs from moving to the low-cost jurisdiction is positive. Shanto Ghosh, Wei Shu and Rahul Tomar, "Location-Specific Advantages: India and China" (2014) *International Tax Review.*

[431] UN Practical Manual *supra* note 3 at 376.

[432] In the automotive industry, LSAs have provided extraordinarily high profits and include: 1) the general preference of Chinese consumers for foreign brands and imported products, which creates the possibility for MNEs to charge higher prices; 2) massive demand for automotive vehicles in China because of the growing wealth of its large population; 3) capacity limitations on the supply of automotive vehicles domestically assembled; 4) large supply of high quality and low cost parts produced by Chinese suppliers. UN Practical Manual *supra* note 3 at 378.

[433] Ghosh, Shu and Tomar, *supra* note 416.

generated by the LSA; and 4) define the applicable transfer pricing method to allocate the profits arising from the LSA[434].

The concepts of location savings and market premiums have recently been used by the SAT in its transfer pricing audits:

> For instance, a foreign company's Chinese subsidiary was determined to adjust its income tax for more than RMB 100 million for 10 years. LSAs also have been used in self-adjustments, which are similar to transfer pricing audits although not legally official and conducted by state bureaus. The SAT has also used LSAs in bilateral APA cases, especially in negotiations with Japan's National Tax Authority. Chinese courts have adjudicated very few transfer pricing cases, and none of them involve LSAs[435].

Therefore, since many Chinese LSAs generate high profits that are rightly earned by Chinese taxpayers, these LSAs are expected to result in profit allocations to Chinese parties. In this context, Tizhong Liao, Deputy Director General of China's SAT International Taxation Department, argues that the world needs to start taking LSAs seriously as China will continue to apply it in both transfer pricing investigations and Advanced Pricing Agreements (APAs) negotiations, adding that taxpayers and competent authorities' counterparts have been understanding and accepting this concept[436].

4.4.4.3 Intangibles

One of the main challenges in the application of the ALP, both for developed and developing countries[437], consists in determining the appropriate transfer price for

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[434] UN Practical Manual *supra* note 3 at 377.
[435] Ghosh, Shu and Tomar, *supra* note 416.
[436] Transfer Pricing Week, "SAT'S Liao Tizhong discusses China's transfer pricing position: Part One" (2013), online: TP Week: <https://www.tpweek.com/articles/sats-liao-tizhong-discusses-chinas-transfer-pricing-position-part-one/araejlcu>.
[437] The Chinese view is that "while MNEs in developed countries often have superior technology intangibles, they need the fast growing market in the developing countries to develop these markets in order to monetize the value in such intangibles". UN Practical Manual *supra* note 3 at 380.

transactions involving intangible property[438] transactions. In the case of China, the issue assumes greater relevance because, as almost all important MNEs currently have subsidiaries in the country – making China the 'factory of the world' – it is common to see related parties charging excessive royalties and shifting away taxable profits of the Chinese enterprise[439]. In this context, the SAT's understanding is that foreign parent enterprises usually overprice intangibles provided to its Chinese-related parties and, for this reason, ensuring that Chinese subsidiaries are appropriately remunerated is one of the SAT's main goals[440]. Article 41 of the EIT Law establishes that:

> As regards the costs of an enterprise and its affiliated parties for jointly developing or accepting intangible assets, or jointly providing or accepting labour services, they shall, when calculating the taxable income amount, apportion them according to the arm's length principle[441].

Since intangibles can assume different forms, the SAT recognizes intangible properties for manufacturing purposes – including manufacturing technologies, technical designs, production molds, information technologies, various patents and non-patent technologies, business administration software, commercial secrets and proprietary technologies – and intangible properties for marketing and sales purposes – including trademarks, brands, logos, product packaging, customer information and customer relation management[442]. One important aspect is that, in order to be recognized by the SAT, intangible property transactions must be able to create consistent and effective benefits for the transferee taxpayer[443].

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438 Intangible property is a taxpayer's asset that, although has no physical form, it is legally protected and can be transferred between different taxpayers. Liao, Tizhong, "P. R. China's Experience of Tax Administration on Transfer Pricing of Intangible Property Transactions" (United Nations Group of Experts Meeting on Tax Aspects of Domestic Resource Mobilization – A Discussion of Enduring and Emerging Issues, Rome, 4-5 September 2007), online: <www.un.org/esa/ffd/tax/2007DRM_SEG/12TransferPricingChina.doc>.
439 *Ibid*.
440 Markham and Liao, *supra* note 346 at 727.
441 EIL Law, Article 41.
442 Supra *note* 424.
443 *Ibid*.

Intangibles, generally in the form of global brand names, technical know-how or business processes, are commonly provided by MNEs to their Chinese affiliates during the initial stages of the local operation as a way of helping the establishment of the business in the country[444]. However, over time, the Chinese parties gain the skills and experience from operations in China and may even improve the MNE's original intangibles[445]. In such cases, China understands that, instead of continuing to pay royalties for the parent company, Chinese affiliates should receive a return on the intangibles that they have developed and shared with the group companies, being entitled to an additional profit[446].

Besides that, in determining whether royalties are deductible or not for a Chinese enterprise, the SAT performs a 'contribution-based value creation analysis'. According to this analysis, royalty payments to non-resident related parties that only have legal ownership of the intangible property but do not contribute to value creation are not deductible in computing taxable income[447]. The idea behind this analysis is that royalties – the economic benefit arising from the value creation – should reproduce the extent of contributions made by each related party to the value creation of the intangible property[448].

4.4.5 Conclusion

Since their development in 1987, Chinese transfer pricing rules have evolved in a series of improvements that have produced the current complete transfer pricing system formed by tax laws, administrative regulations issued by the SAT and tax treaties. However, China's mere 'transplantation' of the ALP and transfer pricing methodologies established by the

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[444] UN Practical Manual *supra* note 3 at 380.
[445] For instance, if the foreign parent company charged a 3 per cent royalty fee for the use of a manufacturing process to the Chinese affiliate when the operations were established in China in 2002, it may not be appropriate for the Chinese affiliate to remain paying the same royalty fee in 2012 because there should be a readjustment as to whether the intangible has continued to provide the same value in these ten years. In this case, it is possible that the Chinese affiliate has improved the manufacturing process provided by the foreign company by a process of trial and error over time. UN Practical Manual *supra* note 3 at 380.
[446] *Ibid*.
[447] Jinyan Li, "China and BEPS: From Norm-Taker to Norm-Shaker" (2015) 69:6/7 *Bulletin for International Taxation* [Li, "China and BEPS"].
[448] *Ibid.*

OECD into its tax system – due to the its lack of experience in dealing with international transactions after years of closed door policies – has left many of the country's particularities unaddressed. China is a large developing country with an emerging economy and unique market features. This gives rise to singular problems in its international transfer pricing regulations, which are not addressed by the OECD Transfer Pricing Guidelines.

Chinese particularities in applying the ALP involve a number of challenges endemic to developing countries. First, there is a lack of reliable comparables, which is occasioned by the absence of public information in China regarding domestic comparable transactions. Because of this difficulty, the SAT and taxpayers need to choose foreign comparables in order to determine the appropriate arm's length price or profit; however, in this case, adjustments are required to eliminate eventual geographical differences. Furthermore, China provides Location Specific Advantages (LSAs) – location savings and market premium – and, according to the SAT, the additional profits it generates should be taken into account in establishing the profits of Chinese affiliates. Finally, China also faces the challenge of evaluating the contribution of its Chinese companies to intangible transactions with foreign related companies.

4.5 South Africa

As Africa continues to grow and become more integrated into the global economy, it is anticipated that more African nations will adopt transfer pricing regulations based on the ALS. Although transfer pricing regimes in Africa are expected to be based on the OECD Guidelines and the UN Practical Manual, African governments' desire to protect revenues from natural resources will probably influence future transfer pricing legislation[449].

[449] Anthony Curtis and Ogniana Todorova, "Spotlight on Africa's transfer pricing landscape", PwC Transfer Pricing Perspectives: Special Edition, online: <https://www.pwc.com/gx/en/tax/transfer-pricing/management-strategy/assets/pwc-transfer-pricing-africa-pdf.pdf>.

4.5.1 Introduction

During the era of apartheid, South Africa experienced a period of economic, social and political isolation from the international market, which was reflected in the country's tax system and transfer pricing rules. Transfer pricing rules were introduced into the South African Income Tax Act in 1995 and were revised and updated in 2012. For years, as part of South Africa's efforts in integrating its tax system into the international scenario, the OECD Transfer Pricing Guidelines were closely followed. However, over time, several challenges have arisen in the application of South African transfer pricing rules, especially because, according to its tax authorities, although the OECD guidelines may be useful in providing an understanding about the ALP, they do not sufficiently respond to practical issues in the application of the principle[450]. At present, transfer pricing is a key area for South African tax authorities and an integral part of the "Compliance Programme" announced by South Africa's Minister of Finance[451].

This section will analyze how South Africa applies its transfer pricing rules and what are the main challenges the country faces in following the ALP and the OECD Transfer Pricing Guidelines. In order to comprehend these concepts, this section will review the historical background of South African transfer pricing rules, the contemporary regulations on the subject and the most relevant challenges and peculiarities in its transfer pricing practices.

4.5.2 Historical Background

In the early 1990s, after years of isolation during the apartheid[452] period, South Africa re-emerged in the international market, experiencing an expansion of its international trade

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[450] UN Practical Manual *supra* note 3 at 410.
[451] The Compliance Programme has the goal of protecting the depletion of the South African tax base as a result of base erosion and profit shifting. The Davis Tax Committee Interim Report, "Addressing Base Erosion and Profit Shifting in South Africa", The Davis Tax Committee, online: <http://www.taxcom.org.za>.
[452] The apartheid was an institutionalized system – created by law and enforced by legal institutions – structured in three pillars: discrimination, territorial fragmentation and political repression. This ideology was formalized as an official state policy in 1948 with the assumption of power by the National Party and lasted until 1994. John Dugard and John Reynolds, "Apartheid, International

and commerce[453]. Considering that a great share of this international economic activity occurs between members of multinational enterprises, protecting the South African tax base from transfer pricing strategies used to transfer profits from South Africa to lower tax jurisdictions has become a significant concern regarding the country's wealth and development. For this reason, in 1994, the "Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa" (the Commission) recommended, in its first report, the introduction of transfer pricing provisions into the South African Income Tax Act[454]. Before this period, the manipulation of transfer prices was avoided by rigid exchange controls; however, with the relaxation of these regulations, the Commission envisaged a negative effect on the South African tax base[455]. The Commission also recommended that South Africa should follow the international consensus in the application of the OECD Transfer Pricing Guidelines. According to the Commission, since the Guidelines were the common language among a relevant group of trading and investment countries, following them would be useful in helping South Africa to integrate its tax system into the international scenario[456].

Therefore, in 1995, transfer pricing rules were introduced into the South African Income Tax Act and, until 2012, when Nigeria implemented its transfer pricing system, South Africa was the only African country with a comprehensive transfer pricing system in

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Law, and the Occupied Palestinian Territory" (2013) 24:3 *The European Journal of International Law* 867 AT 872-873.

[453] As a country isolated during the apartheid, an African country and a developing country, South Africa considers its integration into the global political, economic and social system as a priority. The building of political and economic links with the countries and regions of the world – working for an international system that is more favourable to the development across the world – was one of South Africa's main goals in its first decade of freedom after the apartheid period. South African Government, "History", South African Government, online: < http://www.gov.za/about-sa/history#decade_freedom>.

[454] Lee Corrick, "Transfer Pricing Disputes in Africa" in Eduardo Baistrocchi and Ian Roxan, eds, Resolving Transfer Pricing Disputes (Cambridge: Cambridge University Press, 2015) 790 at 797.

[455] *South African Revenue Service Practice Note no. 7,* "Section 31 of the Income Tax Act, 1962 (the Act): Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing", South Africa 1999, 2.5.

[456] Katz Commission: First and Second Interim Reports of the Inquiry into Certain Aspects of the Tax Structure of South Africa (1995) 3.

practice[457]. The enactment of Section 31 of the Income Tax Act, which covered both transfer pricing and thin capitalization regulations, allowed the adjustments of transaction prices for tax purposes based on the ALP[458]. This legislation was considered "discretionary in nature" and did not provide detailed assistance in the application of the ALP[460]. For this reason, the South African Revenue Service (SARS)[462] published in 1999 the Practice Note no. 7[463] establishing the OECD Transfer Pricing Guidelines as the transfer pricing standard in interpreting the application of the ALP[464]:

> Because of the international importance of the OECD Guidelines, this Practice Note is based on, inter alia, those guidelines. Although South Africa is not a member country of the OECD, the OECD Guidelines are acknowledged as an important, influential document that reflects unanimous agreement amongst the member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries. The OECD Guidelines are also followed by many countries which are not OECD members and are therefore becoming a globally accepted standard. […] The OECD Guidelines should be followed in the

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457 Johann Hattingh, "South Africa" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 234 at 256 [Hattingh, "South Africa"].
458 *Income Tax Act,* South Africa 1962, Section 31.
460 Hattingh, "South Africa", *supra* note 443 at 255.
462 The SARS is South Africa's tax collection authority. According to the South African Revenue Service Act 34 of 1997, the SARS is an autonomous agency – it was established as an "organ of state within the public administration, but as an institution outside the public service" – which is responsible for the administration of the country's tax system and customs service. *South African Revenue Service Act no. 34*, South Africa 1997, Part 1.
463 The SARS usually publishes Practice Notes that provide guidance on their interpretation and practical application of the Income Tax Act. Corrick, *supra* note 440 at 800.
464 Hattingh, "South Africa", *supra* note 443 at 255.

> absence of specific guidance in terms of this Practice Note, the provisions of section 31 or the tax treaties entered into by South Africa[466].

The OECD Transfer Pricing Guidelines were rigorously followed during the first years of the South African transfer pricing system[467]. Nevertheless, over time, the practical application of the ALP according to the OECD guidelines as well as the discretionary nature of the domestic legislation generated several issues in the enforcement of South Africa's transfer pricing rules[468]. These developments resulted in some changes in South Africa's transfer pricing legislation, which – through an amended version of Section 31 of the Income Tax Act that became effective after January 2013 – had its scope broadened, becoming more aligned to Article 9 of the OECD Model Tax Convention[469].

4.5.3 Transfer Pricing Rules in South Africa

South Africa's current relevant transfer pricing law is in Section 31 of the Income Tax Act. The Section provides terminology definitions necessary to its application, including the meanings of goods, services and international agreements. Additional transfer pricing sources include SARS' Practice Note no. 7, which was issued to establish guidelines regarding the procedures to be followed in the determination arm's length prices, taking into account the South African business environment, and to publish the views of the SARS on practical issues in dealing with transfer prices[470].

Since Practice Note no. 7 was drafted as a practical guide, it is not intended to be a prescriptive or exhaustive discussion of every transfer pricing issue neither to override

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466 *South African Revenue Service Practice Note no. 7,* "Section 31 of the Income Tax Act, 1962 (the Act): Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing", South Africa 1999, 3.2.
467 Hattingh, "South Africa", *supra* note 443 at 256.
468 *Ibid*.
469 Corrick, *supra* note 440 at 800.
470 *Ibid*.

provisions of the Income Tax Act, when properly interpreted[471]. Also, according to the South African Constitution, which provides in Section 232 that "customary international law is law in the Republic unless it is inconsistent with the constitution of an act of Parliament"[472], customary international law may also be applied in transfer pricing cases.

4.5.3.1 The arm's Length Principle

South African transfer pricing rules adopt the ALP as the standard for determining the prices of cross-border transactions entered into by its residents[473]. In this context, according to Section 31.1, where any transaction, operation, scheme, agreement or understanding falls within the further explored concept of "affected transaction" and results in any tax benefit, the taxable income must be calculated as if the transaction had been entered into according to the terms and conditions that would exist between independent parties dealing at arm's length[474].

Therefore, when taxpayers enter into transactions with connected persons outside South Africa on terms or conditions that are not in accordance to the ALP and obtain a tax benefit from such terms or conditions, they are required to adjust their taxable income.

4.5.3.2 The Concept of Affected Transactions and Connected Persons

South Africa's transfer pricing provisions are applied to affected transactions, meaning any transaction, operation, scheme, agreement or understanding that: a) have been entered into

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[471] *South African Revenue Service Practice Note no. 7,* "Section 31 of the Income Tax Act, 1962 (the Act): Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing", South Africa 1999, 3.1.

[472] *The Constitution of the Republic of South Africa,* South Africa 1996, S. 232.

[473] "The fundamental principle underpinning South African transfer pricing legislation, since inception, is the arm's length principle as set out in Article 9 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries and the OECD Model Tax Convention on Income and on Capital. The principle is reinforced by the UN Practical Manual on Transfer Pricing for Developing Countries and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines)". UN Practical Manual *supra* note 3 at 617-618.

[474] *Income Tax Act,* South Africa 1962, Section 31.2.

between a resident and non-resident connected person, or between non-resident connected persons where either has a permanent establishment in the country, or between two resident persons where either has a permanent establishment outside the country to which the transaction is related[475] and b) "where any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length"[476]. In this context, a connected person in relation to a company, as defined in Section 1 of the Income Tax Act, is:

> a) any other company that forms part of the same group of two or more companies in which one company directly or indirectly holds shares in at least one other company with the effect that more than 50% of the shares of each controlled group are directly held by the controlling group company, one or more controlled group companies or any combination thereof and the controlling group companies or any combination thereof and the controlling group company directly hold more than 50% of the shares in at least one controlled group; b) any other company with a minimum 20% holding in the equity share capital in the company; c) any person, excluding a company, who individually or jointly with a connected person directly or indirectly holds at least 20% of the company's equity share capital or voting rights; or d) a company managed or controlled by connected persons of the company[477].

4.5.3.3 Transfer Pricing Methods

South Africa's transfer pricing law does not explicitly provide any transfer pricing methodologies. Therefore, taxpayers and tax authorities rely on the SARS' Practice Note no. 7, which incorporates the OECD Transfer Pricing Guidelines, prescribing the following

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[475] Johann Hattingh, *South Africa - Corporate Taxation* sec. 7.2, Country Surveys IBFD [Hattingh, "Country Surveys"].
[476] *Income Tax Act,* South Africa 1962, Section 31.1.
[477] Hattingh, "Country Surveys", *supra* note 458.

methods: a) the comparable uncontrolled price (CUP) method; b) the resale price method; c) the cost plus method; d) the transactional net margin (TNMM) method; and e) the profit split method[478]. Nevertheless, since Practice Note no. 7 does not constitute law, the SARS's Commissioner has to take into consideration the facts of each case individually in order to determine whether an arm's length price has been applied[479].

In order to select the most appropriate method, i.e., the method resulting in the maximum level of comparability and the least necessity of adjustments, it is indispensable to perform an analysis of the facts of each case, taking into account the availability of reliable data[480]. Although Practice Note no. 7 does not prescribe a hierarchy of transfer pricing methods to be applied, the CUP method is preferred over the other methods[481].

4.5.4 Peculiarities and Challenges in South Africa's Transfer Pricing Practices

The key principle underpinning South African transfer pricing law is the arm's length standard as established in Article 9 of both the UN Model Treaty and the OECD Model Treaty. Nevertheless, the application of the ALP in South Africa has presented some challenges since its inception. Indeed, South Africa is one of the five countries, including Brazil, China and India, that informed its transfer pricing practices – focusing on its challenges and particularities – in the 2017 version of the UN Practical Manual on Transfer Pricing for Developing Countries[482]. Additionally, in regards to its tax treaty network,

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[478] *South African Revenue Service Practice Note no. 7,* "Section 31 of the Income Tax Act, 1962 (the Act): Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing", South Africa 1999, 9.1.1 and 9.2.2.
[479] Lynette Olivier and Michael Honiball, *International Tax: A South African Perspective* 5ed (Cape Town: Siber Ink, 2011) 400.
[480] *South African Revenue Service Practice Note no. 7,* "Section 31 of the Income Tax Act, 1962 (the Act): Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing", South Africa 1999, 9.1.2 and 9.3.2.
[481] *Ibid* at 9.1.2 and 9.3.4.
[482] In this respect, it is important to notice that South African commentaries demonstrate a more moderate approach than those of Brazil, India and China.

South Africa has reservations in Article 9(2), reserving the right to making corresponding arm's length adjustments non-compulsory[483].

4.5.4.1 Challenges in Finding Reliable Comparables

One of the main challenges in South Africa's transfer pricing practice is the difficulty in finding domestic reliable comparables. In this sense, South African transfer pricing officials argue that they lack the data on comparables necessary to complete an appropriate transfer pricing analysis[484]. Therefore, since databases containing South African or even African specific comparable data are not available, taxpayers and tax authorities have to use foreign comparables – mostly from European databases – to determine arm's length levels of profitability[485].

In order to account for geographical differences (for instance, market, economic or political differences) and improve the degree of reliability of the comparable data, the SARS usually attempts to perform comparability adjustments[486]. For example, the SARS has made country-risk adjustments based on publicly available ratings and government bond rates; nonetheless, the SARS recognize that this analysis is often complex and, for this reason, comparability adjustments are applied with caution and only in certain circumstances[487].

Because of this lack of reliable comparables, South Africa adopts a more holistic approach in determining whether or not the ALP has been followed by taxpayers[488]. According to this holistic approach, instead of just considering the comparable data and not taking into considerations other relevant commercial factors, the SARS attempts to understand the "business model of taxpayers across the whole value chain, gaining an in-depth understanding of the commercial sensibilities and rationalities governing intra-group

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483 Hattingh, "South Africa" *supra* note 443 at 239.
484 Robert Feinschreiber and Margaret Kent, "South Africa would modify OECD transfer pricing procedures" (2014) 15:5 *Corporate Business Taxation Monthly* 29.
485 UN Practical Manual *supra* note 3 at 624.
486 *Ibid* at 625.
487 Feinschreiber and Kent, *supra* note 467.
488 UN Practical Manual *supra* note 3 at 625.

transactions and agreements" in order to establish the appropriate arm's length level of profit[489].

As it is the case in India[490], risk also plays an important role in the comparability analysis performed by South African tax authorities. Foreign parent companies, when comparing the higher profits earned in South Africa to comparable companies in other markets, do not take into account the actual functional and risk profile of the South African subsidiary and, therefore, are increasingly shifting profits via year-end adjustments to bring the South African subsidiary in line with comparable companies[491]. In this respect, South African transfer pricing administration has also noted that there appears to be an increasing tendency for South African subsidiaries to be classified as limited risk distributors or limited risk manufacturers, when, in reality, these companies assume considerable risks in performing their activities[492].

4.5.4.2 Location-Specific Advantages

In many circumstances, the South African market, as it happens with the other BRICS countries, has unique features that enable South African subsidiaries to earn higher profits than comparable data from foreign databases would suggest or than their related party partners earn in other parts of the world. One example is the South African pharmaceutical industry, which is still not saturated and, as a result, offers significant opportunities for MNEs to obtain higher profits[493]. Furthermore, South Africa has been experiencing

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[489] *Ibid*.
[490] See India Section for a comprehensive analysis of the country's practices regarding the evaluation of risks in its transfer pricing practices.
[491] "What occurs is usually a global policy change by the parent company aimed at limiting the return of its subsidiaries (including those based in South Africa) to a guaranteed return (determined by way of a comparable search). The change in policy is often followed by an introduction of year-end transfer pricing adjustments to ensure that South African entities achieve the often low targeted net margin while the residual profit is returned to the parent or holding company". UN Practical Manual *supra* note 3 at 628.
[492] Feinschreiber and Kent, *supra* note 467.
[493] UN Practical Manual *supra* note 3 at 628.

increasing participation and spending power of the middle class segment of its economy, which also provides important market opportunities for MNEs[494].

The South African approach regarding LSAs is still being developed by the country's tax authorities:

> Building on the practice followed in India and China, SARS is currently considering its approach to location savings, location specific advantages and market premiums within certain industries and those factors will be addressed when conducting audits[495].

4.5.4.3 Intangibles

Because of its unique nature, intangibles present a series of challenges for South Africa's transfer pricing administration[496]. South Africa experiences disputes regarding the existence of local marketing intangibles, cases involving economic versus legal ownership and also the valuation of intangible property[497].

South African transfer pricing rules involving intangibles are applied in conjunction with the country's exchange control rules. In this context, royalties payable by a South African enterprise to a foreign related party must be approved under the exchange control rules[498]. Furthermore, in comparison to the rest of the world, there is one relevant particularity in the treatment of transfer prices of intangibles in South Africa: the country's exchange

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[494] Spencer, "BRICS BEPS and the UN Manual Part 1" *supra* note 65.
[495] UN Practical Manual *supra* note 3 at 628.
[496] "There is a level of ambiguity present in the nature of these transactions as well as the values associated with it. In this ambiguous domain, non goods transactions are rife and pricing mechanisms overly complex, with multiple layers attached to them". The Davis Tax Committee Interim Report, *supra* note 437.
[497] UN Practical Manual *supra* note 3 at 628.
[498] There are two categories of royalties: royalties associated with a process of manufacture and other royalties. Regarding the first category, royalties exceeding 8% are rarely approved. As regards other royalties, the South African Reserve Bank is more flexible: related parties applying for approval have to submit an opinion from an independent transfer pricing specialist demonstrating that the proposed royalty rate is acceptable. The Davis Tax Committee Interim Report, *supra* note 437.

control regulations prohibit the relicensing of intangible property back into South Africa[499]. Accordingly, once the intangible assets are sold to a foreign related party, the latter becomes its legal owner, licensing the intangible property worldwide (except for South Africa) and earning royalties as compensation[500]. This peculiarity generally inhibits the potential for transactions involving transfers of intangibles as those described in the OECD Transfer Pricing Guidelines.

The restrictions in South Africa's exchange control regulations often allow a royalty rate regarding manufacturing royalties lower than the rates usually considered to be in accordance to the ALP in global transfer pricing studies of MNEs[501]. Besides that, one of the main transfer pricing strategies used by MNEs – the transfer of valuable intangible property to a low tax jurisdiction in order to ensure a flow of royalty income to that jurisdiction – is, to a great extent, prevented by South African rules because there are punitive tax consequences for South African taxpayers who pay royalties that were previously owned by them[502].

4.5.5 Conclusion

Transfer pricing is an area that is to be under a "policy flux"[503] in South Africa. Initially, the country completely followed the OECD Transfer Pricing Guidelines; however, in recent years, some fundamental aspects of the OECD standards are being questioned in South African transfer pricing practices. These include the practical application of the concept of comparability and its feasibility in an African context as well as deviations replacing the traditional ALP for a more subjective and holistic approach.

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499 UN Practical Manual *supra* note 3 at 628.
500 *Ibid* at 629.
501 The Davis Tax Committee Interim Report, *supra* note 437.
502 *Ibid*.
503 Hattingh, "South Africa" *supra* note 443 at 266.

Chapter 5

5 BRICS: Potential for Cooperation

The grouping of the BRICS countries as an informal association of emerging economies in the beginning of the 21st century was a response to the rapid growth of these countries and to the misbalance of power in global politics and economics. In recent years, the involvement of the BRICS in international organizations and leading informal unions, as well as their growing economic power, have elevated their political and economic significance. This allowed possibilities of cooperation between the BRICS in favor of new international tax and transfer pricing policies:

> On transfer pricing, the BRICS assume a particular relevance instead of the developing countries. The latter cannot be considered an influential player either in defining the set of rules for transfer pricing, nor in choosing policy-maker leader(s), basically because it is more a residence than source country topic. Instead, the BRICS, because of their strong economies and attractive investment opportunities, are moving from being developing to developed economies and over the last years they have acquired enough status to influence matters in transfer pricing and to justify their presence in the OECD discussions[504].

Nevertheless, considering the differences between the BRICS countries' economies, tax systems and international tax policies, there is no clear evidence demonstrating how these countries are organizing themselves in order to influence the international transfer pricing landscape. Therefore, this chapter considers the potential for cooperation between the BRICS and how they may influence or provide solutions for the problems experienced by emerging economies in applying the ALP and the OECD Transfer Pricing Guidelines. The chapter is organized in three sections, which analyze the convergence and divergence

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[504] Elio Palmitessa, "The Major Players in Recent and Future Tax Policy" in Raffaele Petruzzi and Karoline Spies, eds, *Tax Policy Challenges in the 21st Century* (Vienna: Linde, 2014) 27 at 40.

aspects present in the BRICS transfer pricing legislations; the impact and influence the BRICS have on international organizations, particularly the UN and the OECD; and the limits these countries face in their role of shaping the international transfer pricing scenario.

5.1 Points of Convergence and Divergence in the BRICS Transfer Pricing Policies

The BRICS, as most countries with transfer pricing regimes in force, have adopted – at least formally – the ALP as the standard method to allocate income originating from transactions between related parties. Nevertheless, the BRICS countries have different approaches when it comes to pragmatically interpreting and applying the theory of the ALP designed by the OECD in their domestic transfer pricing systems.

Brazil

The Brazilian transfer pricing rules, established in 1997, have the most distinctive approach in determining the prices of cross-border transactions between related parties[505]. Brazil's transfer pricing law includes only the CUP method, the cost-plus method and resale price method, excluding the profit-based methods recommended in the OECD Transfer Pricing Guidelines and adopted by other BRICS countries. In addition, in order to facilitate the application of the ALP in regard to the cost-plus and resale price methods, Brazil applies a system of predetermined profit margins and formulas, in which taxpayers are allowed to present counterproof when the predetermined margins diverge from the margins practiced between independent parties.

Russia

Russia's first transfer pricing legislation – in force from 1999 until 2011 – was only applied if the transfer prices deviated more than 20% from the prices practiced between unrelated parties. However, in 2012, Russia revised its transfer pricing rules and currently follows

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[505] See Section 4.1.

the OECD Transfer Pricing Guidelines[506]. Contrary to Brazil, Russia seems to be the BRICS member with the transfer pricing system most aligned with the OECD standards. Although the country's transfer pricing legislation diverged in some aspects from the OECD Transfer Pricing Guidelines[507], Russian tax authorities are not as concerned about these peculiarities as the other BRICS representatives[508]. Russian compliance with OECD's transfer pricing policies are related to the country's interest in becoming a member of the organization. Indeed, Russia has made an official request for the OECD membership in 1996 and, in 2007, the OECD Council at Ministerial level adopted a resolution to open discussions concerning the country's accession[509].

India

Indian transfer pricing legislation, introduced in 2001, follows the arm's length standard and is generally consistent with the approach recommended by the OECD, including all the methods prescribed in the OECD Transfer Pricing Guidelines[510]. Nevertheless, India argues that the OECD transfer pricing approach does not effectively considers specific market circumstances of the country, such as location savings realized in India or the actual risks borne by local Indian subsidiaries.

China

The transfer pricing legislation in China follows the ALP and the OECD Transfer Pricing Guidelines methods, including other reasonable methods when necessary[511]. As it is the

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[506] See Section 4.2.
[507] See Section 4.2.4, page 57.
[508] Russia was the only member of the BRICS that did not participate on the UN Practical Manual on Transfer Pricing. Therefore, no contribution regarding the country's transfer pricing practices was presented. Regarding its participation in the OECD, "Russia is a much less vocal observer at the OECD, yet in terms of actual policies it is closer than the other BRICS countries to OECD norms". Yariv Brauner and Pasquale Pistone, "The BRICS and the Future of International Taxation" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 495 at 513.
[509] OECD, The Russian Federation and the OECD, Organisation for Economic Co-operation and Development, online: < http://www.oecd.org/russia/therussianfederationandtheoecd.htm>.
[510] See Section 4.3.
[511] See Section 4.4.

case in India, Chinese tax authorities also understand that the OECD approach is not completely adequate to the country's peculiarities. China argues, for instance, that location-specific advantages – location savings and market premiums – should be taken into account when determining the arm's length price of a related party transaction. Another Chinese particularity in applying the ALP is the difficulty in finding reliable comparables, especially because of the lack of public information regarding domestic comparable transactions.

South Africa

South Africa, which enacted its transfer pricing rules in 1995 and then revised in 2013, follows the OECD Transfer Pricing Guidelines, as elucidated in a South African Revenue Service practice note issued in 1999[512]. Although having recent transfer pricing legislation, South Africa's experience with the application of the ALP aligns with the transfer pricing challenges encountered by other BRICS countries. These challenges include location-specific advantages as well as the lack of domestic reliable comparables and the consequent difficulty in performing an effective comparability analysis. This leads to the application of a more subjective and holistic approach by South African tax authorities.

Therefore, although all the BRICS have adopted transfer pricing rules in their domestic legislation that, at least theoretically follow the ALP, the application of these rules according to the OECD Transfer Pricing Guidelines present pragmatic challenges for them, specifically for Brazil, India, China and South Africa. These challenges and the BRICS countries' practices regarding them are compared and analyzed in the next sections.

5.1.1 Lack of Reliable Comparables: A Common Difficulty with Distinctive Solutions

Some of these challenges, such as the difficulty in finding local reliable comparables, are not particular to only one member of the BRICS. Brazil, China and South Africa have all manifested problems in this respect, demonstrating concerns with the availability and

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[512] See Section 4.5.

quality of domestic information regarding transactions between independent parties that can be used for comparisons. However, the treatment each of these countries gives to the lack of reliable comparables is completely different.

While Brazil has focused on a more pragmatic transfer pricing system with the use of predetermined margins, South Africa tax authorities have opted for a more holistic approach in determining the appropriate transfer price of transactions between related parties. The Chinese transfer pricing policies concerning the lack of local comparables, on the other hand, seem to be the more aligned with the ALP, having influenced international initiatives related to the issue. In June 2017, the Platform for Collaboration on Tax (PCT), a joint initiative of the IMF, OECD, UN and World Bank Group – has developed a "Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses". This toolkit recommends Chinese practices, such as using geographic proximity as a criterion in the selection of foreign comparables[513] or adjusting for differences in geographic market, are recommended for other tax administrations[514].

5.1.2 Location-Specific Advantages, Location Savings and Market Premium: A Shared Concern Among China and India

The concept of location-specific advantages (LSAs) – which, in the last years, acquired a central position in the transfer pricing debate mainly due to the increasing foreign direct investments in emerging economies[515] – has assumed particular importance in India and China. The basic idea behind LSAs is that investments made by MNEs in these countries, because of their unique market features, such as inexpensive and skilled labour force,

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[513] In dealing with the lack of reliable local comparables, when there are no Chinese publicly listed comparables, China accepts pan-Asian comparables, which have economic similarities and relevant regional trade and capital flows.
[514] World Bank, "The Platform for Collaboration on Tax: A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses" (Washington, 2017) World Bank Group, online: <http://documents.worldbank.org/curated/en/447901498066167863/The-platform-for-collaboration-on-tax-a-toolkit-for-addressing-difficulties-in-accessing-comparables-data-for-transfer-pricing-analyses>.
[515] Sébastien Gonnet, Makoto Ikeya and Vladimir Starkov, "Location Specific Advantages – Case Studies" (2011) *Transfer Pricing International Journal* at 1.

access to large consumer markets, cost savings and incentives, are more profitable than the same investments in other countries.

The tax authorities of China and India manifested their positions on LSAs in the UN Practical Manual[516], raising awareness to LSAs as important aspects that should be considered when carrying out comparability analysis in transfer pricing audits. According to these countries, a portion of the LSAs should accrue to the Chinese and India entities and be subjected to tax there. The OECD Transfer Pricing Guidelines, on the other hand, provide examples that, although acknowledging the existence of LSAs in MNEs operations, argue that the entity that has the bargaining power is the one that should be able to claim the LSAs[517].

5.1.3 Intangibles and Risks

As discussed in Chapter 2, the application of the ALP involves a comparability analysis that takes into account functions, assets and risks. Nevertheless, intangible assets and risks are easier to move than functions and tangible assets, which gives MNEs the opportunity to use artificially shift them to jurisdictions where they will receive a more favourable tax treatment[518]. Dealing with intangibles and risks in a transfer pricing context is a complex issue not only for developing and emerging economies but for developed countries as well. However, China and India express particular concerns with the fact that MNEs often shift the profits made in these countries to other jurisdictions by characterizing their Chinese

[516] South Africa also considers LSAs in its transfer pricing audits; however, the country still does not have a definitive position regarding this concept. As the South African representative stated in the UN Practical Manual, “building on the practice followed in India and China, SARS is currently considering its approach to location savings, location-specific advantages and market premiums within certain industries and those factors will be addressed when conducting audits”. UN Practical Manual *supra* note 3 at 628.

[517] “Where significant location savings are derived further to a business restructuring, the question arises of whether and if so how the location savings should be shared among the parties. The response should obviously depend on what independent parties would have agreed in similar circumstances. The conditions that would be agreed between independent parties would normally depend on the functions, assets and risks of each party and on their respective bargaining powers”. OECD Transfer Pricing Guidelines *supra* note 8 at 285.

[518] See Chapter 2, page 19.

and Indian subsidiaries as utilizing foreign-owned intellectual property, on which they have to pay royalties.

5.1.4 Formulary Apportionment

Even though practices in some of the BRICS countries are undermining the idea that there is an international consensus on the ALP and on its traditional application, these countries do not go as far as to support a purely global formulary apportionment approach as an alternative to the arm's length standard. None of the BRICS countries have incorporated the formulary apportionment system into their tax treaties or domestic transfer pricing legislations[519]. China, for example, joined the OECD in advising against a change from the ALP to formulary apportionment in the BEPS Action Plan[520]. The motive for this Chinese position is that the country anticipates huge complications in choosing an acceptable global allocation formula and in implementing the formulary apportionment in practice[521].

Some of the reasons for the non-adoption of the formulary apportionment system include the difficulty to find consensus in the international level about the criteria to be used for the apportionment and, particularly for the BRICS, there is no evidence that this methodology would be more favourable, considering the lower values that a potential formula would assign to emerging economies[522]. On the other hand, it is argued that formulary apportionment, besides being easier and cheaper to administer, avoids the allocation of income to tax havens as no income would be apportioned to haven intangibles holding companies under a formula mainly based on sales (there is no market in tax havens)[523].

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[519] As examined in Chapter 4, Section 4.1.3, even though Brazilian transfer pricing rules, with its predetermined profit margins, may bear resemblance to formulary apportionment, Brazil applies the arm's length principle in its tax treaties and domestic law, using formulas only to simplify the application of the cost-plus and resale price traditional transaction methods.
[520] Hu and Li, *supra* note 383 at 205.
[521] David Spencer, "Formulary Apportionment is not a Panacea" (2014) 25:7 *Journal of International Taxation* 44.
[522] Prats, *supra* note 125 at 416.
[523] Lee Sheppard, "Is Transfer Pricing Worth Salvaging?" (2012) *Tax Notes* 467 at 473.

5.2 The Impact and Influence of the BRICS on Supranational Tax Bodies

The BRICS individual positions and advocacy on particular transfer pricing issues have influenced the public discussions on international tax and transfer pricing policies, including the works of supranational tax bodies, such as the UN and the OECD[524]. This section reviews how this influence has been reflected in the works of the UN Committee of Tax Experts in International Tax Matters and in the OECD/G20 BEPS initiative.

5.2.1 BRICS and the works of the UN Committee of Tax Experts in International Tax Matters and the UN Subcommittee on Transfer Pricing

The UN Committee of Tax Experts in International Tax Matters ("UN Tax Committee") is composed by 25 members – designated by governments but acting in their expert personal capacity – appointed by the Secretary General in accordance with an equitable geographical distribution and representing different tax systems[525]. The main difference between the UN Tax Committee and the OECD Fiscal Committee is that, as opposed to the latter, the UN does not recommend that all members use the UN Model as well as interpret and apply their treaties following the Group of Experts commentaries[526].

The BRICS[527] are influential countries in the context of the UN Tax Committee, having constantly emphasized the necessity to adapt OECD international tax standards to the peculiarities and needs of less developed and developing countries[528]. Although the BRICS

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[524] Ring, *supra* note 113 at 479.
[525] United Nations, "Committee of Experts on International Cooperation in Tax Matters", Financing for Development, online: <http://www.un.org/esa/ffd/tax/>.
[526] Prats, *supra* note 125 at 405.
[527] The BRICS countries that are member of the Committee are: Brazil, China, India and South Africa, while Russia usually participates as an observer.
[528] It is difficult to determine the exact influence of each country in the development of the Committee since its reports do not specifically mention any country position and, besides that, experts contribute in their own personal capacity and not representing their country. The only exception is India, which have made public statements and comments regarding its positions in the UN Tax Committee. Prats, *supra* note 125 at 405.

are gradually moving from a pure capital-importing position to a net capital exporter position, the inflow of foreign direct investment is still crucial for them and, for this reason, the BRICS generally recognize the UN Model Convention and Commentaries as a "starting point strengthening source state jurisdiction"[529]. The UN Tax Committee and its meetings, therefore, are a relevant platform for the BRICS countries as they are able to use their representatives to influence the UN work according to their international tax and transfer pricing policies, especially considering that there is a limited number of representatives from other developing countries that can attend the meetings and that these representatives can support the BRICS positions[530]. In addition, the UN is an international organization in which all countries in the world are members and the documents and publications it issues can attract the attention from the tax world, playing an important role in subsequent discussions on international tax issues[531].

Transfer pricing is one of the core international tax areas where the BRICS and other developing countries pressure the UN to diverge from the OECD traditional standards:

> The peculiarities of the UN Model vis-à-vis the OECD Model are somehow quite relevant, and have resulted not only in the establishment of a specific divergent clause in the text of the UN Model (specifically, article 9(3), but also in the formulation of the UN Practical Manual on Transfer Pricing for Developing Countries in 2013, as a result of the work done by the Subcommittee on Transfer Pricing – Practical Issues[532].

The UN Practical Manual establishes guidance to developing countries and helps them in dealing with peculiar problems when applying the ALP to transfer pricing transactions. There is an agreement between the members of the UN Subcommittee on Transfer Pricing that the UN Practical Manual is not intended to depart from the international consensus

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[529] Prats, *supra* note 125 at 407.
[530] Goede, *supra* note 116 at 427.
[531] *Ibid*.
[532] Prats, *supra* note 125 at 415-416.

and from the framework established in the OECD Transfer Pricing Guidelines[533]. This idea is followed throughout most part of the UN Practical Manual; however, in the last part of the document (in the 2012 version, Chapter 10 and, in the 2017 version, Part D), the tax authorities of Brazil, China, India and South Africa have had the opportunity to present their national perspectives regarding the transfer pricing challenges and the practical solutions adopted by them[534]. These positions – which deviate in some forms from OECD considerations on the application of the ALP – do not necessarily reflected a consensus among the UN Subcommittee.

According to Jan de Goede, who has been personally involved in the work of the UN as an IBFD (International Bureau of Fiscal Documentation) Senior Principal, "this area [transfer pricing] is the one where the BRICS countries present at the [UN Subcommittee on Transfer Pricing] operated in support of each other, even though their individual positions are not fully aligned"[535]. Indeed, although the UN emphasizes that the last part of the manual refers merely to the countries' practices and experiences, the BRICS effectively used this space to outline their transfer pricing policies for countering MNEs' strategies to have value not taxed in the country where it was created. Some of these transfer pricing policies were included in the BEPS measures, as discussed in Section 5.2.2.

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[533] One of the guiding principles in the creation of the UN Practical Manual was "Consistency with the OECD Transfer Pricing Guidelines5 has been sought, as provided for in the Subcommittee's man- date and in accordance with the widespread reliance on those Guidelines by developing as well as developed countries". UN Practical Manual *supra* note 3 at XI.

[534] During the UN Practical Manual discussions, participants referred to the experience of Brazil in using fixed margins for transfer pricing, acknowledging how this approach could eliminate the need to find comparables and provide a simple and low-cost system for taxpayers and tax authorities. This was the object of a great deal of controversy as other participants, among other arguments, found it difficult to conciliate the simplified margins with the arm' length principle. This controversy was one of the reasons for the UN Subcommittee to decide to include a final Chapter/Part in the UN Practical Manual. United Nations Economic and Social Council, "Report on the Informal Meetings on Practical Transfer Pricing Issues for Developing Countries" (2011) United Nations, online: <http://www.un.org/ga/search/view_doc.asp?symbol=E/C.18/2011 /5&Lang=E>. See Chapter 4 for further details on the views and practices of the BRICS expressed on the UN Practical Manual.

[535] Goede, *supra* note 116 at 437.

The BRICS countries participation in UN Tax Committee and in the UN Subcommittee on Transfer Pricing shows that these countries have supported each other in having their positions considered and reproduced in the works of the UN. This mutual support was given even on matters where there was no common agreement between the BRICS regarding the individual tax policies taken by each one of them. The most notable example is the UN Practical Manual, where, even though the individual transfer pricing policies and methodologies of the BRICS countries were diverse, they all supported and contributed to the inclusion of a new chapter in the manual laying out their practices.

5.2.2 BRICS and the BEPS Project

Given the structure of the OECD, the organization's initiatives are predominantly developed by representatives of its member countries. In the case of the BEPS project, in response to previous criticisms regarding the legitimacy of the OECD – as a body with exclusive membership – in articulating global consensus concerning international tax policy rules, selected non-member countries were invited to participate in developing the initiative[536]. The OECD members also have a strong interest in the inclusion of the BRICS and other developing countries in the BEPS initiative because, if these countries were not engaged in the project, the suggested anti-BEPS measures effectiveness would not be guaranteed, possibly leading to the relocation of MNEs to countries where the measures were not adopted[537].

The BRICS countries also have a strong interest in participating in the BEPS project, considering that base erosion and profit shifting are significant issues for their economies. In India, for instance, the analysis of case law suggests that base erosion usually occurs because of the distribution of taxing rights in favor of residence countries. In China, BEPS

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[536] Allison Christians, "BEPS and the New International Tax Order", *supra* note 40.
[537] According to Eva Eberhartinger, there is common understanding between the OECD countries that virtually all the countries should be included in the efforts to avoid base erosion and profit shifting. Nevertheless, the author emphasized that the views of stakeholders that were not completely involved in the development of the project – including the general public and, particularly, non-member countries of the OECD – did not receive significant consideration in the BEPS initiative. Eberhartinger and Petutschnig, supra note 117 at 9.

practices are considered by the SAT as major threats for the country's tax administration[538]. Since BEPS refers to shifting profits from countries where the business activities occur to low-tax jurisdictions, China – as a major producer of goods and market for goods and services with a corporate income tax rate of 25% – is believed by some to be one of the main victims of BEPS[539].

More than that, for the BRICS countries, the BEPS project represents an opportunity for reforming the existent international tax system, including the transfer pricing area. As discussed in Chapter 4, the BRICS have developed their transfer pricing legislations quite late in comparison with other developed economies and, most of them, had to enact domestic laws that did not deviate from the international norms, resulting in a mere implant of international standards to their domestic laws. These international transfer pricing norms, as established by the OECD member countries, have demonstrated to be inadequate for countries in different stages of development, such as the BRICS. For this reason, the BRICS – which were not involved in the decision-making process of the current international tax regime – see the BEPS initiative as an important opportunity to exert their influence regarding the matters that are significant for them[540].

As members of the G20, the BRICS contributed to putting BEPS on the global agenda. Also, the BRICS countries have been invited to participate in the Committee on Fiscal Affairs[541] and in the Global Forum on Transparency and Exchange of Information for Tax

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538 State Administration of Taxation: The People's Republic of China, "State Administration of Taxation People's Republic of China Views on Service Fees and Management Fees", UN, online: <http://www.un.org/esa/ffd/tax/TransferPricing/CommentsPRC.pdf>.

539 Li, "China and BEPS" *supra* note 433.

540 However, the benefits of the BRICS countries participation in the such initiatives are questioned by Tsilly Dagan. The author argues that, because of their different economies structures, cooperation between the BRICS countries and the OECD in international tax matters is only in the interest of OECD member countries. Tsilly Dagan, "BRICS: Theoretical Framework and the Potential of Cooperation" in Yariv Brauner and Pasquale Pistone, eds, *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015) 15.

541 The OECD Committee on Fiscal Affairs (CFA), which is the steering body for the BEPS Project, brings together 44 countries on an equal footing: all OECD members and the BEPS Associates (8 non-OECD G20) and OECD accession countries: Argentina, Brazil, China, Colombia, India, Indonesia, Latvia, Russia, Saudi Arabia and South Africa. OECD, "BEPS Information Brief",

Purposes, being active contributors to these initiatives. For example, China's tax administration representatives, until 2015, had attended 42 BEPS meetings, submitted 52 position papers to the OECD and made several other contributions to the project[542].

With respect to transfer pricing, the BEPS initiative has started as a challenge to the complete dominance of the arm's length standard, recognizing the necessity of using other methods in cases where an arm's length valuation is unmanageable. Although the ALP is still seen by the OECD as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices, the way the OECD is moving towards transactional methods – accepting the profit split method as an appropriate method for intangibles – is consistent with the BRICS desire for a simpler transfer pricing system.

More specifically, the influence of the BRICS on the BEPS initiative is evidenced by the inclusion of location savings and specific market advantages in Action 8 Final Report, according to which "difficult issues can arise in evaluating the differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market […] (location savings). In other situations comparability issues can arise in connection with […] local market advantages or disadvantages"[543]. The following guidance on the treatment of location savings given by BEPS Action 8 is generally in accordance with the Chinese and Indian perspectives[544] on the issue:

> In determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the

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OECD online: <http://www.oecd.org.proxy1.lib.uwo.ca/ctp/beps-2014-deliverables-information-brief.pdf>.

542 Li, "China and BEPS" *supra* note 433.

543 Organization for Economic Co-operation and Development, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports* (Paris, OECD Publishing, 2015) at 43 [OECD, "Actions 8-10 Final Reports"].

544 See Chapter 4 for a detailed analysis of the Chinese and Indian practices regarding location savings.

> MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings. Where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated […] When reliable local market comparables are not present, determinations regarding the existence and allocation of location savings among members of an MNE group, and any comparability adjustments required to take into account location savings, should be based on an analysis of all of the relevant facts and circumstances, including the functions performed, risks assumed, and assets used of the relevant associated enterprises[545].

The BEPS initiative emphasis on the value creation of intangibles, as articulated in Action 8, is also in line with the BRICS – more specifically China and India – transfer pricing approach. The BEPS Final Report new guidance demands a careful analysis of the actual transaction between the related parties, by analyzing not only the contractual relations between them, but also their conduct, through an examination of the functions performed, assets used and risks assumed[546]. According to this revised guidance, the conduct of the related parties will supplement the contractual arrangements (if they are incomplete) or even replace them (when they are not supported by the conduct)[547]. This approach was already applied by Chinese tax authorities, which, when assessing the deduction of intra-group royalties, performed a contribution-based value creation analysis[548]. Likewise,

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[545] OECD, "Actions 8-10 Final Reports", *supra* note 526 at 44.
[546] *Ibid*.
[547] *Ibid*.
[548] According to the Chinese approach, royalties paid to foreign related parties that only have the legal ownership of the intangible property but do not contribute to value creation regarding the

Indian transfer pricing rules also emphasize the conduct of the related parties rather than their contractual arrangements, especially regarding the allocation of risks.

Another influential transfer pricing position from the BRICS can be found in the BEPS revised guidance on the application of the CUP method, usually appropriate for determining the prices of commodity transactions. This new guidance states that quoted prices – such as those from a commodity exchange market – may be useful in establishing arm's length prices of related parties' transactions. This practice has already been applied in Brazil, where it consists in specific transfer pricing methods for import transactions (PCI method)[549] and export transactions (PECEX method)[550].

Therefore, important outcomes of the BEPS project regarding transfer pricing have been influenced by the participation of the BRICS countries in this initiative. The BRICS contributions to the BEPS initiative illustrate what these countries can realistically achieve at a global level. It is important to emphasize that the scope of the BEPS initiative was not to redesign all the basic international tax principles. Thus, the international tax regime continues to be biased in favor of developed capital exporting countries[551]. Also, the "possibilities for non-OECD countries to participate in the decision-making process on anti-BEPS measures have been limited and rarely acted on […] they [non-OECD countries] seem to serve the interests of OECD countries, rather than those of non-OECD countries"[552].

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property, are not in accordance with the arm's length principle. Li, "China and BEPS" *supra* note 433.

[549] See Chapter 4, page 45.

[550] See Chapter 4, page 47.

[551] Analyzing the BEPS initiative bias in favor of developed countries, Yariv Brauner and Pasquale Pistone state that "had the BEPS developments been framed under the aegis of the UN, a much stronger shift towards taxation at source would have naturally occurred, which the world was perhaps not, or is not yet, ready to accept". See Brauner and Pistone, *supra* note 491 at 503.

[552] Eberhartinger and Petutschnig, supra note 117 at 12.

Nevertheless, the BEPS initiative represents the beginning of a discussion process that involves countries other than the OECD members and, to the extent that this initiative is reforming the existent transfer pricing regime, the BRICS are actively involved.

5.2.2.1 BRICS Memorandum of Cooperation on Tax Matters

In July 2017, the BRICS signed a Memorandum of Cooperation on Tax Matters (MoC) between their tax authorities as a recognition of the "significance of strengthening multilateral tax cooperation for BRICS countries in order to improve tax compliance and protect [their] tax base"[553]. The MoC aims to promote cooperation between the BRICS tax administrations on identified common areas of interest regarding tax matters. In this respect, the BRICS have reached the understanding of coordinating their positions on priority work of the G20 tax agenda, including the implementation of the standards of the BEPS initiative and improving their collective involvement in international tax issues under the framework of the UN[554].

The MoC prescribes the cooperation between the BRICS countries on capacity building by organizing expert visits between them in the form of seminars or workshops on international tax matters[555]. Within the available resources, the BRICS will also cooperate in providing technical assistance to developing countries.[556]

Furthermore, the MoC reaffirms the BRICS countries' support for the BEPS initiative. In a Communiqué issued after the BRICS meeting on 27 July 2017, the BRICS affirmed they "remain committed to the facilitation of economic growth, as well as the timely, consistent

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553 BRICS, "Communiqué of BRICS Heads of Tax Authorities Meeting issued in Hangzhou on July 2017", online: <http://idg.receita.fazenda.gov.br/noticias/ascom/2017/julho/receita-federal-participa-de-reuniao-dos-paises-brics/communique-meeting-of-brics-heads-of-tax-authorites.pdf>.
554 BRICS, "Memorandum of Cooperation Between Brazil, Russia, India, China and South Africa", online: < http://lawprofessors.typepad.com/files/brics-mou-for-crs.pdf>.
555 *Ibid*.
556 *Ibid*.

and widespread implementation of the BEPS project outcomes and call upon all relevant jurisdictions to join the inclusive framework on BEPS on an equal footing"[557].

5.2.3 The Roles of the BRICS as Norm Takers and Norm Makers

A considerable part of the literature relating to state influence over, or acceptance of, global governance arrangements describe states in simple and dyadic terms, labeling them as either norm makers – by imposing or playing an essential role in the norms that regulate a global governance issue area – or norm takers – by accepting the existing norms regulating a certain area or accepting norms proposed by other states[558]. European countries and the United States have usually been regarded as norm makers, or normative leaders; on the other hand, developing countries – including emerging economies – because they were socialized into an existing world order, have typically been seen as norm takers[559].

Nevertheless, with the rise of the BRICS countries in the 21st century, some authors now see these emerging economies in a position to be norm makers, particularly because of the economic relevance these countries assumed due to their growth, market size and regional influence[560]. Indeed, one of the shared characteristics among the BRICS is their aspiration to become norm makers instead of norm takers, challenging the dominant states at the center of global decision making and acting as a revisionist power within global economic governance[561].

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557 BRICS, "Communiqué of BRICS Heads of Tax Authorities Meeting issued in Hangzhou on July 2017", online: <http://idg.receita.fazenda.gov.br/noticias/ascom/2017/julho/receita-federal-participa-de-reuniao-dos-paises-brics/communique-meeting-of-brics-heads-of-tax-authorites.pdf>.

558 Tristan Galloway, "Beyond the Norm-Maker/Norm-Taker Dyad: Political Roles & State Engagement with Global Governance" (2013) *International Conference on Political Science, Sociology and International Relations (PSSIR) Proceedings* 11.

559 Sikina Jinnah, "Makers, Takers, Shakers, Shapers: Emerging Economies and Normative Engagement in Climate Governance" (2017) 23 *Global Governance* 285 at 287.

560 *Ibid*.

561 Duggan, *supra* note at 107 at 17.

In respect to the role of the BRICS as norm makers in the international tax regime, it is possible to note a critical attitude among the members of the group towards standard tax policies:

> The BRICS do not approach tax policy formation (including the negotiation of treaties) from the perspective of consumers satisfied with the off-the-shelf, standard version of tax policy. They think critically about their needs, they review the models and guidance currently available and then they mix and match and innovate to the extent that their considerable negotiating power permits[562].

Acknowledging the BRICS as norm makers, however, does not mean that these countries would be able to transform the existing international tax regime, eliminating all the transfer pricing policies that are not convenient for them. Nor does it imply that the BRICS countries would dismiss all the tax policies designed by supranational tax bodies, such as the OECD and the UN[563]. The role of the BRICS as norm makers is rather an indication of how these countries have developed their unique international tax policies on certain matters that are important for them, such as transfer pricing.

Brazil, for instance, has demonstrated resistance to being a norm taker in respect to the traditional arm's length approach to transfer pricing established by the OECD in its Transfer Pricing Guidelines. Having adopted transfer pricing rules where predetermined profit margins are used in the cost-plus and resale price methods, the country has developed a transfer pricing system that is a "conciliation between the arm's length standard and the practicability needs"[564]. However, even though Brazil departed from the traditional OECD arm's length standard, the country manages to reconcile its unique approach with its tax treaty network, which include article 9(1) of the OECD Model Treaty. The Brazilian understanding is that the country's transfer pricing legislation is compatible with the ALP and, as a consequence, with Brazil's responsibilities under its tax treaties.

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562 Ring, *supra* note 108 at 479.
563 *Ibid*.
564 Schoueri, *supra* note 168 at 65.

The Brazilian transfer pricing treatment illustrates how the BRICS may perform their role as norm makers in the international tax regime. Brazil has had enough authority to design and enforce a domestic transfer pricing system that – although significantly different from the dominant transfer pricing regime – is regarded by the country's tax administration as a more pragmatic and effective approach for an emerging economy reality. On the other hand, Brazil has not completely disregarded the ALP or the OECD's influence on the international tax regime: the country's tax treaties incorporate article 9(1) of the OECD Model Treaty and meet the ALP requirements in its transfer pricing law by allowing taxpayers, under certain circumstances, to use different profit margins than those established by the law.

Resistance to merely accepting the OECD's approach to transfer pricing was also expressed by India, which, in 2012, published a letter criticizing the OECD Transfer Pricing Guidelines and, essentially, emphasizing how these guidelines were prejudicial for developing (source) countries[565]. According to David Spencer, "the letter represented a seminal event, as it was the first significant argument by a major developing country against the Guidelines[566]". The Indian role as a norm maker is further explained by Lee Sheppard:

> India is only an observer at the OECD, but its influence on the development and interpretation of treaties cannot be underestimated. India regards the OECD model commentary as a mere recommendation and the 1995 OECD transfer pricing guidelines as a document that takes care of the interests of developed (read capital-exporting) countries at the expense of the taxing rights of developing countries. India has lobbied the U.N. Financing and

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[565] Sanjay Kumar Mishra, Joint Secretary and Permanent Representative of India to the United Nations, in "Letter to the United Nations Conveying Government of India's Views on the Advance Unedited Version of the Report on the Work of the Committee of Experts on International Cooperation in Tax Matters" (2012), online: < http://www.un.org/esa/ffd/tax/2012ICTM/LetterIndia.pdf> .

[566] Spencer, "BRICS, BEPS and the UN Manual Part 1", *supra* note 65.

> Development Office to devalue the guidelines as guidance for article 9 of the U.N. model treaty[567].

Correspondingly, as examined above, the participation of Brazil, India, China and South Africa in the UN Practical Manual provided "an 'end run' around the OECD Transfer Pricing Guidelines"[568].

5.3 Limits and Possibilities on the BRICS Role in Shaping the International Transfer Pricing Landscape

The BRICS have been recognized as a relevant group in the tax community. As discussed in the previous sections, the grouping of the BRICS countries and their relevance in the international transfer pricing scenario derives mainly from their economic power and status as emerging economies. Moreover, the BRICS have common features and international tax practices that support them as a coalition seeking to shift the balance of global political influence towards the developing world[569].

Nevertheless, the BRICS also have significant historical, social, economic, geographic and political dissimilarities that challenge their performance as a unified group, which may reduce their impact on possible international tax and transfer pricing policy reforms. In a study conducted by The Hague Centre for Strategic Studies (HCSS) on the impact of emerging economies on global governance, an analysis of the BRICS countries emphasized their differences as a significant barrier for their cooperation as a group:

> While cooperation between the BRICS countries is increasing, differences between them remain large as well. These differences include economic structure, level of economic development, external and internal security situation, level of democracy and so on. They create substantial barriers for finding true common ground and often limit cooperation among the BRICS

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[567] Sheppard, *supra* note 506 at 468.
[568] Feinschreiber and Kent, *supra* note 467.
[569] Nikonov, *supra* note 141.

> on many issues. The absence of a broadly shared positive agenda is the main reason why it is highly unlikely for these countries to grow into a geo-economic, geopolitical alternative to the West within the next five to ten years[570].

Some authors argue that, having not much in common – and, in fact, having a great deal of rivalry between them – all the BRICS countries share is the challenge to Western hegemony[571]. Analyzing the uniqueness of the BRICS countries through a Brazilian perspective, Luís Schoueri argues that "the idiosyncrasies of the Brazilian tax environment mean that it may have different positions than the other BRICS countries. However, the BRICS countries may have common needs and claims that are not currently represented in the OECD"[572]. In this sense, assuming that these differences with the OECD are the main connection between the BRICS, the question that arise is whether this is a sufficient tie to unite these countries and their international tax policies.

In the international transfer pricing area, considering that nearly all of the BRICS countries are becoming, or at least aspire to become capital exporter countries, their adoption of policies associated with residence jurisdictions may weaken their role as representative source countries and move them closer to the OECD approach[573]. This could lead to a transformation in the existing international tax landscape, where "perhaps the role currently

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[570] Sijbren de Jong, Rem Korteweg, Joshua Polchar and Artur Usanov, *New Players, New Game? The Impact of Emerging Economies on Global Governance* (Amsterdam: Amsterdam University Press, 2012) 71.

[571] The author emphasizes the experiences of the BRICS regarding the Western hegemony: "India still remembers its colonial past and the international order dictated and dominated by the colonial powers. China, the most significant economic power of the group, also remembers the Opium Wars and its humiliations in the hands of the same powers. South Africa still remember the apartheid regime". Sengupta, *supra* note 304 at 174.

[572] Schoueri, *supra* note 168 at 77.

[573] As the BRICS expand their outbound investments and see themselves as capital exporters, the OECD approach starts to seem more attractive for them. China is one example of this trend: "If the high-speed growth continues and Chinese outbound investment continues to expand, China may need to alter its international tax policy to reflect more factors as a residence country in the near future. As a consequence, more features of the OECD Model and its Commentary would be seen in Chinese tax treaties that are newly negotiated or amended through protocols. Hu and Li, *supra* note 383 at 227.

occupied by the BRICS, as a vocal 'counterpoint' to the OECD and developed countries will be filled in the future by a new set of countries with a new acronym"[574]. Still, this close alignment with the OECD depends on the continuing economic development of the BRICS in the foreseeable future, which is not guaranteed.

However, even in their present stage of economic development – in which the importance of source-based taxation is still a priority – the BRICS usually rely on OECD standards as the accepted baseline against which they advocate a different policy. The transfer pricing policies of the BRICS countries are not created in isolation but rather as a departure from established practices, demonstrating the significant influence that the supranational tax bodies (the OECD and the UN) have in these countries:

> An organization or, more precisely, a pair of organizations that provide a common starting point for negotiating (e.g. in the case of the two model treaties) or discussion (in the case of the OECD guidance and initiatives) can facilitate international tax policy conversations. If every discussion and every negotiation started 'at the beginning', coordination and agreement would likely be slower and the prospects for resolution likely diminished. Additionally, to the extent that many jurisdictions (beyond OECD countries and the BRICS) are not in a position to prepare their own models or draft regulations or guidelines, the ability to access a comprehensive set of tax materials can be valuable[575].

Although several transfer pricing practices and interests of the BRICS are distinct from those of the OECD countries, it is possible to note a general reliance on the OECD's framework and on the ALP. For instance, Brazil's predetermined profit margins methodology does not create a new system or principle, but rather reconciles the ALP (prescribed in Article 9 of the OECD Model Treaty) with a more practical approach. Moreover, the Chinese and Indian dissonant transfer pricing policies examined above –

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[574] Ring, *supra* note 108 at 490.
[575] *Ibid* at 490-491.

such as LSAs – and their recognition by the international community were not developed through a consensus between the BRICS, but through pressure on the UN to provide them a space in the UN Practical Manual to express their practices and on the OECD to incorporate some of these concepts in the BEPS initiative.

5.4 Conclusion

The BRICS have selected the ALP as the standard method in dealing with transfer pricing; however, the interpretation and the application of this principle in each of the BRICS countries is different. There are similarities in the challenges presented by the ALP for the BRICS, such as the difficulty in finding comparables and in establishing appropriate transfer prices for intangible transactions. Nonetheless, there is no coordination between the BRICS regarding the solutions they found for these challenges, except for China and India, which seem to cooperate and coordinate their positions on LSAs.

The BRICS identification as a group as well as their resistance to being merely norm takers have influenced the public debate on international transfer pricing policies. Therefore, these countries have had an impact on the works of relevant tax organizations, such as the UN and the OECD. However, because of a series of limitations – particularly regarding the differences among them – the BRICS do not seem to be able to act as a ‘unified front’ or to dismantle the current international transfer pricing regime.

Chapter 6

6 Conclusion

This thesis has examined the role of the BRICS in the governance of the international transfer pricing regime as well as their potential for cooperation in rebalancing the existing power structures in international taxation.

Transfer pricing is a complex issue for tax administrations and taxpayers across the world. The ALP and the OECD Transfer Pricing Guidelines have frequently been adopted as the basis for transfer pricing systems, being considered by some scholars as the international consensus on transfer pricing. Nevertheless, over time, the ALP, as applied and interpreted under the OECD Transfer Pricing Guidelines, has encountered a series of limitations and challenges in its practical application, especially for countries that are not members of the OECD, such as the BRICS. Recognizing these difficulties, in 2013, the UN developed a Practical Manual on Transfer Pricing for Developing Countries. The contributions from four of the BRICS countries – Brazil, China, India and South Africa – to the last part of the UN Practical Manual were examined in Chapter 2, concentrating on the practices of these countries that were not aligned with the OECD's approach.

When the BRICS countries were grouped in 2001, they did not share a collective identity, but rather an identity that was established by others. Indeed, the BRICS have few common characteristics, differing from each other in terms of their political, legal, geographic, economic and cultural structures. Nonetheless, based on a common self-identity as emerging economies[576], the BRICS have built an extensive network of interactions, having institutionalized important areas of cooperation where they share common interests. This overall perspective regarding relevant characteristics of the BRICS as individual countries and as a group were discussed in Chapter 3, which set the stage for an analysis of the

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[576] This self-identity the BRICS have as emerging economies is accompanied by the idea that the existing governance of the international tax regime does not take into consideration the interests of emerging countries, which, consequently, may be an obstacle for their fully development.

potential for cooperation between these countries in Chapter 5.

In particular, Chapter 3 focused on the BRICS performance as a group, where the BRICS countries representatives have agreed on the need for cooperation and coordination of their international tax policies for countering tax evasion and tax avoidance. In this respect, one of the areas identified by the BRICS heads of tax authorities[577] for extending their cooperation was the development of international standards on transfer pricing considering the needs of developing countries in general and, more specifically, the aspirations of the BRICS countries. However, considering all the above-mentioned differences between these countries, the question that arises is if it is possible for the BRICS to coordinate their positions in order to develop a new (or reform the existing) international standard on transfer pricing. Chapter 4 – which essentially explores the transfer pricing rules of the five BRICS countries – addresses this question.

A comparison between the transfer pricing rules of the BRICS countries demonstrates that all of them, explicitly or implicitly, follow the ALP in their domestic laws, at least in theory. Nevertheless, the practical application of the principle, particularly as designed by the OECD Transfer Pricing Guidelines, presents challenges for the tax authorities of all the BRICS, to a lesser or greater extent. The commonalities and dissimilarities between their transfer pricing practices were extensively discussed in Chapter 5. Fundamentally, although these countries face similar difficulties, the solutions developed by each one of them are different. In this respect, this research did not find indications of a coordination between the five BRICS countries' tax laws towards developing one common international transfer pricing standard. Only China and India have been able to coordinate their positions on transfer pricing matters such as LSAs and intangibles in order to achieve a greater global influence.

Even though the BRICS have not developed a unified position regarding transfer pricing or a formal coordination between their practices, it is possible to observe a sense of

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[577] As discussed in page 36, the BRICS heads of tax authorities held regular meetings – also called Heads of Revenue Meetings – where they discuss potential areas for cooperation and exchange opinions towards reaching a globally fair tax system.

cooperation and support among them. One evidence of this cooperation is found in their involvement in the UN Subcommittee on Transfer Pricing, where, while they did not agree with the individual practices expressed by each of them (i.e., their transfer pricing methodologies were dissimilar), they cooperated to have the inclusion of Chapter 10 (Part D in the 2017 version) in the UN Practical Manual as a space for them to describe their distinctive approaches to transfer pricing[578]. Thus, the most successful form of cooperation between the BRICS has been challenging international transfer pricing standards that are inadequate for their national interests as emerging economies.

Individually, the aspiration for a stronger influence in the development of the international transfer pricing regime is also noticeable among the BRICS countries. The participation of the BRICS in supranational tax bodies – even acting only as observers – suggests how these countries attempt to use their status as members of the BRICS in order to, independently, achieve a more influential position in the international transfer pricing debate. In this respect, Chapter 5 reviewed some influences the BRICS countries had in the development of the UN Practical Manual and the G20/OECD BEPS initiative. A comparative analysis between the proposed BEPS Actions and the BRICS transfer pricing rules indicated that the BRICS countries had an individual impact on the outcomes of the BEPS initiative.

Therefore, it is possible to conclude that, based on their differences and limitations, currently, the BRICS are not an imminent threat to the dominance of the existing power structures in international taxation, specifically the OECD. An analysis of the BRICS transfer pricing laws in combination with their latest institutional developments suggests that these countries do not sufficiently cooperate and coordinate their positions to oppose the OECD in an organized manner. Thus, the BRICS are unlikely to, as a cohesive group,

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[578] The contributions from four of the five BRICS to the UN Practical Manual, more than merely describing their approaches to transfer pricing, represents one important step in their wish for a stronger voice in the international transfer pricing scenario. According to Diane Ring, “in a Manual targeted at developing countries, the decision to include a chapter highlighting the work of these four countries signals their role as leaders for developing countries seeking successful resolutions to tax problems. This message is particularly apparent given that some of the practices of the featured countries were not closely aligned with the arm’s length message that permeated the Manual”. [578] Ring, *supra* note 108 at 484.

create their own transfer pricing framework or model.

Nevertheless, despite their difficulties in formally and cohesively developing a detailed transfer pricing policy as a group, it is clear that the BRICS have the potential ability to influence the direction of the international transfer pricing regime. Indeed, the BRICS countries individual positions as well as their participation in other international organizations and initiatives, such as the UN, the G20 and the G20/OECD BEPS, have added new perspectives to the international tax debate. In this respect, the OECD's new international taxation approach regarding collaboration and multilateral action – as demonstrated in the BEPS initiative – was an important step in the BRICS quest for having a stronger voice in international tax governance.

Even though the BRICS have been active in cooperating with supranational tax bodies, including the OECD, this does not mean that these countries are aligning with the traditional and dominant powers in international tax governance. Specifically in regards to the OECD, while there is the possibility that the BRICS reach sufficient levels of development and join the organization, this is not an opportunity expected to happen in the foreseeable future. However, even as non-member countries, the BRICS have acquired a significant voice and influence in the OECD, who is also interested in having them included in the organization's decisions.

According to the above analysis, one of the possible future outcomes for the BRICS countries in the international tax landscape is to continue to act as an informal group, focusing on their individual participation in organizations and initiatives in which they are already involved. This way, even not having a coordinated transfer pricing policy, they can use the power of their association and still be able to further increase their influence in the international tax regime.

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