ALBANIA

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TRANSFER PRICING: GENERAL OVERVIEW

1. WHAT ARE THE MAIN CHARACTERISTICS OF TRANSFER PRICING LAW AND POLICY IN YOUR JURISDICTION?

Transfer pricing law in Albania is evolving and becoming more detailed as national policy mirrors general international trends.

Transfer pricing rules were first introduced in Albania in 1998 in Article 36 of the Income Tax Law (*no. 8438, 28 December 1998*), but specific and detailed regulations on the application of this Article were only published in 2014 (*Official Journal no. 78, 20 May 2014*).

The recent regulations have totally transformed Article 36 by adding more requirements and specific rules and actions.

The Albanian Ministry of Finance issued an instruction (*no. 16 of 18 June 2014*) on the introduction of new transfer pricing legislation, providing further guidance, specifically on the application of the arm's length principle and the preparation of transfer pricing documentation.

In February 2015, the Ministry of Finance issued a further instruction (*no. 9 of 27 February 2015*), implementing advance pricing agreements.

2. WHAT HAVE BEEN THE MAIN DEVELOPMENTS OF SIGNIFICANCE FOR TRANSFER PRICING LAW AND PRACTICE IN YOUR JURISDICTION IN THE PAST 12 MONTHS?

See *Question 1*. The most significant development in the last 12 months has been the introduction of advance pricing agreements into Albanian Law (*instruction no. 9 of 27 February 2015*).

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TRANSFER PRICING LEGISLATION

FEDERAL OR NATIONAL LEGISLATION

3. WHAT IS THE MAIN FEDERAL (NATIONAL) LEGISLATION REGULATING TRANSFER PRICING IN YOUR JURISDICTION?

Primary legislation

The primary legislation on transfer pricing is Articles 2, 36 and 37 of the Income Tax Law (*no. 8438, 28 December 1998*). The articles provide definitions of associated parties, controlled transactions, arm's length and comparability, transfer pricing methods, adjustments and advance pricing agreement.

Associated parties are legal entities where one is directly or indirectly managed, controlled or owned by the other entity, or where the same person or persons directly or indirectly manages, controls or owns both. A person participates directly or indirectly in the management, control or ownership of another where that person owns, directly or indirectly, 50% or more of the share capital of the other (legal) person, or effectively controls the business decisions of that other person.

Domestic transactions between associated parties are not covered by transfer pricing regulation. Only cross-border transactions are covered.

A controlled transaction is:

- Any transaction between associated parties where:
  - one party to the transaction is a resident and the other party is a non-resident;
  - one party to the transaction is a non-resident that has a permanent establishment in Albania to which the transaction is attributable and the other party is another non-resident; or
  - one party to the transaction is a resident and the other party is a resident that has a permanent establishment outside of Albania to which the transaction is attributable.
- Any dealings between a non-resident and a permanent establishment in Albania of that non-resident.
- Any dealings between a resident and its permanent establishment outside Albania.
- Any transaction between a resident of Albania or a non-resident with a permanent establishment in Albania to which the transaction is attributable and a resident of a jurisdiction listed by the Minister of Finance as a tax haven.

Transfer pricing law uses the arm's length principle to determine whether a taxpayer's taxable profits related to one or more controlled transaction are appropriate and consistent with the market conditions that would have been applied between independent parties.

The law specifies the use of the Organisation for Economic Co-operation and Development's transfer pricing methods to determine whether a controlled transaction is consistent with the arm's length principle.

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Secondary legislation

Secondary legislation on transfer pricing in Albania includes:

- Instruction number 16 of 18 June 2014, providing guidance on the application of the arm's length principle and the preparation of transfer pricing documentation.
- Instruction number 9 of 27 February 2015, on advance pricing agreements.

These instructions on transfer pricing complement the primary legislation and introduce a wider explanation of the definitions and regulations provided in the Income Tax Law. Matters covered include controlled transactions, comparability factors, transfer pricing methods, transfer pricing adjustments, and appropriate documentation to verify that the conditions of the controlled transactions are consistent with the arm's length principle. The instructions also provide guidance on practical implementation.

STATE OR LOCAL TRANSFER PRICING LEGISLATION

4. WHAT ADDITIONAL REGIONAL (LOCAL STATE) LEGISLATION AND REVENUE AUTHORITIES ARE RELEVANT TO TRANSFER PRICING IN YOUR JURISDICTION?

Legislation

Transfer pricing is regulated only by the national legislation discussed in *Question 3*. There is no additional local legislation.

Revenue authorities

Transfer pricing adjustments, corresponding adjustments and advance pricing agreements are handled by the General Directorate of Taxation. Regional directorates of taxation have a moderate role in transfer pricing regulation.

INTERNATIONAL TRANSFER PRICING TREATIES AND AGREEMENTS

5. WHAT ARE THE MAIN INTERNATIONAL TREATIES AND AGREEMENTS THAT APPLY IN YOUR JURISDICTION?

Albania has applied a liberal foreign trade regime since 1990. This is based on guidelines set by the EU and the World Trade Organization (of which Albania has been a member since 2000). Imports and exports of goods from and to the EU are not generally subject to special authorisation requirements.

Trade agreements

Albania has signed several free trade agreements allowing Albanian-based manufacturers to use the country as a gateway to markets in Southern Europe and for transshipping to the EU. Current major agreements include:

- Central European Free Trade Agreement (CEFTA). An agreement between the members of CEFTA to amend and enlarge the free trade area.
- European Free Trade Association (EFTA). The EFTA states (Iceland, Liechtenstein, Norway and Switzerland) have signed a free trade agreement with Albania.

- US generalised sytem of preferences (GSP). Albania benefits from the US GSP programme.
- Stabilisation association agreement with the EU. The EU–Albania stabilisation agreement was signed in June 2006. It allows all industrial goods originating in Albania to be exported to the EU, and most industrial goods to be imported into Albania from the EU without any customs . It forms part of a broader regional process and is aimed at supporting Albania's market transition and strengthening its integration into the EU single market.
- Free trade agreement with Turkey. Albania has signed a free trade agreement with Turkey removing tariffs on Albanian industrial goods exported into Turkey and on certain Turkish products exported into Albania.

Bilateral investment treaties

The Republic of Albania has signed 44 bilateral investment protection treaties with the following parties: Austria, Azerbaijan, the Belgium–Luxembourg Economic Area, Bosnia and Herzegovina, Bulgaria, China, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Finland, France, Germany, Greece, Hungary, Islamic Republic of Iran, Israel, Italy, Kosovo, Kuwait, Lithuania, Macedonia, Malta, Malaysia, Moldova, the Netherlands, Poland, Portugal, Republic of Korea, Qatar, Romania, Russia, San Marino, Serbia, Slovenia, Spain, Sweden, Switzerland, Tunisia, Turkey, Ukraine, the UK, and the US. Ten of these agreements are not yet in force.

Treaties for the avoidance of double taxation

Albania has signed 42 bilateral treaties for the avoidance of double taxation and fiscal evasion which have priority over Albanian domestic laws. Double taxation treaties have been signed with the following countries: Austria, Belgium, Bosnia and Herzegovina, Bulgaria, China, Croatia, Czech Republic, Egypt, Estonia, France, Germany, Greece, Hungary, India, Ireland, Italy, Iceland, South Korea, Kosovo, Kuwait, Latvia, Luxembourg, Macedonia, Malaysia, Malta, Moldova, Montenegro, The Netherlands, Norway, Poland, Qatar, Romania, Russia, Serbia, Singapore, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Arab Emirates, and the UK.

6. WHAT IMPACT DO INTERNATIONAL TREATIES AND AGREEMENTS HAVE IN YOUR JURISDICTION?

International agreements and treaties are essential for the development of the Albanian economy. Statistics show a higher volume of trade with countries with which Albania has signed an agreement.

There are advantages and disadvantages to a domestic economy from international agreements, but indicators suggest that countries obtain important benefits from trade co-operation.

The ratification of the Central European Free Trade Agreement (CEFTA) between Albania and the other countries in the region aims to establish a free trade zone, promote prosperity and economic development, achieve gradual trade liberalisation and open up markets in the region. The agreement has had a positive impact on trade, resulting in higher trade volumes, increasing exports and imports, influencing lower prices for goods through reduction of custom tariffs, increasing economic competition and introducing technological improvements to boost the competitiveness of local production in the open market.

Free trade agreements have had a positive impact on both established and developing sectors of the economy. In particular, domestic agricultural productivity has greatly improved. This

has been a high priority sector for the Albanian government in recent years. The removal of taxes on export and import of agricultural machinery, equipment and goods, has led to technological improvements, an increase of the quality of agro-food products and growth in the volume of exports.

Along with increased co-operation in trade matters comes increased co-operation over tax matters, as evidenced by Albania's various treaties for the avoidance of double-taxation (*see Question 5*).

TRANSFER PRICING POLICY

7. WHAT IS THE OVERALL NATIONAL TRANSFER PRICING POLICY IN YOUR JURISDICTION?

The priority of the Albanian tax authorities in the last couple of years has remained more oriented towards combating tax evasion, rather than abusive tax avoidance and transfer pricing. The aim of the tax administration is to strengthen revenue management, by revising tax policy and reforming the tax and customs administrations to increase efficiency in the collection of revenues, decrease the tax gap, and reduce the informal economy.

However, the introduction of the new legal framework for transfer pricing is evidence of increased attention on transfer pricing from Albania's public administration, and tax officials have been undergoing training in this field.

With the entry into force of new legislation in 2014, taxpayers must report all controlled transactions annually, submitting a Controlled Transaction Notice if their aggregate amount of controlled transactions exceeds ALL50 million. Practical experience from tax audits is still limited and the tax administration has not yet published the outcomes from any transfer pricing audits.

No research has yet been done to understand which industries are most likely to abuse transfer pricing mechanisms. However, some professionals in the field suggest that several companies in telecommunication, energy and mining use transfer pricing schemes to avoid paying taxes in Albania.

8. WHAT ARE THE MAIN TRANSFER PRICING METHODOLOGIES THAT ARE USED TO DETERMINE AN ARM'S LENGTH PRICE IN YOUR JURISDICTION?

Albania's transfer pricing legislation follows the Organisation for Economic Co-operation and Development's guidelines in listing the most appropriate transfer pricing methods as the:

- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.
- Transactional net margin method.
- Transactional profit split method.

The law does not require the application of more than one method to determine consistency with the arm's length principle for a given controlled transaction. A taxpayer can apply a transfer pricing method other than one of the above, when it can be proven that none of the

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above methods can reasonably determine consistency with the arm's length principle for the controlled transaction. The taxpayer must bear the burden of proving that the requirements have been satisfied.

The tax authority's examination of the controlled transaction must be based on the transfer pricing method applied by the taxpayer, unless the tax authority proves that the method applied by the taxpayer is not the most appropriate method.

9. TO WHAT EXTENT, IF ANY, DOES YOUR JURISDICTION FOLLOW THE OECD TRANSFER PRICING GUIDELINES?

Albania is not a member of the Organisation for Economic Co-operation and Development (OECD). However, the OECD transfer pricing guidelines have been introduced into the Income Tax Law (*see Question 1*) and secondary legislation.

Albania has implemented basic transfer pricing rules as well as more specialised provisions, such as advanced pricing agreements. Paragraph 2 of transfer pricing instruction number 9 of 27 February 2015, which introduces advanced pricing agreements, states that Albania's legislation on transfer pricing is based on OECD principles. This statement shows clearly the influence that the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations have had on the Albanian legal framework.

The OECD guidelines are likely to be an important source of practical guidance for both taxpayers and the tax administration when interpreting and applying transfer pricing provisions. However, if there is a conflict between the OECD guidelines and Albanian legislation, the local legislation will prevail.

10. IS IT POSSIBLE TO OBTAIN ANY CLEARANCES OR ADVANCE PRICING AGREEMENTS FROM THE REVENUE AUTHORITIES IN RESPECT OF TRANSACTIONS?

Clearances

Local legislation contains no regulations related to clearances.

Advance pricing agreements

Under instruction number 9 of 27 February 2015, which introduces advanced pricing agreements, a taxpayer can request an advance pricing agreement with the tax authorities to pre-empt possible disagreements on transfer pricing issues. An advance pricing agreement will determine an appropriate set of criteria for ensuring that transactions comply with the market principle.

The 2015 instruction contains detailed information on advance pricing agreements. The types of agreement covered include:

- Unilateral advance pricing agreements.
- Bilateral advance pricing agreements.
- Multilateral advance pricing agreements.

An application for an advance pricing agreement will be considered only if the controlled transactions for the entire period covered by the agreement exceed a total value of EUR30 million. The maximum duration of an advance pricing agreement is five years.

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11. WHERE THE REVENUE AUTHORITIES MAKE A TRANSFER PRICING ADJUSTMENT, WHAT IS THE EFFECT OF THAT ADJUSTMENT ON THE OTHER PARTY TO THE TRANSACTION?

The Albanian transfer pricing legal framework regulates cross-border controlled transactions only. It does not regulate domestic controlled transactions. Therefore, Albanian law regulates only corresponding adjustments made by the tax administration of another country with which Albania already has a double tax treaty in force.

When a transfer pricing adjustment related to a controlled transaction is made by a tax administration in another country, the Albanian taxpayer can ask the Albanian tax administration to reflect the adjustment in its books.

Within three months of receiving the request, the Albanian General Tax Directorate must notify the taxpayer as to whether the requested corresponding adjustment will be granted in part or in full (*Article 36-6, Income Tax Law*).

If the General Tax Directorate rejects a taxpayer's request for a corresponding adjustment in part or in full, it must give reasons for its decision. These reasons must be given to the taxpayer in writing at the time the taxpayer is notified of the decision.

12. WHAT ARE THE REPORTING AND OTHER ADMINISTRATIVE OBLIGATIONS THAT APPLY TO HELP THE AUTHORITIES EVALUATE TRANSFER PRICES?

The main reporting and other administrative obligations that assist the authorities to evaluate transfer prices are discussed below.

Controlled transaction notice

A taxpayer engaged in controlled transactions (including loan balances) exceeding ALL50 million in total must submit an Annual Controlled Transactions Notice (*Transfer Pricing Instruction no. 16 dated 18 April 2017, inst no.14.1*). When determining aggregate transactions, income and expenses cannot be offset.

The form of the Controlled Transactions Notice is specified in Appendix 2 of transfer pricing instruction number 16 of 18 June 2014. A taxpayer must submit the form together with their annual financial statements to the regional tax directorate where they are registered. Submission may be in hard copy or electronic, as requested by the tax administration. The due date for submission is the end of March of the calendar year following the relevant tax year.

Transfer pricing documentation

The law requires taxpayers to have in place sufficient documentation to verify that a controlled transaction is consistent with the arm's length principle. The content of the documentation is specified in Article 15 of the 2014 transfer pricing instruction. The documentation must be provided to the tax administration within 30 days from its request.

Taxpayers with an annual turnover of less than ALL50 million are considered to satisfy the transfer pricing documentation requirements. Provided there have been no material changes to the controlled transactions, this applies even when external comparable transactions are used to benchmark against the arm's length standard and the external comparables are updated only every third reporting period.

TRANSFER PRICING COURTS AND DISPUTE RESOLUTION

NATIONAL COURTS AND TRANSFER PRICING DISPUTE RESOLUTION

13. WHAT ARE THE RELEVANT NATIONAL COURTS AND WHAT DISPUTE RESOLUTION MECHANISMS EXIST FOR TRANSFER PRICING ISSUES IN YOUR JURISDICTION?

Transfer pricing is treated as an administrative issue because either the claimant or the defendant is generally a tax authority. Transfer pricing issues are treated in the same way as other administrative or tax court cases. The following administrative courts have jurisdiction:

- Administrative courts of first instance.
- The Appeal Administrative Court.
- The Administrative College of the Supreme Court.

Apart from court litigation, in Albania it is possible to resolve transfer pricing disputes through alternative dispute resolution methods, including mediation and arbitration. In practice, despite the general availability of alternative dispute resolution methods in Albania, there are no legal provisions enabling public authorities to choose alternative dispute resolution as a way to resolve disputes.

As an advance pricing agreement procedure is available in Albania (*see Question 10*) this can turn out to be less time-consuming than a transfer pricing examination followed by a dispute resolution mechanism. Therefore, some taxpayers are seeking advance pricing agreements as a way to re-consider use of a specific transfer pricing method or resolve a past or ongoing transfer pricing dispute.

INTERNATIONAL COURTS AND TRANSFER PRICING DISPUTE RESOLUTION

14. WHAT INTERNATIONAL DISPUTE RESOLUTION METHODS ARE AVAILABLE IN YOUR JURISDICTION, AND WHICH ARE PREFERRED FOR TRANSFER PRICING ISSUES?

The Ministry of Justice in Albania has prepared a draft law on international arbitration in the Republic of Albania. This was presented to the Albanian Parliament in 2016, but has not yet been approved. In the meantime, despite the lack of a special law, any person (physical or legal) can submit a case to international arbitration.

In addition, in several cases, the Albanian Supreme Court has decided that the Albanian courts do not have jurisdiction to hear a particular matter when there was a valid contractual clause stipulating that any dispute between the parties must be referred to international arbitration.

In the absence of specific legislation on international arbitration, the following will be applied:

- Relevant provisions of the civil procedure code.
- Relevant international agreements.

Albania is a party to the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958. It is also part of the European Convention on International Commercial Arbitration 1961, and has enacted the following domestic legislation:

- Law no. 8687, 9 November 2000, on the accession of the Republic of Albania to the European Convention on International Commercial Arbitration.
- Law no. 8688, 9 November 2000, on the accession of the Republic of Albania to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

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In addition, from March 2015 an advance pricing agreement (APA) has been an option. This is an agreement concluded between Albania's local tax authorities, a taxpayer, and a third country's authorities. An APA can be a less time-consuming alternative to other forms of transfer pricing examination followed by dispute resolution (*see Question 10*).

TRANSFER PRICING CASE LAW

15. WHAT ARE THE MOST SIGNIFICANT CASE LAW DEVELOPMENTS ON TRANSFER PRICING IN YOUR JURISDICTION?

Transfer pricing case law is very rare in Albania. However, the Civil College of the Supreme Court analysed a transfer pricing situation in *decision no. 83, dated 5 February 2013*.

The taxpayer claimant submitted the case to the court following an audit and a decision by the Directorate of Large Taxpayers. The Directorate had decided that the taxpayer was engaged in tax avoidance, by unjustifiably reducing the profits of the company through a reduced payment mechanism (selling at below cost). The Directorate had found the taxpayer liable for unpaid income tax and a penalty of the same amount. The relevant tax assessment notice was submitted for court evaluation. One of the arguments presented by the tax authorities in support of their stance was that the assessment notice was also based on transfer pricing procedures.

The taxpayer sold mineral chrome to a foreign company. The foreign company was considered an associated party because it owned all the shares of the Albanian company. Having calculated the price at which the company could have sold without profit, the tax authority had concluded that the company had sold the goods at a price below the production cost. As the sales were made to a related foreign company, the authorities considered this to be covered by transfer pricing provisions.

The court considered the tax authority's actions as not legally based. It stated that, to verify transfer prices, the Directorate must comply with specific legal procedures. These include issuing an appropriate order, following certain investigation procedures and investigation methods provided by law, and then waiting for the legal opinion of the Transfer Pricing Committee at the General Tax Unit. The court held that the tax authorities should have strictly implemented the relevant law and guidelines, in particular the Organisation for Economic Co-operation and Development's transfer pricing guidelines.

As the Albanian company had sold chrome mineral, which was not quoted on the stock market, the tax authorities had been required to perform several investigations to prove the market price of the product. However, the only evidence that the tax authorities had produced in this case was sale at a price lower than the production cost.

TRANSFER PRICING ADJUSTMENTS

ADJUSTMENTS AND PENALTIES

16. WHERE THE REVENUE AUTHORITIES MAKE AN ADJUSTMENT OF TRANSFER PRICES FOR TAX PURPOSES, CAN ANY OTHER PENALTIES ALSO BE IMPOSED IN ADDITION TO THAT ADJUSTMENT?

When the tax administration makes a transfer pricing adjustment, the taxpayer is penalised for an amount equal to 0.06% of the unpaid tax liability for every day that the tax liability was not paid, up to a maximum of 365 calendar days.

TRANSFER PRICING DEVELOPMENT AND REFORM

17. ARE THERE ANY CURRENT TRENDS, DEVELOPMENTS OR REFORM PROPOSALS THAT HAVE OR WILL AFFECT THE AREA OF TRANSFER PRICING IN YOUR JURISDICTION?

In general, the introduction of a legal framework for transfer pricing is still considered a recent change in Albanian tax legislation. The most recent development has been the introduction of new secondary legislation in the form of:

- Instruction no. 16 of 18 June 2014, which provides further guidance on the application of the arm's length principle and the preparation of transfer pricing documentation.
- Instruction no. 9 of 27 February 2015, implementing advance pricing agreements in Albanian legislation.

Tax audits on transfer pricing have been very rare. Therefore, there have been very limited disputes between taxpayers and the tax administration and little light has been shed on issues with the existing law and areas that may need reform.

TAX AVOIDANCE: GENERAL OVERVIEW

18. WHAT HAVE BEEN THE MAIN NATIONAL AND INTERNATIONAL TRENDS AFFECTING TAX ENFORCEMENT AND ANTI-AVOIDANCE PRACTICE IN YOUR JURISDICTION IN THE PAST 12 MONTHS?

In late 2015 and during 2016, the Albanian government launched a large-scale reform effort against tax evasion, non-compliance and informality. The latest tax law changes have introduced tougher penalties for taxpayers. These fiscal reforms, tightening of procedures, and use of information technology all promise to reduce tax evasion in the future.

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In November 2016, the Ministry of Finance proposed several changes to address some issues related to abusive tax avoidance. The tax authorities had studied 100 of the largest companies in the country and observed that the method most often used to avoid taxes was borrowing from a parent company, but as this activity is legal, it was difficult to impose penalties based on a tax assessment. The Ministry of Finance proposed limiting an entity's tax-deductible expenses due to interest on loans from related parties to 30% of its net profit before interest, depreciation and amortisation. An amendment to the law was approved in January 2017 and will be effective from 1 January 2018.

19. HOW DOES YOUR JURISDICTION MAKE THE DISTINCTION BETWEEN ABUSIVE TAX AVOIDANCE AND LEGITIMATE TAX PLANNING?

Albanian tax legislation does not provide clear definitions of tax planning or abusive tax avoidance. It is generally accepted that legitimate tax planning is a business activity intended to minimise tax liability through the best use of available allowances, deductions, exclusions, and exemptions to reduce net taxable profits, within the spirit of the law.

In contrast to tax planning, abusive tax avoidance is generally considered to be tax evasion. The Albanian legal framework sees both tax evasion and tax avoidance as forms of tax non-compliance. Tax evasion is the concealment or avoidance of tax liabilities, through non-compliance, non-declaration of information, or providing false documents or fraudulent tax statements, and which leads to inaccurate calculation of tax obligations (*Article 116, Law on Tax Procedure*).

As avoidance is not regulated by law, and tax reforms are mainly still related to the fight against tax evasion, the Albanian tax authorities tend not to penalise tax avoidance but they may regard some attempts at avoidance as tax evasion.

20. DO THE REVENUE AUTHORITIES IN YOUR JURISDICTION OFFER ANY GUIDANCE ON THE DISTINCTION BETWEEN LEGITIMATE TAX PLANNING MECHANISMS AND ABUSIVE OR AGGRESSIVE TAX AVOIDANCE?

As Albanian tax legislation has not developed its definitions of these concepts (*see Question 19*), and has concentrated on tax evasion, the tax administration has not offered any specific guidance on distinguishing legitimate planning from abusive tax avoidance.

TAX ANTI-AVOIDANCE PROVISIONS

21. CAN YOU IDENTIFY ANY DIRECT OR INDIRECT IMPACT IN YOUR JURISDICTION OF THE OECD OR OTHER RECENT INTERNATIONAL INITIATIVES TO COMBAT ABUSIVE TAX AVOIDANCE?

Transfer pricing is one of the main mechanisms used by multinational companies to perform abusive tax avoidance. Companies reduce their worldwide tax liabilities by shifting their profits from countries with higher tax rates to countries with relatively low tax rates.

ONLINE RESOURCE

LEGIFRANCE

W www.legifrance.gouv.fr

Description. Legifrance is an official website used by the French Government to publish legislation, regulations and legal information. Some of the content is translated into English.

GERMANY

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TRANSFER PRICING: GENERAL OVERVIEW

1. WHAT ARE THE MAIN CHARACTERISTICS OF TRANSFER PRICING LAW AND POLICY IN YOUR JURISDICTION?

For many years, transfer pricing was not a major area of interest for the German tax authorities. Tax adjustments were rare, and occurred only in extreme cases. However, after 1988 and the issuance of the US White Paper on section 482 of the Internal Revenue Code, the German tax authorities began taking a closer look at the profitability of international group companies. Since then, Germany has incorporated the Organisation for Economic Co-operation and Development's principles into its tax legislation, and has enacted a detailed system of rules on transfer pricing. The overall purpose is to ensure adherence to the arm's length principle in transactions between related parties. This principle is also applied to German domestic transactions.

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2. WHAT HAVE BEEN THE MAIN DEVELOPMENTS OF SIGNIFICANCE FOR TRANSFER PRICING LAW AND PRACTICE IN YOUR JURISDICTION IN THE PAST 12 MONTHS?

In 2016, the German legislator implemented the following action items from the Organisation for Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS) project into national law by enacting the BEPS 1 Transformation Act:

- Action item 5, countering harmful tax practices more effectively, taking into account transparency and substance.
- Action item 13, transfer pricing documentation and country-by-country reporting.

As a consequence, multinational companies headquarted in Germany or those abroad and with German subsidiaries now have increased duties of co-operation relating to country-by-county reporting. Among other things, companies must provide documentation to the federal tax office, which can now exchange data with foreign tax authorities. Several related changes to administrative directives have come into force providing guidance on the new documentation duties.

TRANSFER PRICING LEGISLATION

FEDERAL OR NATIONAL LEGISLATION

3. WHAT IS THE MAIN FEDERAL (NATIONAL) LEGISLATION REGULATING TRANSFER PRICING IN YOUR JURISDICTION?

Primary legislation

The main provisions in Germany's tax legislation that deal with transfer pricing are:

- Section 8 of the Corporate Income Tax Act (CITA).
- Section 1 of the Foreign Tax Act (FTA).

Section 8(3) of CITA deals with hidden distributions. A hidden distribution will be subject to tax if a business transaction between affiliates results in a loss or forgone increase in net assets, that would not have been accepted by a prudent managing director in a transaction between unrelated parties. This is commonly referred to as the arm's length principle.

The arm's length principle also applies to both:

- Any unjustified benefit that a subsidiary provides to its shareholders.
- Benefits provided to a sister company, as these are assumed to be a hidden distribution to the joint shareholder and a subsequent hidden contribution to the shareholder of the sister company.

While any kind of benefit might be a hidden distribution, a hidden contribution can only be assumed if a tangible or intangible asset is transferred. Therefore, an interest free loan to a subsidiary is not covered by these rules.

Section 1(1) of the FTA establishes the basis for an adjustment if a taxpayer's taxable income is reduced as a result of a violation of the arm's length principle while contracting with a related party. Although section 1(1) of the FTA is similar to section 8(3) of the CITA, it only applies to cross-border transactions where no other provision is applicable. Section 1(5) of the FTA deals with business relations between a domestic company and its foreign permanent establishment (and vice versa) and declares these to be subject to the provisions of section 1(1) of the FTA.

In 2003, the German General Tax Code (GTC) was amended to include section 90(3). These rules establish the general documentation requirements for compliance with the arm's length principle. In the course of transforming the Organisation for Economic Co-operation and Development's base erosion and profit shifting project into national legislation, section 138a was created and section 90(3) of the GTC among other provisions, was amended in 2016, to expand and tighten the formal requirements for compliance with the arm's length principle.

Secondary legislation

Most of the primary legislation is accompanied by secondary legislation which provides more detail. The following two pieces of secondary legislation are particularly significant:

- The Ordinance on Transfer Pricing Documentation, which regulates how to prepare transfer pricing documentation.
- The Ordinance on the Allocation of Profit between a Business and its Foreign Permanent Establishment, which states that the arm's length principle is applicable when a company contracts with a foreign permanent establishment.

The German Federal Ministry of Finance has released several circulars describing specific matters in detail. One of the more important circulars is the Administrative Principles–Procedures 2005, which essentially deals with whether and to what extent the taxpayer has organised his or her business relations in a way that demonstrates that she or he has considered the arm's length principle.

STATE OR LOCAL TRANSFER PRICING LEGISLATION

4. WHAT ADDITIONAL REGIONAL (LOCAL STATE) LEGISLATION AND REVENUE AUTHORITIES ARE RELEVANT TO TRANSFER PRICING IN YOUR JURISDICTION?

Legislation

In Germany, tax legislation is federal. However, tax administration is the responsibility of the German states. Therefore, tax returns must be filed with local tax offices. The local tax authorities are responsible for conducting tax audits. In recent years, the local authorities have acquired trained experts on transfer pricing. These experts are typically included in the audit team whenever a transaction involves a significant business relationship with a non-German affiliate. In addition, a group of transfer pricing specialists exists at the federal level. These experts can elect to take part in any audit, and are entitled to determine both the direction and the intensity of any audit in which they participate. The involvement of both local and federal authorities imposes a substantial burden on the taxpayer, and tends to make the audit procedure lengthier. Where both the local and the federal authorities are involved, a period of three years for a tax audit is not uncommon.

Revenue authorities

As Germany is a federal state system, revenue authorities exist at the state and the federal level. At state level, tax administration is the responsibility of the almost 550 local tax offices located in the German states. The tax offices are subordinated to a state's finance ministry or, in some states, to intermediary authorities, which in turn are subordinated to the ministry.

At federal level there is the Federal Ministry of Finance, which is responsible for federal fiscal and budgetary policy. The Federal Ministry of Finance maintains the Federal Central Tax Office (BZSt) whose principal activities deal with foreign and international matters. In particular, the BZSt is the competent authority for the exchange of information and data with other countries.

INTERNATIONAL TRANSFER PRICING TREATIES AND AGREEMENTS

5. WHAT ARE THE MAIN INTERNATIONAL TREATIES AND AGREEMENTS THAT APPLY IN YOUR JURISDICTION?

Germany has entered into tax treaties with most of the key economic countries. German tax treaties typically follow the Organisation for Economic Co-operation and Development's model, and include rules on corresponding adjustments. Most treaties include provisions on the mutual agreement procedure, as well as the exchange of information between the contracting states. In particular, Germany intends to agree tax treaties with comprehensive disclosure provisions to ensure a wide-ranging exchange of data.

In a significant number of cases the legislator has released national tax laws that have the effect of treaty overrides, which means that although effective tax treaties with other countries are in force, national rules override those treaties. Recently the Federal Constitution Court declared national treaty overrides to be constitutional in general, subject to some legal requirements.

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6. WHAT IMPACT DO INTERNATIONAL TREATIES AND AGREEMENTS HAVE IN YOUR JURISDICTION?

As German tax treaties typically follow the Organisation for Economic Co-operation and Development's model, the arm's length principle is part of nearly all of Germany's tax treaties. Therefore, transactions between related parties can be adjusted by either or both contracting states, if the transaction is not at arm's length. However, the German legislator reserves the power to deviate from effective bilateral tax treaties by making overriding national rules (*see Question 5*).

Germany attaches great importance to the wide-ranging exchange of data. The scope of this exchange is defined in international treaties and agreements and has enormous impact on the German taxation of both domestic and foreign companies. Although Germany's right of taxation ends at its national boundary, the fiscal authorities are increasing their ability to assess even complex matters by receiving tax-relevant data from abroad. This is accompanied by national rulings that regulate comprehensive documentation duties for domestic and foreign companies and permanent establishments. Therefore, international treaties, which are the basis for the exchange of data, are essential background for the taxation of cross-border matters. The same applies to those international treaties that enable the tax authorities to initiate mutual agreement procedures. Since cross-border transactions are continually more complex, bilateral procedures with foreign tax authorities provide ways to ensure more-or-less exhaustive taxation.

TRANSFER PRICING POLICY

7. WHAT IS THE OVERALL NATIONAL TRANSFER PRICING POLICY IN YOUR JURISDICTION?

German tax authorities support the Organisation for Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS) project. In 2016, Germany transformed several BEPS action items into national law. As a result, the main BEPS issues, which are regulated through effective controlled foreign company legislation and detailed transfer pricing rules, will be replaced by national primary legislation and detailed regulations and rules.

In 2008, Germany introduced special rules on the transfer of risks and functions. These rules have been incorporated in section 1(3) of the Foreign Tax Act (FTA), together with the accompanying Ordinance on the Application of the Arms-length Principle in Cases of Relocation of Functions.

In a cross-border transaction involving the transfer of business functions, it is desirable that the value of the transferred assets is determined as a whole in what is known as a transfer package. Before the implementation of the special rules, a cross-border transaction was a taxable event only if assets (tangibles or intangibles, including goodwill) were involved. The special rules in section 1(3) of the FTA impose the following four-part valuation process to the transfer package:

- First, the transferring entity must be valued before and after the transfer. The difference between the valuations is deemed to be the minimum selling price of the business functions.
- Second, the receiving entity must be valued before and after the transfer. The difference between the valuations is deemed to be the maximum price a buyer would pay for the business functions.

- Third, as the valuation process is based on the assumption of perfect knowledge between the buyer and the seller, the appropriate price is determined to be the mean average between the two valuations. This is the price to be paid by the receiving entity. If the average price has not been paid, the transferring entity's profit will be adjusted accordingly.
- Fourth, where profits are different from the original valuations, the deemed purchase price may be retroactively adjusted for a period of ten years.

It has been argued that these rules violate both EU law and constitutional law. However, this issue has not yet been determined by the courts.

Germany has also incorporated the authorised OECD approach for permanent establishments. In 2014 it became national law (section 1(5), FTA) accompanied by the Ordinance on the Allocation of Profit between a Business and its Foreign Permanent Establishment.

8. WHAT ARE THE MAIN TRANSFER PRICING METHODOLOGIES THAT ARE USED TO DETERMINE AN ARM'S LENGTH PRICE IN YOUR JURISDICTION?

Section 1(3) of the Foreign Tax Act (FTA) expressly favours transaction-based methods. Therefore the German tax authorities have displayed a clear preference for these standard methodologies. However, section 1(3) of the FTA does not limit the standard methodologies that can be applied, and provides that the transactional net margin method (TNMM) and the profit split method (PSM) are acceptable if no comparables are available.

In Germany, disputes frequently arise because the TNMM is only accepted for routine functions, and limited risk distributors are often not accepted as routine entities. Also, auditors typically focus on the qualification of functions exercised in Germany, and lengthy questionnaires are used to identify any intangibles that should be allocated to the distribution entity using the PSM rather than the TNMM.

With respect to dispute resolution mechanisms, German tax authorities tend to favour arbitration. Recent German tax treaties concluded with the US and Liechtenstein include a clause providing for last-best-offer arbitration. And, although the recent German tax treaty with Switzerland did not explicitly provide for last-best-offer arbitration, official announcements from both Germany and Switzerland have confirmed that arbitration under that treaty will follow the same principles established in the Germany–US treaty.

9. TO WHAT EXTENT, IF ANY, DOES YOUR JURISDICTION FOLLOW THE OECD TRANSFER PRICING GUIDELINES?

Germany is an active member of the Organisation for Economic Co-operation and Development (OECD). The OECD's transfer pricing guidelines did and still have a great impact on German transfer pricing legislation. In 1988, Germany began incorporating the guidelines into national primary and secondary legislation, much of which is effective today. Some national rules have been amended and adjusted from time to time, to accord with the OECD's rules or even to converge to them. For example, the three transaction-based methods were incorporated into section 1(3) of the Foreign Tax Act (*see Question 8*) following the OECD's guidelines and even profit-based methods are accepted in general by the national tax authorities, although they did not become national law. Furthermore, the 2005 circular Administrative Principles–Procedures (*see Question 3*) was strongly influenced by the OECD's guidelines. However, the circular was not updated after the OECD's guidelines from 2010 and therefore the current version does not represent the current OECD guidelines. This is partly because the original version already contained essential content from the OECD's update. Therefore, although the legal framework is not identical, the OECD's guidelines are implemented in practice.

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10. IS IT POSSIBLE TO OBTAIN ANY CLEARANCES OR ADVANCE PRICING AGREEMENTS FROM THE REVENUE AUTHORITIES IN RESPECT OF TRANSACTIONS?

Clearances

Up-front clearances are not granted in Germany. In theory, clearances might be granted following a tax audit and only in exceptional cases with specific circumstances.

Advance pricing agreements

Advance Pricing Agreements (APAs) are available in Germany. The Federal Ministry of Finance has issued a detailed circular describing the APA process. Although the Federal Central Tax Office is responsible for negotiating any agreement with another country, it must include both federal and state auditors in the fact-finding process. As a result, the procedure is lengthy, and the APA often expires before an agreement is reached. Therefore, APAs should only be considered in very important cases, particularly because the tax authorities impose a fee of EUR20,000 on an application for an APA. APAs are frequently used in combination with mutual agreement procedures. In addition, a roll-back can be used to extend the period during which a binding result can be negotiated. If the taxpayer agrees with the APA and declares a waiver, in general the APA becomes binding for both the taxpayer and the tax authorities.

11. WHERE THE REVENUE AUTHORITIES MAKE A TRANSFER PRICING ADJUSTMENT, WHAT IS THE EFFECT OF THAT ADJUSTMENT ON THE OTHER PARTY TO THE TRANSACTION?

German law does not govern the consequences for the counterparty that result from a transfer pricing adjustment following the cross-border transaction. Therefore, a corresponding adjustment is not inevitable, if the counterparty's country does not provide specific rules.

In domestic cases adjustments are available under German law. Germany may allow counter-adjustments, particularly following mutual agreement procedures and arbitration.

12. WHAT ARE THE REPORTING AND OTHER ADMINISTRATIVE OBLIGATIONS THAT APPLY TO HELP THE AUTHORITIES EVALUATE TRANSFER PRICES?

Extensive documentation obligations have been created to enable German revenue authorities to evaluate transfer prices. These obligations are continually being strengthened. Taxpayers contracting with related foreign parties must file detailed documentation (*section 90(3), General Tax Code (GTC); Ordinance on Transfer Pricing Documentation*). This means that the taxpayer must be able to provide the relevant data and prove the facts and circumstances of a transfer pricing relationship. This includes both the legal and the economic background of the general business relationship and the specific transaction.

The documentation must show a taxpayer's serious effort to agree conditions that comply with the arm's length principle. Ultimately the documentation must prove that the transaction was at arm's length. The taxpayer must provide information that is sufficiently comprehensive to enable a neutral third party to review the relevant facts and circumstances. The required documentation may be requested during a tax audit (*section 90(3), GTC*), and must be provided to the auditor within 60 days of any request. In the case of an extraordinary transaction (for example, a reorganisation, the sale of a business, the introduction of a new supply chain, and so on), the required documentation must be prepared within 30 days of a request. If the taxpayer does not submit the required documentation by the deadline, a penalty of EUR2,500 to EUR250,000 can be imposed.

In practice, the tax authorities frequently do not impose late penalties. However, if the taxpayer fails to submit the required documentation, or if the documentation is of no use to a "reasonable expert", the taxpayer has the burden of proving that the transaction satisfies the arm's length principle. A tax auditor can impose adjustments to a transaction to bring it within the range of arm's length results. Where the taxpayer fails to submit the required documentation or the documentation is insufficient, a penalty of 5% to 10% of the adjustment can be charged. In addition, where documentation was submitted late, a penalty of up to EUR1 million can be imposed, with a minimum additional penalty of EUR100 per day.

In addition, domestic multinational enterprise (MNE) group parent companies as well as subsidiaries of foreign MNE groups must provide a master file, a local file and a country-by-country report (*section 138a GTC*), which requirements mirror the Organisation for Economic Co-operation and Development's base erosion and profit shifting project action item 13. Domestic parent group companies as well as companies that are associated with a multinational group must provide extensive documentation. The documentation should enable the tax authorities to check the group's structure, its worldwide business operations, revenues, and other key data broken down to single countries. This documentation must be provided annually to the Federal Central Tax Office (BZSt). A penalty of EUR10,000 can be imposed if the taxpayer does not provide the documentation to the BZSt. The deadline for delivery is one year after the end of the fiscal year.

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TRANSFER PRICING COURTS AND DISPUTE RESOLUTION

NATIONAL COURTS AND TRANSFER PRICING DISPUTE RESOLUTION

13. WHAT ARE THE RELEVANT NATIONAL COURTS AND WHAT DISPUTE RESOLUTION MECHANISMS EXIST FOR TRANSFER PRICING ISSUES IN YOUR JURISDICTION?

When a transfer pricing dispute arises that cannot be settled by compromise, the taxpayer must commence litigation in the domestic tax courts. This can be a reasonable option when there is no benefit to be gained under a mutual agreement procedure (MAP). For example where the affiliate in the other country is loss-making, and there would be no cash benefit from increasing carried forward losses. Litigation can also be reasonable where the entity in the other country has a much lower tax burden. Each decision should be evaluated on a case-by-case basis, involving consultation with an experienced litigator.

In Germany, tax audits tend to be lengthy (*see Question 3*). Therefore, it is common for litigation to begin several years after the end of the fiscal year under dispute. Although memoranda can be used as the factual basis for an audit or MAP, a taxpayer who elects to proceed with litigation must provide sufficient evidence to satisfy the burden of proof. To be used in the course of litigation, documents such as contracts, invoices and expert valuations must comply with the requirements of the court. As new evidence is not permissible on an appeal, any relevant fact must be submitted to the court of first instance. To help ensure compliance with the formal requirements, a taxpayer should consult with an experienced tax litigator before commencing litigation.

INTERNATIONAL COURTS AND TRANSFER PRICING DISPUTE RESOLUTION

14. WHAT INTERNATIONAL DISPUTE RESOLUTION METHODS ARE AVAILABLE IN YOUR JURISDICTION, AND WHICH ARE PREFERRED FOR TRANSFER PRICING ISSUES?

If litigation is not feasible or not reasonable, a taxpayer can proceed under a mutual agreement procedure (MAP) in accordance with the applicable tax treaty. This can be more reasonable in cases where existing precedents do not support the taxpayer's position, or where evidence is not available in the form required by the courts.

In theory, the taxpayer can proceed under a MAP and, if the desired result is not achieved, subsequently begin litigation to obtain a more favourable result. To do this:

- A taxpayer must file a protest against the amended tax assessment notice.
- The tax assessment notice is stayed for the duration of the MAP.
- At the end of the MAP, the taxpayer is asked if he or she accepts the result agreed upon by the two countries.
- If the taxpayer refuses to accept the agreement, the stay is lifted and the taxpayer can proceed with litigation.

However, it is possible that the result of the litigation will be the same or less favourable than the MAP. Further, in rendering its decision, the court may be influenced by the agreement reached between the countries.

If the taxpayer chooses to proceed under the MAP, it should still file an administrative protest against the amended tax assessment notice. This is to suspend the requirement for immediate payment. If the taxpayer fails to file a protest, the additional tax becomes due immediately. Although the additional tax is refundable if the MAP is resolved successfully, the payment can considerably reduce the cash position of the group. In addition, the filing of an administrative protest is necessary to preserve the taxpayer's right to commence litigation if the MAP does not achieve the desired result.

During the MAP, the taxpayer is not formally involved as a party to the procedure. However, the taxpayer receives additional information requests, which may be co-ordinated between the two countries. Typically, the taxpayer has additional informal contact with at least one competent authority. Where more than one country is involved in a potential corresponding adjustment, a strategic decision must be made as to which procedure should be initiated first. This can depend on procedural considerations, such as the availability of arbitration. It can also depend on context, such as the economic position of the other country. Following the MAP the taxpayer still has the opportunity for arbitration.

A dispute can also be settled by arbitration according to Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises. This EC-wide dispute settlement procedure provides arbitration rules for special taxation situations involving companies from different EC member states. Whereas most of Germany's double tax treaties provide for a reduction of company's profits if the profits of the contracting party are increased in its country, this does not apply to all tax treaties. To avoid double taxation, the parties are allowed to carry out the arbitration according to the convention. In practice, this arbitration procedure offers a high chance of agreement.

TRANSFER PRICING CASE LAW

15. WHAT ARE THE MOST SIGNIFICANT CASE LAW DEVELOPMENTS ON TRANSFER PRICING IN YOUR JURISDICTION?

There are relatively few cases on transfer pricing in Germany. However, the following cases summarised have played a major role in the development of the German transfer pricing rules:

- Federal Tax Court I R 29/14 as of June 24, 2015. In this case, the Federal Tax Court limited an adjustment based on national law, because the arm's length principle in Article 9 of the applicable tax treaty (with Great Britain) only allows an adjustment where the price of a transaction is not compliant with the principle (here, the interest rate on a loan), but not where the conditions of the transaction do not comply with the principle (here, no security for the loan). Therefore, measures contained in German tax treaties which are equivalent to Article 9 of the German tax treaty with the UK may have a limiting effect on national adjustment laws if the arm's length principle is incorporated in those treaties.
- Federal Tax Court I R 75/11 as of October 11, 2012. In this case, the tax authority took the position that a hidden distribution could be assumed if no written agreement was concluded between the affiliated companies before the transaction, even if the terms and conditions of the transaction were at arm's length. This position was consistent with court decisions in domestic cases. However, the court held that the relevant treaty (Article 9 in the OECD's model) did not permit such a formalistic approach; rather, it was necessary to identify the arm's length price.
- Federal Tax Court I R 45/11 as of April 10, 2013. In this case, the taxpayer argued that the transfer pricing documentation requirements in the General Tax Code were a violation of EU law because they only applied to cross-border transactions, while domestic transactions between affiliates were not subject to any documentation requirements. The Federal Tax Court held that existing options for the tax authorities to obtain information from other EU member states under Directive 77/799/EEC on mutual assistance by the competent authorities of the member states in the field of direct taxation were insufficient. Therefore the transfer pricing documentation requirements were justified, given the objective of maintaining equitable tax collection, and did not violate EU law.
- Federal Tax Court I R 3/92 as of February 17, 1993. The first major transfer pricing case in Germany was decided in 1993. This case involved the German subsidiary of a Danish group that acted as a distributor for its parent company. The German subsidiary had incurred losses for a number of years. On the basis of general principles, the court held that an unrelated distributor would not have accepted ongoing losses for more than three years.
- Federal Tax Court I R 103/00 as of October 17, 2001. In this case, the Federal Tax Court settled a number of transfer pricing issues that had been in dispute at the time. The decision resulted in the introduction of the transfer pricing documentation rules in 2003. Among other things, the Court held that:
  - according to section 8(3) of the Corporate Income Tax Act, the arm's length principle is relevant to determine the amount of a hidden distribution;
  - an estimate made by a tax authority can be replaced by the tax court even if the tax authority's estimate is within the reasonable range;
  - although the right to inspect files extends to third party files where the third party is used as a comparable, this rule does not apply if it would violate a tax secret;

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- although anonymous evidence may be used by the court, this evidence must comply with legal requirements, and any remaining doubts should be taken into account in determining the weight to be given to the evidence;
- if a German entity has not provided information on how transfer prices have been determined, it is assumed that transfer prices have been influenced by the affiliation;
- the tax authorities have the burden of proof in establishing inappropriate transfer pricing;
- external comparables are not relevant if they have not been in place in all disputed fiscal years, or if they represent 5% or less of the total turnover; and
- if an estimate is required, the range of reasonable prices (as opposed to the average) is relevant because it is still an arm's length price.

TRANSFER PRICING ADJUSTMENTS

ADJUSTMENTS AND PENALTIES

16. WHERE THE REVENUE AUTHORITIES MAKE AN ADJUSTMENT OF TRANSFER PRICES FOR TAX PURPOSES, CAN ANY OTHER PENALTIES ALSO BE IMPOSED IN ADDITION TO THAT ADJUSTMENT?

If taxes are increased retroactively after an audit, German tax law generally does not provide for the imposition of penalties. However, the interest is charged at a rate of 6% per year for any adjustment made, starting 15 months after the end of the relevant fiscal year. While this interest charge has some characteristics of a penalty, interest can also be paid in favour of the taxpayer in the event of a downward adjustment.

Penalties on the adjustment

If a taxpayer fails to submit the required documentation, or if the documentation provided by the taxpayer is of no use to a "reasonable expert", the tax authorities have the discretion to impose a penalty (*section 162(4), General Tax Code (GTC)*). The penalty must be between 5% and 10% of the adjustment, with a minimum of EUR5,000. However, cases where the taxpayer fails to provide documentation are rare so penalties under section 162(4) of the GTC are used infrequently, and the issue of usefulness to a reasonable expert can be disputed.

In addition, where documentation is submitted late, a penalty can be imposed. However, in practice, the taxpayer can seek an extension of the deadline if more time is required. In the case of an extraordinary EUR1 million, with a minimum charge of EUR100 per day.

Penalty for not responding on information request

During a tax audit, auditors have a broad discretion to make necessary inquiries. The only limit imposed on the auditors' discretion is that questions must not be inappropriate or disproportionate. If a taxpayer fails to respond to a reasonable inquiry, they can be subject to a penalty of EUR2,500 to EUR250,000 (*section 146(2b), GTC*). Although this provision is occasionally used as a threat to put pressure on the taxpayer, it is rarely applied, as it would prevent co-operative discussions between the taxpayer and the auditors.

The tax authority can impose a penalty of EUR10,000 for failing to provide a county-by-country report, providing an incomplete report, or providing the report late (*section 379 (II no 1c), (IV), GTC*).

Criminal fines

In transfer pricing cases, criminal investigations are rare. However, if documentation is purposely misleading or incorrect with regard to obvious facts, criminal fines or a term of imprisonment can be imposed. For example, in a recent case, the owner of a medium-sized family company was arrested for tax fraud because of transfer pricing.

TRANSFER PRICING DEVELOPMENT AND REFORM

17. ARE THERE ANY CURRENT TRENDS, DEVELOPMENTS OR REFORM PROPOSALS THAT HAVE OR WILL AFFECT THE AREA OF TRANSFER PRICING IN YOUR JURISDICTION?

As the BEPS I Transformation Act (*see Question 2*) applies to fiscal years ending after 2016, the practical execution of the law will be a significant challenge in the near future. In particular, because some of the new documentation obligations may not be achievable, the fiscal authority may be called upon to provide further assistance in circulars and other guidance.

Furthermore the German legislator is endeavouring to enact a new restriction to disallow tax deductions for specific royalty payments made by multinational enterprises to related group companies if the participating group company is located in a country with special preferential regimes (that is, IP, licence or patent box regimes). The proposal would limit the deductibility of royalty payments only in cases where the related payment is subject to a tax rate lower than 25%, and on a sliding scale reflecting the amount by which the tax rate is below the 25% threshold. According to the current draft, the new deduction limits would be applied to all expenses incurred after 2017.

TAX AVOIDANCE: GENERAL OVERVIEW

18. WHAT HAVE BEEN THE MAIN NATIONAL AND INTERNATIONAL TRENDS AFFECTING TAX ENFORCEMENT AND ANTI-AVOIDANCE PRACTICE IN YOUR JURISDICTION IN THE PAST 12 MONTHS?

Generally speaking, Germany's tax system is not prone to abusive practices due to effective tax controls and legislative measures. However, in common with other jurisdictions, Germany faces contentious practices within or beyond a grey area, and the legislator endeavours to close any gaps.

As already mentioned (*see Question 18*), the deduction of royalty payments is restricted to avoid the transfer of profits into countries with special preferential regimes. Another current focus is the control on missing trader (carousel) fraud within the EC-wide VAT system as well as filling the gaps of taxation in manufactured dividend transactions (*see Question 25*).

Increasingly, German tax authorities involve prosecution authorities when potentially illegal practices are disclosed by the taxpayer himself or herself or when the tax authority discovers these practices. Fraudulent behaviour in tax matters is no longer accepted as a misdemeanour.

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19. HOW DOES YOUR JURISDICTION MAKE THE DISTINCTION BETWEEN ABUSIVE TAX AVOIDANCE AND LEGITIMATE TAX PLANNING?

In Germany, taxpayers have the discretion to structure their businesses as they see fit. However, artificial structures chosen solely or primarily to circumvent otherwise applicable tax provisions, or to obtain a tax benefit that otherwise would not be available, are disregarded for tax purposes. This rule applies to abusive business structures designed to avoid the payment of taxes, as well as those aimed at obtaining unwarranted tax advantages. Additionally, this rule does not distinguish between different areas of tax law, and generally disallows an abuse of legal means for all potential tax law provisions. However, this rule does not affect the legal validity of a chosen business structure. Therefore, a contract that is re-classified for tax purposes under anti-avoidance rules remain effective for civil law purposes.

Where the tax authorities allege that a business structure is abusive, the taxpayer has two principal lines of defence:

- First, the taxpayer can challenge the allegations that the selected business structure abuses legal means. Where a business structure does not abuse legal means, it does not constitute tax avoidance that would give rise to the anti-avoidance rules.
- Second, the taxpayer can adduce evidence of legitimate tax structuring. To prove a legitimate structuring objective, the taxpayer must demonstrate that there are valid business reasons underlying the selected business structure.

20. DO THE REVENUE AUTHORITIES IN YOUR JURISDICTION OFFER ANY GUIDANCE ON THE DISTINCTION BETWEEN LEGITIMATE TAX PLANNING MECHANISMS AND ABUSIVE OR AGGRESSIVE TAX AVOIDANCE?

In general, Germany's fiscal authorities do not offer guidance on the distinction between legitimate tax planning and abusive or aggressive tax avoidance.

TAX ANTI-AVOIDANCE PROVISIONS

21. CAN YOU IDENTIFY ANY DIRECT OR INDIRECT IMPACT IN YOUR JURISDICTION OF THE OECD OR OTHER RECENT INTERNATIONAL INITIATIVES TO COMBAT ABUSIVE TAX AVOIDANCE?

The BEPS 1 Transformation Act 2016 (*see Question 2*) transforms the Organisation for Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS) project action item 5 into national law. The aim is to counter harmful tax practices more effectively. This is a step towards greater transparency between different tax jurisdictions regarding taxpayers with activities in more than one country.

In future, national tax authorities will regularly exchange more data with national tax authorities abroad. This includes exchanging data about tax rulings given in one country to enable another country to take notice of them, without the taxpayer's involvement in the exchange. OECD BEPS project action item 5 is also expressed in the proposed restriction on deductibility of royalty payments (*see Question 18*). Another topic is the OECD's rules for controlled foreign companies, which are based on Directive EU 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (Tax Avoidance Directive) and which will certainly be updated within the next legislative period. Finally, anti-hybrid rules, also based on the Tax Avoidance Directive, have not yet been fully incorporated into national law, so the impact of international initiatives may increase.

22. DOES YOUR JURISDICTION HAVE GAAR DESIGNED TO PREVENT OR REDUCE ABUSIVE TAX AVOIDANCE?

The general anti-avoidance rule (GAAR) is set out in section 42 of the General Tax Code (GTC). It states that an abuse will be deemed to exist where an inappropriate legal option is chosen which, by comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer or a third party. It is not considered abusive where the taxpayer provides evidence of non-tax reasons for the selective option, viewed from an overall perspective.

Therefore, a structuring decision is not acceptable if it is aimed at circumventing German taxes. As a general rule, structures that are artificial, complex or cumbersome are more likely to be deemed abusive. Likewise, structures that are simple, straightforward, and economically efficient are generally not deemed to be abusive.

Further, German tax law accepts structuring decisions that are made for valid business reasons. Tax savings do not necessarily render a business structure abusive. For example, the reduction of foreign taxes is usually deemed to be a legitimate business reason for selecting a particular business structure. Other business reasons that have been accepted in the past include limiting personal liability or affecting other non-tax savings. Additionally, the allocation of assets to individuals may serve as a justification for certain gifts to be made and accepted for tax purposes.

Apart from the GAAR, there are several other anti-avoidance provisions targeting particular forms of perceived abuse (*see Question 24*). Most of these provisions were enacted after the emergence of specific model transactions, to prevent the wider use of the structures. Examples of specific anti-avoidance rules include the:

- Limitation of losses carried forward on a change of ownership.
- Holding requirements for tax neutral contributions.
- Indirect change of control rules in the Real Estate Transfer Tax Act.

The applicability of the special anti-avoidance rules does not affect the application of the GAAR. Thus, any structure must be measured against the GAAR as well as the specific anti-avoidance rules.

23. WHAT ARE THE LEGISLATIVE PROVISIONS THAT ARE DESIGNED TO REINFORCE GAAR AND ANY OTHER ABUSIVE TAX AVOIDANCE PROVISIONS?

Notwithstanding the general anti-avoidance rule (*see Question 23*), German tax law provides several other anti-avoidance rules (GAAR), which mostly were designed to counter specific tax avoidance strategies. Some examples from the fairly recent past are:

- Section 4i of the German Income Tax Act (ITA). This came into force at the beginning of 2017 to deny the deductibility of a payment made by the foreign member of a domestic partnership if this payment is also deductible from the member's foreign tax base.
- Section 50j of the ITA. A new section 50j of the ITA has been introduced. This is intended to thwart with-dividend treaty shopping by which an artificial arrangement is made so that dividends paid by a German company and received by a foreign shareholder are taxed at a lower tax rate according to an applicable double tax treaty. Since the introduction of section 50j of the ITA, the receiving foreign shareholder must retain the shares for at least 45 days around the dividend record date if he or she wants to benefit from the provision of section 50d(1) of the ITA, which is the provision on withholding tax refunds for capital gains where a double tax treaty applies.

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- Section 50d(9) of the ITA. Section 50d(9) of the ITA rules that for the earnings of persons subject to unlimited taxation, the application of the exemption method, which is incorporated in most of Germany's double tax treaties, depends on whether and at what tax rate these earnings are taxed by the other contracting country. Under revised rules, this will also apply where the earnings are only partly taxed or are partly subject to a low tax. As a consequence, the subject-to-tax rule in section 50d(9) of the ITA will apply to such part of these earnings.

In general, the tax authorities have the burden of proof to establish that a chosen business structure or arrangement is abusive. While structures are not abusive just because they are complex, the tax courts have imposed a rebuttable presumption that objectively inappropriate structures are abusive structures intended to circumvent tax laws. The onus to prove the existence of a valid business reason for the structure rests with the taxpayer. Therefore, it is the taxpayer's duty to establish the non-tax reasons underlying the structuring decision.

The purpose of GAAR is not to impose penalties, but rather, to achieve consistent and uniform taxation. Therefore, the application of GAAR should not give rise to double taxation. Where a business structure is deemed to be abusive, the application of GAAR will ensure that the overall transaction is taxed in the same manner as an economically suitable transaction with the same result. However, in practice, this creates uncertainty as it is usually not clear what the alternative, non-abusive structure would have been.

24. IDENTIFY AND DISCUSS ANY CASE LAW OF INTEREST CONCERNING GAAR AND ANY OTHER CASES DEALING WITH ABUSIVE TAX AVOIDANCE IN YOUR JURISDICTION.

Current case law relevant to abusive tax avoidance

The most controversial case dealing with alleged tax abuse relates to manufactured dividends in with- and without-dividend transactions. In these transactions, shares were purchased with dividend but only delivered without dividend in accordance with the general practice of the stock market and the over-the-counter market. In lieu of a dividend, the purchaser received a dividend compensation payment totalling the net dividend (that is, the dividend net of withholding taxes). At the same time, the shareholder obtained a tax withholding certificate from his or her bank. With the certificate, the taxpayer obtained a credit for dividend withholding taxes, even though no tax was actually withheld. According to estimates from the tax authorities, approximately EUR12 billion of withholding taxes that were never withheld at source were paid out to taxpayers. The main issue in the case was whether the purchaser in a with- or without-dividend transaction is entitled to a withholding tax credit, or whether such purchases are to be treated as an abuse of form. In a recent preliminary ruling, the Federal Tax Court declined to rule on the substantive issue.

Historic case law relevant to abusive tax avoidance

In a series of cases, the Federal Tax Court expanded the application of general anti-abuse rules (GAAR) in German tax law. The Court held that under the step-transaction doctrine, a series of transactions undertaken with the objective of achieving the chosen structure should be treated in the same way as a single transaction. Therefore, the Federal Tax Court has held that a series of gifts made from one person to an intermediary, who must forward the gift to the ultimate recipient, is to be treated as a direct gift from the first donor to the ultimate beneficiary. Whether or not this is part of the GAAR under section 42 of the General Tax Code (GTC) or whether this is a separate legal instrument based on the substance-over-form approach stipulated in section 39 of the GTC is disputed among scholars.

In addition, many of the most well-known cases in German tax law relating to the issue of tax abuse have been decided in favour of the taxpayer. For example, in one case, the court approved the use of a business loan for private purposes under a dual-account structure, which effectively permitted an interest deduction for funds used in private investments. As a consequence, legislation was enacted to override the case law and prohibit such structures. In another case, the Federal Tax Court held that dividend stripping did not constitute an abuse of law, even if the purchaser only owned shares in order to receive the dividend, and subsequently resold the shares to their previous owner.

TAX AVOIDANCE PENALTIES

CIVIL AND ADMINISTRATIVE PENALTIES FOR ABUSIVE TAX AVOIDANCE

25. WHAT CIVIL AND ADMINISTRATIVE PENALTIES CAN BE IMPOSED IN ABUSIVE TAX AVOIDANCE CASES IN YOUR JURISDICTION?

German anti-avoidance rules (GAAR) do not in themselves impose penalties. However, sanctions for an abusive structure can arise from subsequent tax filings, which rely on the abusive structure to obtain a tax benefit. Where a potentially abusive tax structure has been chosen, the taxpayer must disclose the facts underlying the structure to the tax office. If the taxpayer fails to disclose all the facts and circumstances that are necessary for the tax office to determine the taxes owing, the taxpayer may be subject to criminal sanctions. However, if an abusive tax structure has been chosen and then disclosed to the tax office, this may lead to adjustments at the expense of the taxpayer.

While GAAR and the specific anti-avoidance rules do not impose direct sanctions for the use of an abusive structure, the application of these rules will result in the structure being taxed as it would have been had the taxpayer chosen the appropriate structure. In addition, section 233a of the General Tax Code provides for a 6% interest charge on any adjustment, the interest starting to accrue 15 months after the end of the relevant fiscal year. Where tax fraud can be proven, the interest begins compounding immediately after the tax fraud was committed. Finally, where accounting functions have been shifted abroad, as an administrative penalty, the tax office may request that they are repatriated and impose a fine up to EUR250,000 if the taxpayer refuses the repatriation.

For administrative penalties, the legislative authority is always the local tax office of the affected tax payer.

CRIMINAL PENALTIES FOR ABUSIVE TAX AVOIDANCE

26. WHAT CRIMINAL PENALTIES CAN BE IMPOSED IN ABUSIVE TAX AVOIDANCE CASES IN YOUR JURISDICTION?

If a taxpayer is charged with tax fraud for failing to provide complete information on the chosen structure, a criminal sanction can be imposed. Either the local tax authority or the local prosecutor is the competent legislative authority. Usually it is a monetary penalty, but a prison sentence is quite possible and can be up to ten years in serious cases of tax fraud. The Federal Supreme Court has decided that a suspended custodial sentence can be imposed where the fiscal damage is below EUR50,000, whereas the custodial sentence will not be suspended if the fiscal damage exceeds EUR1 million. The competence for the prosecution and the amount of the penalty depend mainly on the seriousness of the breach of law.

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W www. normattiva.it

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CENTRO RICERCHE E DOCUMENTAZIONE ECONOMICA E FINANZIARIA (CERDEF)

W www.cerdef.it

Description. The CeRDEF website offers a database of the legislation, case law and administrative practice in the field of fiscal and economic matters. The database is managed by the Ministry of Economy and Finance and takes advantages of the co-operation of the Italian tax authorities and tax courts.

The texts stored in the database are not official, although they are highly reliable. The database is updated daily.

No English translations are available.

WEBSITE OF THE ITALIAN REVENUE AGENCY

W www1.agenziaentrate.gov.it/english/

Description. The website of the Italian Revenue Agency has an English section which contains general information about the Italian tax system as well as English versions of tax forms for non-residents.

JAPAN

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TRANSFER PRICING: GENERAL OVERVIEW

1. WHAT ARE THE MAIN CHARACTERISTICS OF TRANSFER PRICING LAW AND POLICY IN YOUR JURISDICTION?

The Japanese transfer pricing taxation system was introduced during the 1986 tax reforms. Where a corporation has conducted a transaction with a foreign affiliated entity and the amount of the consideration received by the corporation from the foreign affiliated entity for the transaction is different from the arm's length price, the foreign affiliated transaction is deemed to have been conducted at the arm's length price for purposes of taxation in Japan (*Article 66-4.1, Act on Special Measures Concerning Taxation*). In this case, a foreign affiliated entity is a foreign corporation that has a relationship with the corporation where either corporation holds, directly or indirectly, shares or capital contributions that account for 50% or more of the total number or total amount of issued shares of or capital contributions to the other corporation (excluding shares or capital contributions held by the other corporation, or any other special relationship specified by a cabinet order).

The key points of transfer pricing in Japan is that:

- It applies to a corporation but does not to an individual person.
- It does not apply to domestic transactions.

2. WHAT HAVE BEEN THE MAIN DEVELOPMENTS OF SIGNIFICANCE FOR TRANSFER PRICING LAW AND PRACTICE IN YOUR JURISDICTION IN THE PAST 12 MONTHS?

After the release of the Organisation for Economic Co-operation and Development (OECD)/G20 Base Erosion and Profit Shifting (BEPS) Project, "Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting)", the Act on Special Measures Concerning Taxation was partially revised during the 2016 tax reforms, enhancing the system of transfer pricing documentation (*National Tax Agency, "Outline of the Revision of the Transfer Pricing Documentation", June 2016*):

- A Japanese corporation and foreign corporation with a permanent establishment (PE) who is a constituent entity of a multinational enterprise group with a total consolidated revenue of JPY100 billion or more in the preceding fiscal year must submit to the national tax authorities:
  - a notification for ultimate parent entity;
  - a country-by country report; and
  - a master file.

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- Corporations who engaged in:
  - transactions involving total amounts for the previous business year (if there is no previous year, the current business year would apply) of JPY5 billion or more; or
  - transactions of intangibles whose total value for the previous business year (if there is no previous year, the current business year would apply) was JPY300 million or more, with one foreign related party required to prepare or obtain and store documents necessary to calculate arm's length prices for the transactions by the deadline for submission of final tax returns (known as the "duty of contemporaneous documentation").

This revision applies to:

- The reports for the ultimate parent entity's fiscal year beginning on 1 April 2016 or thereafter.
- Corporation tax for the business years beginning on 1 April 2017 or thereafter.

TRANSFER PRICING LEGISLATION

FEDERAL OR NATIONAL LEGISLATION

3. WHAT IS THE MAIN FEDERAL (NATIONAL) LEGISLATION REGULATING TRANSFER PRICING IN YOUR JURISDICTION?

Primary legislation

The primary national legislation for transfer pricing in Japan is the Act on Special Measures Concerning Taxation, mainly Article 66-4. If a corporation has conducted a transaction with a foreign affiliated entity, the foreign affiliated transaction is deemed to have been conducted at the arm's length price for the purposes of the Act and any other corporation tax provisions on the corporation's income for the business year, if (*Article 66-4.1, Act on Special Measures Concerning Taxation*):

- The amount of the consideration received by the corporation from the foreign affiliated entity is below the arm's length price.
- The amount of the consideration paid by the corporation to the foreign affiliated entity is above the arm's length price.

In this case, a "transaction" includes:

- A transaction for the sale of assets.
- A purchase of assets.
- A provision of services.
- Any other transaction with a foreign affiliated entity.

The Act on Special Measures Concerning Taxation provides the methods for calculating an arm's length price (*Article 66-4.2*) and the other procedural provisions (Article 66-4.15).

For a more detailed explanation, see *Question 8* below.

Secondary legislation

The secondary national legislations that are most relevant for transfer pricing in Japan are:

- The Order for Enforcement of the Act on Special Measures Concerning Taxation (mainly, Article 39-12), which was promulgated by the Cabinet.
- The Ordinance for Enforcement of the Act on Special Measures Concerning Taxation, which was promulgated by the Ministry of Finance.

The Act on Special Measures Concerning Taxation delegates to the Order for Enforcement of the Act on Special Measures Concerning Taxation the specific details concerning the application of certain provisions of the Act on Special Measures Concerning Taxation (for example, Article 66-4.20). The Order provides the specific standard for determining whether or not a foreign corporation falls under the category of foreign affiliated entity (*Article 39-12.1, Order for Enforcement of the Act on Special Measures Concerning Taxation*).

STATE OR LOCAL TRANSFER PRICING LEGISLATION

4. WHAT ADDITIONAL REGIONAL (LOCAL STATE) LEGISLATION AND REVENUE AUTHORITIES ARE RELEVANT TO TRANSFER PRICING IN YOUR JURISDICTION?

Legislation

There is no regional legislation for transfer pricing in Japan.

Revenue authorities

The National Tax Agency issues circular notices for the interpretation of relevant laws as well as other guidelines for enforcement, such as the:

- Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines).
- Reference Case Studies on the Application of Transfer Pricing Taxation.
- Mutual Agreement Procedure (Administrative Guidelines).

These guidelines provide, for example:

- The examination policy.
- Items to be noted at the Advance Pricing Arrangement procedure.
- Calculation methods for arm's length price regarding the transaction of intangible property.
- Procedure of Mutual Agreement.

All of the above are important, from a practical perspective, as administrative guidelines on transfer pricing.

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INTERNATIONAL TRANSFER PRICING TREATIES AND AGREEMENTS

5. WHAT ARE THE MAIN INTERNATIONAL TREATIES AND AGREEMENTS THAT APPLY IN YOUR JURISDICTION?

As of 1 January 2017, Japan is a party to:

- 55 tax conventions for the avoidance of double taxation and the prevention of tax evasion and tax avoidance (that is, tax treaties), covering 66 jurisdictions.
- Eight treaties dealing primarily with the exchange of tax information (that is, tax information exchange agreements) covering ten jurisdictions.
- The Convention on Mutual Administrative Assistance in Tax Matters, a multilateral treaty covering 75 jurisdictions aside from Japan.

These treaties have legal force within Japanese territory.

The provisions in the tax treaties to which Japan is a party were generally based on the OECD Model Tax Convention, therefore the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995 and Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 have significant impact on actual tax practices in Japan.

6. WHAT IMPACT DO INTERNATIONAL TREATIES AND AGREEMENTS HAVE IN YOUR JURISDICTION?

In Japan, in order to directly apply a provision of an international treaty as a legal standard to a specific situation, a specific provision of a treaty must, in general, satisfy the requirements of clarity and integrity, as well as reflect the parties' (member states) intentions, as set forth in a leading case decided by the Tokyo High Court on 5 March 1993.

As for tax treaties, the widely-accepted opinion is that, from the viewpoint of the principle of no taxation without a specific law, domestic legislation is necessary in order to rectify price manipulation by member states (*Hiroshi Kaneko, Itenkakaku Zeisei no Hourironteki Kento [The analysis of legal theory on Transfer Pricing] (1993)*). Indeed, through various periodic tax reforms, the provisions of the OECD Model Tax Convention have been incorporated into Japanese tax law.

TRANSFER PRICING POLICY

7. WHAT IS THE OVERALL NATIONAL TRANSFER PRICING POLICY IN YOUR JURISDICTION?

The practical guidelines for transfer pricing have more than a few ambiguities, such that tax authorities have wide discretion to decide on the propriety of a tax disposition or to certify the amount of tax due in any particular case (*Minoru Nakazato et al, Itenkakaku Zeisei no Frontier [Frontiers of Transfer Pricing], "Prologue"*). In recent years, the National Tax Agency of Japan has begun actively applying transfer pricing taxation not only to transactions made by large companies, but also to transactions by small and medium-sized companies. Therefore, taking appropriate action to prevent or mitigate transfer pricing taxation has become even more important in recent years, regardless of the size of the company or transaction. According to recent statistics announced by the National Tax Agency of Japan, the number of transactions taxed as transfer pricing cases was 218, with the collective amount of taxable income in these cases was JPY13.7 billion in 2015.

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8. WHAT ARE THE MAIN TRANSFER PRICING METHODOLOGIES THAT ARE USED TO DETERMINE AN ARM'S LENGTH PRICE IN YOUR JURISDICTION?

While there is no definition of what constitutes an "arm's length price" in Japanese law, the methods of calculating an "arm's length price" are clearly provided in Article 66-4.2.1 of the Act on Special Measures Concerning Taxation. The specific methods are:

- If a transaction is the sale or purchase of inventory assets:
  - the comparable uncontrolled price (CUP) method;
  - the resale price method;
  - the cost plus method; or
  - another method equivalent to the methods listed above or any other method specified by a Cabinet Order (that is, the profit split method, the residual profit split method, the comparable profit split method, the transactional net margin method (TNMM), among others (*Article 39-12.8 of Order of Enforcement of the Act on Special Measures Concerning Taxation)*).
- If a transaction is for something other than the sale or purchase of inventory assets, a method equivalent to the methods listed above.

As for the choice of calculation method, an arm's length price must be calculated by using "the most appropriate method", taking into consideration the particular facts and circumstances of the specific case (*Article 66-4.2, Act on Special Measures Concerning Taxation*).

9. TO WHAT EXTENT, IF ANY, DOES YOUR JURISDICTION FOLLOW THE OECD TRANSFER PRICING GUIDELINES?

The provisions in the tax treaties to which Japan is a party were generally based on the OECD Model Tax Convention, therefore the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995 and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 have significant impact on actual tax practices (*see Question 5*). For example, the National Tax Agency established the Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines) on 1 June 2001 in response to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995. Furthermore, in response to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 provision that the most appropriate method for calculating an arm's length price must be used, the Act on Special Measures Concerning Taxation was amended to require the use of the most appropriate method during the 2011 tax reform (*see Question 8*).

In Chapter 1, 1-2(3) of the Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines), it clearly states that to eliminate international double taxation caused by transfer pricing taxation, it is important for the tax authorities of each country to share an understanding of transfer pricing, and therefore, an examination or a review of Advance Pricing Arrangements must be conducted in an appropriate manner by referring to the OECD Transfer Pricing Guidelines as necessary.

10. IS IT POSSIBLE TO OBTAIN ANY CLEARANCES OR ADVANCE PRICING AGREEMENTS FROM THE REVENUE AUTHORITIES IN RESPECT OF TRANSACTIONS?

Clearances

There is no clearance system in Japan.

Advance pricing agreements

The National Tax Agency of Japan has introduced the Advance Pricing Arrangement (APA) system for avoiding disputes with taxpayers as to transfer pricing taxation. The APA is an administrative procedure based on a circular notice, the Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines). Once the relevant tax authority examines and confirms the reasonableness of the transfer pricing methodology and other items submitted by the taxpayer, the tax authority will not impose transfer pricing, provided that the taxpayer submits a tax return complying with the terms of such transfer pricing methodology. An APA can be arranged to be either unilateral or between two or more nations. The latter APA, known as an "MAP/APA", is an approval system established in conjunction with the mutual agreement procedures found in tax treaties.

11. WHERE THE REVENUE AUTHORITIES MAKE A TRANSFER PRICING ADJUSTMENT, WHAT IS THE EFFECT OF THAT ADJUSTMENT ON THE OTHER PARTY TO THE TRANSACTION?

Even if the National Tax Agency makes a transfer pricing adjustment, the transaction price between the parties will not be affected. Such an adjustment means recalculating the price of income only in relation to the corporate tax.

12. WHAT ARE THE REPORTING AND OTHER ADMINISTRATIVE OBLIGATIONS THAT APPLY TO HELP THE AUTHORITIES EVALUATE TRANSFER PRICES?

Reporting obligations

If a company conducts a transaction with a foreign affiliated entity in a particular business year, said company must disclose the foreign affiliated entity's name and the location of its head or principal office, as well as any other information specified by the relevant ordinance of the Ministry of Finance, by attaching documents providing such information to its final tax return form for the relevant business year (*Article 66-4.15, Act on Special Measures Concerning Taxation*).

Documentation

Mirroring requirements found in other countries, the 2010 tax reforms mandated that taxpayers are required to prepare and preserve documents that are considered to be necessary for the calculation of arm's length prices in order to facilitate investigations against the taxpayer, to allow taxpayers to more easily respond to investigatory inquiries, and to provide clarity as to the ultimate results of any investigation (*Article 66-4.6, Act on Special Measures Concerning Taxation; Article 22-10, Ordinance for Enforcement of the Act on Special Measures Concerning Taxation*).

Right to question and inspect

When necessary as part of an examination of a transaction between a corporation and a foreign affiliated entity, the relevant official at the National Tax Agency or the Tax Office can request that the corporation present or submit books and documents, or copies, maintained by the foreign affiliated entity (*Article 66-4.7, Act on Special Measures Concerning Taxation*). In such cases, the corporation must endeavour to obtain the requested books and documents or copies. If a corporation fails to submit the documents needed to calculate an arm's length price, the tax authority can, to the extent necessary to perform the calculations, question

persons who are engaged in business of the same type or nature as the target corporation, or inspect a similar corporation's books or documents (*Article 66-4.8, Act on Special Measures Concerning Taxation*). If a similar corporation approached in connection with an investigation fails to co-operate with inspectors from the tax authority, it will be punished with a fine (*Article 66-4.12, Act on Special Measures Concerning Taxation*).

TRANSFER PRICING COURTS AND DISPUTE RESOLUTION

NATIONAL COURTS AND TRANSFER PRICING DISPUTE RESOLUTION

13. WHAT ARE THE RELEVANT NATIONAL COURTS AND WHAT DISPUTE RESOLUTION MECHANISMS EXIST FOR TRANSFER PRICING ISSUES IN YOUR JURISDICTION?

Complaint procedures

If a taxpayer is dissatisfied with his taxation disposed by the superintendent of a tax office or other applicable office under the national tax laws, the taxpayer may file a complaint for purposes of attempting a revocation or amendment of such disposition. The specific complaint procedures, which apply to dispositions after April 2016, are that a taxpayer may choose, within three months from the day following the day on which such taxpayer became aware that the original administrative disposition was made:

- To make a petition for an administrative review of the original administrative disposition (*sinsa-seikyuu*) to the National Tax Tribunal.
- To make a petition for an administrative disposition for redress to the original administrative agency (for example, to the superintendent of a tax office) (*sai-chousa-seikyuu*).

A taxpayer who chooses to make a petition for *sai-chousa-seikyuu* can thereafter request a *sinsa-seikyuu* within one month of receipt of a certified copy of a *sai-chousa-seikyuu* administrative decision. In a *sinsa-seikyuu*, the National Tax Tribunal will investigate and decide the issues in dispute between the taxpayer and the original administrative agency. The National Tax Tribunal usually sets one year as the standard term within which it will make a decision on a petition it receives.

Litigation

If a taxpayer is dissatisfied with the National Tax Tribunal's decision, the taxpayer may appeal to a competent court for the revocation of the original administrative disposition within six months from the day on which such taxpayer became aware that the decision was made (*Article 14.1, Administrative Case Litigation Act*), provided that no action for the revocation of an administrative disposition may be filed when a period of one year has elapsed from the date of the administrative disposition on appeal (*Article 14.2, Administrative Case Litigation Act*). If no decision has been made by the National Tax Tribunal after three months have elapsed from the day following the day on which the taxpayer files a *sinsa-seikyuu*, the taxpayer may file an action with a competent court despite not having received any such decision. In such case, the taxpayer can still request that the National Tax Tribunal provide a decision, in a process separate from the litigation.

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INTERNATIONAL COURTS AND TRANSFER PRICING DISPUTE RESOLUTION

14. WHAT INTERNATIONAL DISPUTE RESOLUTION METHODS ARE AVAILABLE IN YOUR JURISDICTION, AND WHICH ARE PREFERRED FOR TRANSFER PRICING ISSUES?

Mutual agreement procedure

In the event an international double taxation occurs due to transfer pricing that is incompatible with a particular provision of a tax treaty Japan has with another country, a taxpayer can make a request to the Japanese authorities that a mutual agreement procedure (MAP) take place according to the relevant tax treaty provisions. In this case, the relevant Japanese authorities are the:

- Minister of Finance.
- Director-General of the Tax Bureau in the Ministry of Finance.
- Deputy Commissioner of the National Tax Agency.

If the taxation authority determines that the request has reasonable grounds, the taxation authority would start consultations with the competent tax authority of the relevant treaty partner nation in order to avoid such double taxation. If the mutual consultation results in an agreement where, for example, it is agreed that Japanese tax levied against a Japanese company is to be reduced, the Japanese tax authority will issue a correction notice and will refund the amount that corresponds to the reduction in the initial assessment to the taxpayer (known as "corresponding adjustments"). Therefore, the MAP can be used as a form of dispute resolution.

Arbitration

Tax treaties typically adopt arbitration as a rapid and final resolution method to avoid international double taxation. Japan was first subject to an arbitration clause in a tax treaty between Japan and The Netherlands that went into effect on 29 December 2011. Arbitration clauses were subsequently adopted in tax treaties between Japan and the United Kingdom and between Japan and the United States.

If the competent authorities are unable to reach a mutual agreement in a particular case through the process outlined above within two years from the presentation of the case to the competent authorities, any unresolved issues would be submitted to arbitration (*see above, Mutual agreement procedure*). An arbitration decision will be deemed a settlement by the relevant tax authorities and will bind both contracting countries unless the taxpayer refuses to accept the arbitration decision. If the taxpayer refuses to accept an arbitration decision, such taxpayer can thereafter only resort to the relevant national courts or other domestic dispute resolution processes for relief (*see Question 13*).

TRANSFER PRICING CASE LAW

15. WHAT ARE THE MOST SIGNIFICANT CASE LAW DEVELOPMENTS ON TRANSFER PRICING IN YOUR JURISDICTION?

Imabari Shipbuilding case (Takamatsu High Court judgment dated 13 October 2006 (Case No. 17 (Gyou-ko) 2004/Takamatsu High Court))

The taxpayer, Imabari Shipbuilding, was a shipbuilding company constructing ships for one of its foreign affiliated enterprises located in the Republic of Panama. The tax authority applied the comparable uncontrolled pricing (CUP) method and determined that the price agreed to in a transaction between Imabari and its foreign affiliated enterprise was less than what the arm's length price would have been if the transaction were between Imabari and a non-affiliate. Therefore, the tax authority applied transfer pricing taxation to the transaction with the foreign affiliated enterprise and made a reassessment. Following this reassessment, Imabari filed a lawsuit seeking the revocation of the reassessment.

At trial, the Takamatsu High Court rejected Imabari's claim and held that the tax authority's analysis could be limited to the factors that clearly affected the price, and that not all differences between the transaction and the comparison purpose transaction were required to be considered in the calculation of the arm's length price, as well as holding that it was unnecessary to adopt the concept of arm's length range to this case. Currently, Article 66-4(3)-4 of the administrative statement of Special Taxation Measures Law clarifies that arm's length range is applicable under certain conditions.

Adobe case (Tokyo High Court judgment dated October 30, 2008 (Case No. 20 (Gyou-ko) 2008/Tokyo High Court))

Adobe Systems Co., the Japanese affiliate of the US company Adobe Systems Inc., received remuneration from its Dutch and Irish affiliate companies comprising an amount equivalent to its general administrative expenses plus 1.5% of the net sales accrued in Japan of Adobe products. The remuneration was received as consideration for the services Adobe provided in the promotion and marketing of Adobe computer graphics software sold in Japan. The tax authority selected a transaction in which a seller resold the same or similar software as a comparison purpose transaction in the calculation of the arm's length price. Subsequently, it applied transfer pricing taxation to the transactions with the foreign affiliated enterprises and made a reassessment. Adobe then filed a lawsuit seeking revocation of the reassessment.

The Tokyo High Court held that the reassessment should be revoked, finding that the arm's length price calculation method used by the tax authority did not fall under the definition of "a method equivalent to a method consistent with the resale price method". The resale price method, or a similar method, should have been adopted in this case due to the differences between Adobe and the selected comparison purpose enterprise in terms of the functions and risks in each respective transaction. This case marked the first complete victory for a taxpayer in a transfer pricing lawsuit in Japan.

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TRANSFER PRICING ADJUSTMENTS

ADJUSTMENTS AND PENALTIES

16. WHERE THE REVENUE AUTHORITIES MAKE AN ADJUSTMENT OF TRANSFER PRICES FOR TAX PURPOSES, CAN ANY OTHER PENALTIES ALSO BE IMPOSED IN ADDITION TO THAT ADJUSTMENT?

Presumptive tax imposition

Where the tax authority has requested that a corporation present or submit books and documents, or copies, that are considered to be necessary for the calculation of an arm's length price, and the corporation has failed to present or submit these books and documents or copies without delay, the tax authority can make a correction or determination based on the presumption that the arm's length price would be the amount calculated by the resale price method or the cost plus method (or an equivalent method), based on the gross profit margin obtained by another corporation of a similar size and whose business is of the same type as the corporation in question in a foreign affiliated transaction (*Article 66-4.7, Act on Special Measures Concerning Taxation*).

Additional tax

If a taxpayer does not comply with required tax obligations, an additional tax will be imposed. Non-compliance includes:

- A taxpayer files a tax return by the due date but the amount paid in the tax return is found to be less than the amount due to be paid.
- A taxpayer does not file a tax return by the due date.
- A person who is required to deduct and pay withholding taxes does not pay such tax by the due date.

The additional tax is a form of administrative sanction.

Types of additional taxes are:

"Additional tax for understatement" (Article 65, Act on General Rules for National Taxes). In general, the taxpayer must pay an amount equivalent to 10% of the amount to be paid in the tax return (15% for any amounts exceeding the larger of the amount payable in the tax return or JPY500,000) as an "additional tax for understatement".

- **"Additional tax for failure to file" (Article 66, Act on General Rules for National Taxes).** The taxpayer must pay an amount equivalent to 15% of the tax amount to be paid (20% if the amount exceeds JPY500,000) as an "additional tax for failure to file". After 2016, if a taxpayer has been penalised with an "additional tax for failure to file" or a "substantial additional tax" within the past five years and once again fails to file a tax return by the due date, the taxpayer must pay an additional amount equivalent to 10 percent of the tax amount due.
- **"Additional tax on non-payment" (Article 67, Act on General Rules for National Taxes).** The taxpayer must pay an amount equivalent to 10% of the unpaid tax as an "additional tax on non-payment".

- **"Substantial additional tax" corresponding to those additional taxes (Article 68, Act on General Rules for National Taxes).** This includes:
- "substantial additional tax for understatement";
- "substantial additional tax for failure to file"; and
- "substantial additional tax on non-payment".

The substantial additional tax may be imposed if a taxpayer does not comply with required tax obligations by concealing or falsely representing all or part of the facts that should be the basis for the calculation of the taxpayer's tax amount. The taxpayer is must pay a penalty of 35% of the tax amount due instead of an additional tax for understatement or additional tax on non-payment, and a penalty of 40% of the tax amount due instead of additional tax for failure to file.

TRANSFER PRICING DEVELOPMENT AND REFORM

17. ARE THERE ANY CURRENT TRENDS, DEVELOPMENTS OR REFORM PROPOSALS THAT HAVE OR WILL AFFECT THE AREA OF TRANSFER PRICING IN YOUR JURISDICTION?

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New guidelines on transfer pricing issues relating to transactions involving intangibles were provided in the BEPS Report 2015 on Actions 8-10 by the OECD/G20, such that corresponding legislation related to these guideline is must be implemented in Japan. The Tax Reform Outline 2017, which was released by the government and the ruling parties on 8 December 2016, provided that the transfer pricing policy will be reviewed and analysed as necessary, including the implementation of the "commensurate with income standard" proposed by the BEPS Project, to better handle the overseas transfer of intangibles by reducing the burden of taxation, such as intellectual property (*"Items to be Addressed over the Medium Term", "Appendix: Basic Concepts of the International Taxation in the Future, Tax Reform Outline 2017*). Additionally, the Japan Business Federation, a comprehensive economic organisation with a membership comprised of representative Japanese companies, nationwide industrial associations, and regional economic organisations, mentioned in a release that, regarding the taxation of hard-to-value intangibles, it is essential that the application of the commensurate income standard be restricted as much as possible and detailed implementation guidance be developed (*"Policy Proposal on BEPS", 19 April 2016*). As a result, it is expected that transfer pricing legislation dealing with the transfer of hard-to-value intangibles will be enacted based on the new guidelines set out in the 2015 BEPS Report.

TAX AVOIDANCE: GENERAL OVERVIEW

18. WHAT HAVE BEEN THE MAIN NATIONAL AND INTERNATIONAL TRENDS AFFECTING TAX ENFORCEMENT AND ANTI-AVOIDANCE PRACTICE IN YOUR JURISDICTION IN THE PAST 12 MONTHS?

The leak of the Panama Papers could greatly affect tax enforcement and anti-tax avoidance practice in Japan, although it has not yet been confirmed whether any Japanese enterprises have been described in the Panama Papers as having engaged in any unfair practices, including tax evasion using an off-shore company that exists only on paper. So far, no prosecution or tax disputes resulting from the leak have been reported. However, as dozens of Japanese enterprises and several hundred Japanese shareholders, including executive officers of leading companies, are listed in the papers, there may be cases for fraud brought against executive officers of prominent companies, or maybe even a company itself, depending on what develops from a thorough review of the Panama Papers.

If fraud through an off-shore paper-only company is discovered through the Panama Papers, it is highly likely that tax haven counter measures, tax treaties, and other relevant laws and ordinances of Japan, as well as their application, would be greatly affected. Therefore, any future investigation by tax authorities is sure to garner significant attention.

19. HOW DOES YOUR JURISDICTION MAKE THE DISTINCTION BETWEEN ABUSIVE TAX AVOIDANCE AND LEGITIMATE TAX PLANNING?

"Legitimate tax planning" is defined as "permitted acts intended to reduce the tax burden in accordance with tax laws and ordinances (*Hiroshi Kaneko, Tax Law, Japan, 2013, p110*). Examples of particular, legitimate tax schemes found in statute include certain scheme geared toward corporate reorganisation (*Article 62-2, Corporation Tax Act*), by which enterprises may defer capital gains or losses of transferred assets and debts, as well as tax credits for foreign tax paid (*Article 69 and 81-15, Corporation Tax Act*) . By contrast, "tax avoidance" is defined as the "reduction or exemption of a tax burden while attaining an economic objective or economic outcome by being exempted from commonly-applicable tax requirements through the selection of not commonly used law without reasonable reasons" (*Hiroshi Kaneko, Tax Law, Japan, 2013, p121*). For example, in a situation where a small company with impaired capital absorbs a company that has large scale interests, with the company surviving the absorption-type merger later changing its trade name to the name of the acquired company, a court has determined the merger to be abnormal and constituting tax avoidance, with the only objective in the transaction being the accrual of deductible expenses (*Case No.467 (Ne) 1961/Tokyo High Court*).

20. DO THE REVENUE AUTHORITIES IN YOUR JURISDICTION OFFER ANY GUIDANCE ON THE DISTINCTION BETWEEN LEGITIMATE TAX PLANNING MECHANISMS AND ABUSIVE OR AGGRESSIVE TAX AVOIDANCE?

As there are no specific statutory provisions restricting tax avoidance (as only relatively general provisions exist), there is no guidance or guidelines that have been issued by regulatory authorities on the distinction between legitimate tax planning mechanisms and abusive or aggressive tax avoidance.

For further information on the general provisions on tax avoidance, see *Question 23*.

TAX ANTI-AVOIDANCE PROVISIONS

21. CAN YOU IDENTIFY ANY DIRECT OR INDIRECT IMPACT IN YOUR JURISDICTION OF THE OECD OR OTHER RECENT INTERNATIONAL INITIATIVES TO COMBAT ABUSIVE TAX AVOIDANCE?

In response to its commitment to the G20 and OECD regarding the automatic exchange of financial account information, Japan promulgated the Common Reporting Standard developed by OECD when it reformed its tax system in 2015 to address international tax evasion and abusive tax avoidance using foreign bank accounts.

22. DOES YOUR JURISDICTION HAVE GAAR DESIGNED TO PREVENT OR REDUCE ABUSIVE TAX AVOIDANCE?

Although there are relatively general provisions restricting abusive tax avoidance in Japan (*see Question 24*), there are no General Anti-Avoidance Rules. To determine the application of specific provisions of the tax laws, Japanese courts use close and comprehensive consideration of the transactions and actions of the taxpayer on a case-by-case basis.

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23. WHAT ARE THE LEGISLATIVE PROVISIONS THAT ARE DESIGNED TO REINFORCE GAAR AND ANY OTHER ABUSIVE TAX AVOIDANCE PROVISIONS?

There are no specific statutory provisions restricting abusive tax avoidance. However, there are relatively general provisions, including:

- Provisions applicable to acts and accounting processes of a taxpayer's affiliated company (*Article 132, Corporation Tax Act*).
- Provisions providing principles for the taxation of real income (*Article 12, Income Tax Law; Article 11, Corporation Tax Act, among others*).

The provisions preventing international abusive tax avoidance are as follows:

- Anti-tax haven rules. The anti-tax haven rules were enacted to prevent income transfers from a company located in Japan to any of its subsidiaries located in countries where any such subsidiary would be charged substantially no corporate tax (*Article 66-6 to 66-8, Special Taxation Measures Law (STML)*). In these circumstances, the retained income of the foreign subsidiary is regarded as the taxable income of the resident or domestic corporation that holds, directly or indirectly, ownership of the foreign subsidiary of 10% or greater.
- Transfer pricing taxation.
- Thin capitalisation taxation system. A thin capitalisation taxation system was enacted to prevent companies from engaging in tax avoidance by borrowing substantial funds in place of issuing shares in cases where companies receive funds from foreign affiliated companies. This system provides that where the ratio of loans to investments exceeds 300%, any interest expense corresponding to the excess portion must not be included in deductible expenses (*Article 66-5, STML*).

24. IDENTIFY AND DISCUSS ANY CASE LAW OF INTEREST CONCERNING GAAR AND ANY OTHER CASES DEALING WITH ABUSIVE TAX AVOIDANCE IN YOUR JURISDICTION.

Current case law relevant to abusive tax avoidance

In order not to inhibit sound foreign investment, the anti-tax haven rules do not apply to a foreign subsidiary that meets certain criterion. Specifically, if a company is regarded as having business entity assumption in the country of location as well as sufficient economic rationality for conducting business activities in the country, the anti-tax haven rules do not apply (*Article 66-6(3), Special Taxation Measures Law*).

In a judgment rendered by the Tokyo High Court on 29 May 2013 (*Case No.421 (Gyou-ko) 2013/ Tokyo High Court*), the court dealt with the issue of whether anti-tax haven rules should be applied to a Japanese individual shareholder (claimant) of a certain legal entity (Company A) that was established under the laws of Singapore to sell goods in Southeast Asia that were manufactured by a Japanese precision equipment manufacturer. The business activities of Company A were entrusted to a Singaporean company (Company B) whose main role was business support in Singapore.

The business support activities involved an employee of Company B installing a computer and modem owned by Company A in a rental office leased by Company B, while performing tasks for other outsourcing companies.

The court ruled that the two requirements for tax exemption were met, specifically, that:

- The requirement that a foreign subsidiary has a fixed facility (for example, an office, a shop, a factory and so on) needed to engage in its main business activities in the state or territory where its head office or principal office is located (substantial criteria).
- The requirement that a foreign subsidiary administers, controls, and conducts its business by itself in the state or territory where its head office or principal office is located (administration-control criteria).

There are few cases relating to substantial criteria and/or administration-control criteria as applicable to the anti-tax avoidance rules in Japan. The above case is the only case in which a taxpayer prevailed due to having met such criteria. Recently, an increasing number of Japanese companies are establishing holding subsidiaries in a state or territory where the corporate tax burden is significantly lower than in Japan. The above case is highly worth referring to when considering strategies to free holding subsidiaries from the application of the anti-tax haven rules.

Historic case law relevant to abusive tax avoidance

Case No.133 (Gyou-hi) 2000/Supreme Court (Film Lease Case). A partnership established under the Civil Code of Japan, a portion of whose interests a real estate company (Company B) held, purchased a film and assigned distribution rights to a separate distributor. Company B declared its earnings to the tax office, with the film recorded as an asset and depreciation charges for the film recorded as expenses in proportion to Company B's portion of the partnership. The tax authority in this case refused to allow the depreciation charge to be recorded as an expense and made a reassessment. The Supreme Court of Japan refused to allow the depreciation charge for the film to be recorded as an expense for Company B, reasoning that the film was not a source of income originating from the partnership's business, and therefore cannot be considered as being used for the partnership's business.

Case No.128 (Gyou-hi) 2004/Supreme Court (Obunsha Holdings Co., Ltd. Case). In this case, a certain Japanese company (X) established a subsidiary in The Netherlands (A) whose shares were wholly owned by X, and X made A issue a large amount of new shares and allot them to a related company (B) of X in The Netherlands at a price especially favourable to B. The taxing authority decided that X, through the above actions, transferred a valuable asset in the form of shares from A to B, and made a reassessment where a monetary amount corresponding to the value of the transferred shares of A was deemed to be a donation to B from X, and X sought a revocation of the reassessment. The Supreme Court of Japan ruled that even if the series of actions outlined above were based on resolutions passed during shareholders meetings of A, such resolutions were made by X (the sole shareholder of A) with the intention of realising the transfer of a valuable asset though mutual communication, and therefore, the series of actions would be considered "transactions" as provided in Article 22(2) of the Corporation Tax Act (CTA). The amount to be included in the gross profits of X would be any amount related to that series of actions.

In the above cases, the Supreme Court of Japan determined, through close and comprehensive consideration of the respective transactions and actions of the taxpayers in these cases, whether specific provisions of Japan's tax laws applied so as to require the imposition of taxes.

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TAX AVOIDANCE PENALTIES

CIVIL AND ADMINISTRATIVE PENALTIES FOR ABUSIVE TAX AVOIDANCE

25. WHAT CIVIL AND ADMINISTRATIVE PENALTIES CAN BE IMPOSED IN ABUSIVE TAX AVOIDANCE CASES IN YOUR JURISDICTION?

An additional tax will be imposed on a person if such person fails to pay taxes (*Article 65 et seq., Act on General Rules for National Taxes*). In particular, in the event that a person's tax base and/or other facts that are the basis for calculating the amount of tax are hidden or obscured due to tax avoidance, a special, additional tax amounting to 35% or 40% (depending on the legal status of the taxpayer in question) of the accrued tax amount due will be imposed.

Additionally, if tax is not paid by the statutory payment date, a person is subject to a delinquency tax corresponding to interest. The amount of delinquency tax varies according to the number of days that have lapsed from the payment date (*Article 60 et seq., Act on General Rules for National Taxes*).

The above regulations also apply to local tax laws.

CRIMINAL PENALTIES FOR ABUSIVE TAX AVOIDANCE

26. WHAT CRIMINAL PENALTIES CAN BE IMPOSED IN ABUSIVE TAX AVOIDANCE CASES IN YOUR JURISDICTION?

If a taxpayer avoids a corporate tax or income tax by means of deception or other wrongful conduct, the taxpayer may be punished by imprisonment with labour for a period of not more than ten years and/or a fine of not more than JPY10 million (*Article 159(1), Corporation Tax Act (CTA); Article 238(1), Income Tax Act (ITA)*). Purposefully concealing profits and submitting a final return to the tax office that includes only a portion of the company's income as a result of engaging in abusive tax avoidance can fall into the category of "fraud and any other unfair actions" and constitutes a criminal act (*Article 159(1), CTA; Article 238(1), ITA*).

TAX AVOIDANCE DEVELOPMENTS AND REFORM

27. ARE THERE ANY CURRENT TRENDS, DEVELOPMENTS OR REFORM PROPOSALS THAT HAVE OR WILL AFFECT THE AREA OF TAX AVOIDANCE IN YOUR JURISDICTION?

As more Japanese begin possessing overseas property, the issue of appropriate taxation for the overseas property becomes all the more pressing. As a result, a system for the submission of overseas property statements was introduced in 2014. Under this system, a Japan resident who possesses an overseas asset that is valued at JPY50 million or more as of 31 December of a particular year must submit a statement for such overseas property to the director of the appropriate tax office by 15 March of the following year (*Article 5(1), Act on Submission of Statement of Overseas Wire Transfers for Purpose of Securing Proper Domestic Taxation*) describing the:

- Type of asset.
- Quantity.
- Value.
- Other necessary information pertaining to the overseas asset.

A person who breaches these regulations may be punished by imprisonment without labour for a period of not more than one year or a fine of not more than JPY500,000 (*Article 10, Act on Submission of Statement of Overseas Wire Transfers for Purpose of Securing Proper Domestic Taxation*).

THE REGULATORY AUTHORITY

NATIONAL TAX AGENCY

T +813 3581 4161
W www.nta.go.jp/foreign_language/

Outline structure. The National Tax Agency is a government office that deals with national tax imposition and collection. It is comprised of:

- The National Tax Agency headquarters.
- 11 regional taxation bureaus.
- An Okinawa regional taxation office.
- 524 tax offices.

Responsibilities. The National Tax Agency headquarters is responsible for tax administration and supervises the regional taxation bureaus (including the Okinawa regional taxation office) and tax offices. The regional taxation bureaus, under the supervision of the National Tax Agency headquarters, supervise the imposition and collection of taxes by each tax office located in their respective areas of jurisdiction, imposes and collects taxes on high income taxpayers, and performs other related tasks. The tax offices are primary enforcement agencies that impose and collect taxes under the supervision of the National Tax Agency headquarters as well as the regional taxation bureaus.

Procedure for obtaining documents. To obtain documents such as Tax Certifications from the tax authority, a taxpayer must:

- Make a request online (e-tax).
- File or mail an application to the tax office which has jurisdiction over the taxpayer.

ONLINE RESOURCE

JAPANESE LAW TRANSLATION DATABASE SYSTEM

W http://www.japaneselawtranslation.go.jp/?re=02

Description. The Japanese Law Translation Database System is a database maintained by the Ministry of Justice. All of the translations contained in the Japanese Law Translation Database System are unofficial. Only the original Japanese texts of the laws and regulations have legal effect, and the translations are to be used solely as reference materials to aid in the understanding of Japanese laws and regulations.

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SOUTH AFRICA

Karen Miller, Anne Bennett and Carryn Alexander,
WEBBER WENTZEL

TRANSFER PRICING: GENERAL OVERVIEW

1. WHAT ARE THE MAIN CHARACTERISTICS OF TRANSFER PRICING LAW AND POLICY IN YOUR JURISDICTION?

South Africa's transfer pricing rules are based on the Organisation for Economic Co-operation and Development's arm's length standard. The rules require a legal connection between the parties to the transaction and although the definition of a connected party is complex, for companies it can be summarised as including members of a group where the common shareholding is 50% or more, and companies which own a shareholding of 20% in a company in which no other party owns a majority holding.

The legislation permits recharacterisation of a transaction where any of the terms and conditions differ from those found between unrelated parties. The legislation is a self-assessment provision, in that the taxpayer must file a return based on the transaction being in accordance with the arm's length principle. If the taxpayer is party to a transaction that is not priced on an arm's length basis, the taxpayer must adjust the pricing to an arm's length amount when filing the return.

A transfer pricing adjustment attracts a secondary adjustment in the form of a deemed dividend which is subject to dividends withholding tax at a rate of 15%. This will also apply where a taxpayer makes an adjustment on filing the tax return to accord to the arm's length principle.

There are no specific transfer pricing penalties at present, but general administrative and understatement penalties can apply.

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2. WHAT HAVE BEEN THE MAIN DEVELOPMENTS OF SIGNIFICANCE FOR TRANSFER PRICING LAW AND PRACTICE IN YOUR JURISDICTION IN THE PAST 12 MONTHS?

South Africa has adopted certain of the minimum standards proposed under the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) recommendations. Section 29 of the Tax Administration Act (TAA) has been extended to include document retention requirements for transfer pricing. These are onerous and go beyond the requirements proposed by the OECD under Action 13 relating to master file and local file requirements. There is also a particular section of the annual tax return which requires specific transfer pricing disclosure, mostly relating to financial data on transactions. As yet there is no statutory requirement to submit transfer pricing documentation to the South African Revenue Service although this is expected.

The transfer pricing documentation retention requirements apply to taxpayers that have aggregated connected party transactions of a value of ZAR100 million or more. If this threshold is met, documentation should be retained for all transactions of ZAR5 million or more.

South Africa has also adopted country-by-country (CbC) reporting. CbC reports must be completed by parent companies of groups that have consolidated turnover of ZAR10 billion or more. South Africa has adopted the proposed legislation outlined in Action 13 of the OECD BEPS reports and largely follows this. The CbC reports must be submitted in accordance with section 25 of the TAA. Currently there are no penalties associated with non-compliance.

TRANSFER PRICING LEGISLATION

FEDERAL OR NATIONAL LEGISLATION

3. WHAT IS THE MAIN FEDERAL (NATIONAL) LEGISLATION REGULATING TRANSFER PRICING IN YOUR JURISDICTION?

Primary legislation

The main transfer pricing provisions in South Africa are:

- Section 1 of the Income Tax Act no 58 of 1962 (ITA), which defines connected person. A connected person can be either another company within a group or a natural person, subject to certain percentages of equity shares and voting rights indicating a controlling interest (see Question 1).
- Sections 31(1) and (2) of the ITA , which state that an affected transaction is one that is direct or indirect, between connected persons, and not at arm's length.
- Section 31(3) of the ITA, which states that a transfer pricing adjustment is deemed to be a distribution of an asset or a deemed dividend.
- Section 64E of the ITA, which imposes a 15% charge to tax on the affected transaction.

Secondary legislation

In addition to the primary taxing Act, South Africa also has the Tax Administration Act (TAA) which governs the manner in which the Tax Act is administered. Relevant sections specific to transfer pricing are:

- Section 25 of the TAA, requiring the completion of country-by-country reports.
- Section 29 of the TAA, requiring the retention of transfer pricing documentation.

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STATE OR LOCAL TRANSFER PRICING LEGISLATION

4. WHAT ADDITIONAL REGIONAL (LOCAL STATE) LEGISLATION AND REVENUE AUTHORITIES ARE RELEVANT TO TRANSFER PRICING IN YOUR JURISDICTION?

Legislation

Other than that referred to in *Question 3* there is no additional local legislation pertaining to transfer pricing in South Africa.

Revenue authorities

The South African Revenue Service is the taxing authority for South Africa and operates on a national basis.

INTERNATIONAL TRANSFER PRICING TREATIES AND AGREEMENTS

5. WHAT ARE THE MAIN INTERNATIONAL TREATIES AND AGREEMENTS THAT APPLY IN YOUR JURISDICTION?

South Africa has a broad network of tax treaties. These largely follow the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention, although there are some treaties that include elements of the UN Model Tax Convention.

South Africa is a party to a number of tax treaties with both developed countries within the OECD and neigbouring countries across the African continent. In total South Africa has entered into 104 treaties of which six are awaiting ratification. A further 21 are in the process of negotiation.

6. WHAT IMPACT DO INTERNATIONAL TREATIES AND AGREEMENTS HAVE IN YOUR JURISDICTION?

The treaties referred to at *Question 5* follow the Organisation for Economic Co-operation and Development's (OECD) Model Tax Convention and provide for relief from double taxation, both juridical and economic, by assigning taxing rights either to South Africa or to the other country party to the treaty.

In addition, South Africa has also signed the OECD Multilateral Competent Authority Agreement on the Exchange of Country by Country Reports. At the time of writing the authors are of the view that South Africa will also sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. It is not clear at the time of writing to what extent South Africa will adopt the recommended changes to its treaties or which options it will adopt.

TRANSFER PRICING POLICY

7. WHAT IS THE OVERALL NATIONAL TRANSFER PRICING POLICY IN YOUR JURISDICTION?

South Africa is closely following developments at the Organisation for Economic Co-operation and Development (OECD) relating to base erosion and profit shifting (BEPS) and those impacting transfer pricing. It has first-world transfer pricing legislation in place and extensive double tax treaties which adopt the arm's length standard for determining the taxable profit allocation between South Africa and its treaty parties in respect of transactions entered into between members of multinational enterprises.

South Africa endorses the OECD guidance on transfer pricing and is adopting much of the revised guidance recommendations on BEPS, notably the proposed changes to documentation requirements.

South Africa has issued the following two legislative notices under the Tax Administration Act 28 of 2011 (TAA):

- Related to section 29 , the requirement for South African taxpayers to retain transfer pricing records. This was issued on 28 October 2016 and applies to years of assessment starting on or after 1 October 2016.
- Related to section 25, rules relating to the completion of country-by-country (CbC) reports for multinational enterprise groups for fiscal years commencing on or after 1 January 2016.

Under section 29 of the TAA, a South African corporate taxpayer must retain documents and records of account relating to its transfer pricing if the aggregate of its related party transactions (excluding any set-off or netting) totals ZAR100 million or more. Detailed records must be kept for all transactions valued at ZAR5 million or more.

In addition, South Africa has adopted the OECD recommendations for completion of CbC reports which will be shared with other signatory countries by automatic exchange. The notice bringing in this requirement was issued on 23 December 2016 and applies to all years of assessment starting on or after 1 January 2016.

Although South Africa has indicated it will adopt the OECD's guidance on keeping master file and local country file documentation, no formal notification has yet been issued by the South African Revenue Service. It is anticipated that this will be legislated through a notice sometime during 2017.

Finally, The Minister of Finance has appointed a committee to oversee South Africa's tax legislation and make recommendations on improving this. Part of this committee's mandate is to consider what changes should be made to adhere to certain of the BEPS recommendations. At the time of writing, the committee has made certain recommendations in relation to Action 8 on transfer pricing of intangibles and Action 13 on transfer pricing documentation. While the recommendations on transfer pricing documentation have largely been adopted, the committee has concluded that no real legislative amendments are needed to address Action 8 because there are controlled foreign company rules, and existing legislative restrictions contained in the Income Tax Act 1962, including the current transfer pricing rules (*see Question 2*).

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8. WHAT ARE THE MAIN TRANSFER PRICING METHODOLOGIES THAT ARE USED TO DETERMINE AN ARM'S LENGTH PRICE IN YOUR JURISDICTION?

In implementing its transfer pricing rules, South Africa adopts all five methods recognised by the Organisation for Economic Co-operation and Development (OECD). These are:

- The transaction-based methods:
  - comparable uncontrolled price method;
  - resale price method;
  - cost plus method;
- The profit-based methods:
  - profit split method.
  - transactional net margin method.

There is no hierarchy and South Africa recognises the most appropriate method approach endorsed by the OECD.

9. TO WHAT EXTENT, IF ANY, DOES YOUR JURISDICTION FOLLOW THE OECD TRANSFER PRICING GUIDELINES?

South Africa endorses and follows the guidance provided by the Organisation for Economic Co-operation and Development (OECD). With the proposed changes to these guidelines as recommended under the base erosion and profit shifting (BEPS) actions, there may be certain areas where South Africa does not wholly adopt this guidance. For example, the authors expect that there may be some resistance to accepting the recommended approach for the treatment of low value-adding services which is a proposed change to Chapter VII of the guidelines.

Currently, other than the developments indicated earlier relating to the changes under the Tax Administration Act (TAA), South Africa's transfer pricing guidance is contained in Practice Note 7 to the Income Tax Act which dates back to 1999. There have been several key legislative changes which impact the relevance of this practice note, notably around certain key definitions. The documentation guidance has also been superseded by section 29 of the TAA (*see Question 7*). However certain aspects of the practice note can provide some additional guidance. For example, the practice note states that "The OECD Guidelines should be followed in the absence of specific guidance in terms of this Practice Note, the provisions of section 31 or the tax treaties entered into by South Africa" (*paragraph 3.2.3, Practice Note, 7 August 1999*).

10. IS IT POSSIBLE TO OBTAIN ANY CLEARANCES OR ADVANCE PRICING AGREEMENTS FROM THE REVENUE AUTHORITIES IN RESPECT OF TRANSACTIONS?

Clearances

South Africa has an advanced ruling programme that, in certain circumstances, enables taxpayers to seek advanced interpretation on the application of the Income Tax Act. Interpretation is provided through a "binding ruling". However the provisions that permit a taxpayer to seek a binding ruling specifically exclude situations that relate to the pricing of a transaction. Therefore, there is no opportunity to obtain a binding ruling on a transfer pricing matter.

Advance pricing agreements

South Africa does not have an advanced pricing programme in place. At the time of writing there is also no intention on the part of the South African Revenue Service to introduce an advance pricing agreement programme.

11. WHERE THE REVENUE AUTHORITIES MAKE A TRANSFER PRICING ADJUSTMENT, WHAT IS THE EFFECT OF THAT ADJUSTMENT ON THE OTHER PARTY TO THE TRANSACTION?

A primary transfer pricing adjustment gives rise to a secondary adjustment in the form of a deemed dividend which is subject to dividends withholding tax at the rate of 15% (*see Question 3*).

There is uncertainty as to whether this would be subject to treaty reduction under Article 10 of the relevant treaties (*see Question 5*).

12. WHAT ARE THE REPORTING AND OTHER ADMINISTRATIVE OBLIGATIONS THAT APPLY TO HELP THE AUTHORITIES EVALUATE TRANSFER PRICES?

South Africa has adopted the base erosion and profit shifting Action 13 on country-by-country reporting which will provide the South African Revenue Service (SARS) with information on the activities and profitability of companies within a multinational group. It is envisaged that these resports, including those provided to SARS under the automatic exchange of reports, will provide a significant source of information to enable SARS to carry out risk assessments.

In addition, the annual income tax return has gradually changed over the last few years to require more detailed and granular information from corporate taxpayers relating to their inter-company transactions. These disclosures are used by SARS to assess possible areas ot risk.

Finally, SARS has a standard transfer pricing questionnaire which is issued to taxpayers and which requests additional information relating to the taxpayer's transfer pricing practices. This often preceeds a request from SARS for transfer pricing documentation from the taxpayer.

TRANSFER PRICING COURTS AND DISPUTE RESOLUTION

NATIONAL COURTS AND TRANSFER PRICING DISPUTE RESOLUTION

13. WHAT ARE THE RELEVANT NATIONAL COURTS AND WHAT DISPUTE RESOLUTION MECHANISMS EXIST FOR TRANSFER PRICING ISSUES IN YOUR JURISDICTION?

The dispute resolution process is a tiered process that is designed to give the taxpayer opportunity to present additional information. Once an audit is concluded, the South African Revenue Service (SARS) will normally issue a "letter of findings" which proposes the adjustments it intends to make and the basis for each adjustment. The taxpayer is given the opportunity to respond and provide additional information, clarification and an opposing view. SARS will consider the merits of the response and then either issue an assessment or confirm satisfaction with any rebuttal. The letter of findings also provides the taxpayer with an opportunity to explain itself and provide evidence of extenuating circumstances justifying the non-imposition of penalties and interest on any additional tax that may be due as a result of a proposed adjustment.

Once an assessment is issued, the taxpayer can object to the assessment and state its grounds for objecting. SARS will consider the objection and can either allow, partially allow or disallow the objection. As part of this process, the taxpayer can request reasons for the basis of the assessment, if SARS's grounds for raising the assessment are unclear.

Assuming that an objection is disallowed, the taxpayer can appeal this decision to the Tax Court. The taxpayer can also request that the alternative dispute resolution (ADR) process be considered. The taxpayer can also make an objection to the competent authority to invoke the mutual agreement procedure (MAP) under the relevant treaty. If either ADR or the competent authority route is chosen, the appeal process will be halted pending the outcome.

The ADR process involves the taxpayer and SARS discussing the merits of the case and putting forward their respective arguments in front of an independent person. This person is a SARS official but is independent from the audit. The independent person can make recommendations to SARS following the ADR, after which SARS may or may not accept the taxpayer's arguments in whole or in part.

The competent authority route involves invoking the MAP process between the two affected revenue authorities. This is a closed discussion and the taxpayer cannot make any additional representations during the process.

If the appeal continues, the matter will be heard in the Tax Court. The ruling of the judge in the Tax Court can be appealed to the Supreme Court. The procedures for dealing with dispute resolution are contained in Chapter 9 of the Tax Administration Act 2011.

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INTERNATIONAL COURTS AND TRANSFER PRICING DISPUTE RESOLUTION

14. WHAT INTERNATIONAL DISPUTE RESOLUTION METHODS ARE AVAILABLE IN YOUR JURISDICTION, AND WHICH ARE PREFERRED FOR TRANSFER PRICING ISSUES?

The only international dispute resolution available is appeal to the competent authority to invoke the mutual agreement process under the relevant double tax treaty.

TRANSFER PRICING CASE LAW

15. WHAT ARE THE MOST SIGNIFICANT CASE LAW DEVELOPMENTS ON TRANSFER PRICING IN YOUR JURISDICTION?

There have been no transfer pricing cases published in South Africa at the time of writing.

TRANSFER PRICING ADJUSTMENTS

ADJUSTMENTS AND PENALTIES

16. WHERE THE REVENUE AUTHORITIES MAKE AN ADJUSTMENT OF TRANSFER PRICES FOR TAX PURPOSES, CAN ANY OTHER PENALTIES ALSO BE IMPOSED IN ADDITION TO THAT ADJUSTMENT?

There are no specific transfer pricing penalties. Adjustment made under the transfer pricing rules can attract penalties for understatement of tax and penalties for underpayment of tax. These are general penalties imposed under the Tax Administration Act 2011.

Legislative amendments in 2016 have changed the definition of an understatement to encompass any additional tax arising from an adjustment made by SARS under any general anti-avoidance provision. It is arguable whether the transfer pricing rules constitute a general anti-avoidance provision and this remains untested at the time of writing. If SARS successfully argue that the transfer pricing rules are an anti-avoidance provision, a penalty equivalent to 75% of the additional tax due will be imposed on a transfer pricing adjustment.

TRANSFER PRICING DEVELOPMENT AND REFORM

17. ARE THERE ANY CURRENT TRENDS, DEVELOPMENTS OR REFORM PROPOSALS THAT HAVE OR WILL AFFECT THE AREA OF TRANSFER PRICING IN YOUR JURISDICTION?

There have been several recent developments associated with transfer pricing in South Africa, largely in the context of South Africa having adopted certain base erosion and profit shifting recommendations. The requirement for retention of transfer pricing documentation was introduced in October 2016 and applies to years of assessment starting on or after that month. Taxpayers that fall within the threshold limits must keep certain documentation on the transactions they enter into with connected persons.

In addition, in December 2016 South Africa legislated for country-by-country reporting.

TAX AVOIDANCE: GENERAL OVERVIEW

18. WHAT HAVE BEEN THE MAIN NATIONAL AND INTERNATIONAL TRENDS AFFECTING TAX ENFORCEMENT AND ANTI-AVOIDANCE PRACTICE IN YOUR JURISDICTION IN THE PAST 12 MONTHS?

In recent years, multinational companies that avoid or evade tax by shifting taxable income to low-tax regimes or tax havens have come under the global spotlight.

South Africa has been proactive in taking policy action in this area and has joined the Group of Twenty (G20) and the OECD to examine base erosion and profit shifting.

South Africa has also taken the following steps:

- Improving the quality of information that corporates are required to provide to the South African Revenue Authority (SARS) for SARS to identify aggressive or abusive tax planning schemes.
- Taking action on transfer pricing. SARS will soon have access to country-by-country information on all large multinationals operating in South Africa.
- Enhancing rules on foreign companies controlled by a South Africa resident to ensure that a portion of the profits earned by a South African-owned subsidiary, operating in another country, is taxed in South Africa if no meaningful economic activity took place in the other country.
- Introducing rules that limit excessive interest deductions.

19. HOW DOES YOUR JURISDICTION MAKE THE DISTINCTION BETWEEN ABUSIVE TAX AVOIDANCE AND LEGITIMATE TAX PLANNING?

In South Africa, to determine whether a taxpayer has engaged in legitimate tax planning, a distinction is made between:

- Tax evasion.
- "Impermissible" tax avoidance.
- Legitimate tax planning or "tax mitigation".

In adopting the Organisation for Economic Co-operation and Development's (OECD) definition of tax evasion, South Africa defines tax evasion as encompassing "illegal arrangements through or by means of which liability to tax is hidden or ignored". That is, arrangements in which the taxpayer pays less tax than he or she is legally obligated to pay by deliberately hiding income or information from the tax authorities.

The term "impermissible tax avoidance" is described as an artificial or contrived arrangement with little or no actual economic impact upon the taxpayer, that is, usually designed to manipulate or exploit perceived loopholes in the tax laws to achieve results that conflict with or defeat the intention of the legislature.

Legitimate tax planning has been described as a situation in which the taxpayer has arranged his or her affairs in a legal manner, either reducing their income or ensuring that there is no income on which tax is payable and genuinely suffering the economic consequences that the legislature intended to be suffered by taking advantage of a fiscally attractive option. A taxpayer is not barred from entering into a bona fide transaction which, when carried out, has the effect of avoiding or reducing liability to tax, provided that there is no provision in the law that prevents the avoidance or the reduction of tax.

20. DO THE REVENUE AUTHORITIES IN YOUR JURISDICTION OFFER ANY GUIDANCE ON THE DISTINCTION BETWEEN LEGITIMATE TAX PLANNING MECHANISMS AND ABUSIVE OR AGGRESSIVE TAX AVOIDANCE?

South Africa has had a general anti avoidance rule (GAAR) in its income legislation for many years. The South African Revenue Service (SARS) published a *Discussion Paper on Tax Avoidance and Section 103 of the ITA* in November 2005, discussing issues of tax evasion and impermissible tax avoidance, and how best to address them. SARS also published an interim response in March 2006, taking into account the comments received on the discussion paper. South Africa introduced the current version of its GAAR in 2006, after these publications.

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TAX ANTI-AVOIDANCE PROVISIONS

21. CAN YOU IDENTIFY ANY DIRECT OR INDIRECT IMPACT IN YOUR JURISDICTION OF THE OECD OR OTHER RECENT INTERNATIONAL INITIATIVES TO COMBAT ABUSIVE TAX AVOIDANCE?

International initiatives have had an impact on South African general anti-avoidance legislation and tax rules. In the 2005 discussion paper on tax avoidance (*see Question 20*), the South African Revenue Authority provided an overview of the recent experiences with, and responses to, abusive tax avoidance schemes and impermissible tax avoidance in six different countries, namely, Australia, Canada, New Zealand, Spain, the UK, and the US. South Africa's current GAAR was drafted against the backdrop of international experience in this area.

22. DOES YOUR JURISDICTION HAVE GAAR DESIGNED TO PREVENT OR REDUCE ABUSIVE TAX AVOIDANCE?

South Africa's general anti-avoidance rule (GAAR) is contained in sections 80A to 80L of the Income Tax Act no 58 of 1962 (ITA) and applies to any arrangement entered into on or after 2 November 2006.

In general, the South African Revenue Authority's Commissioner can apply the GAAR to a transaction if four requirements are met:

- There must be an arrangement.
- The arrangement must result in a tax benefit.
- The arrangement must lack commercial substance and:
  - be carried out by means or in a manner that would not normally be employed for bona fide business purposes, other than obtaining a tax benefit;
  - create rights or obligations that would not normally be created between persons dealing at arm's length; or
  - result directly or indirectly in the misuse or abuse of the provisions of the ITA.
- The arrangement's sole or main purpose must be to obtain a tax benefit.

An arrangement having these characteristics is an "impermissible avoidance arrangement". The Commissioner has explicit authority to determine the tax consequences of any impermissible avoidance arrangement for any party by, among other things, "disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement". The Commissioner can also apply the GAAR either to an impermissible avoidance arrangement as a whole or to any step in or part of such an arrangement.

23. WHAT ARE THE LEGISLATIVE PROVISIONS THAT ARE DESIGNED TO REINFORCE GAAR AND ANY OTHER ABUSIVE TAX AVOIDANCE PROVISIONS?

In addition to the general anti-avoidance rule (GAAR), the Income Tax Act 1962 (ITA) also contains a large number of specific anti-avoidance provisions. In the context of companies, some of the most significant of these include:

- The definition of "connected person" contained in section 1, which provides a limitation on the quantum of deductions or allowances in respect of certain second-hand assets acquired from connected persons.

- Sections 7(5) and (6), which deem donors to be liable to tax on income received by or accrued to trustees or to the trust's beneficiaries as a result of their donations.
- Section 7(8), which provides that donors who cede or otherwise make over to other persons their right to receive income from certain assets are in certain circumstances liable to tax on the income ceded or made over.
- Section 7(9), which provides that where an asset has been disposed of for a consideration less than its market value, the amount by which the market value exceeds the consideration will be deemed to be a donation.
- Sections 8A and 8C, which contain specific anti-avoidance provisions aimed at share incentive schemes.
- Section 8E, which deems dividends on hybrid equity instruments as defined to be interest.
- Section 8F, which denies a deduction in respect of any amount paid or payable by an issuer under a hybrid debt instrument as defined.
- South Africa's controlled foreign company rules in section 9D, which includes as income in the hands of a resident who holds participation rights in a controlled foreign company, a notional amount of the foreign company's net income, unless certain exemptions apply.
- Section 24J, which deems interest to have accrued or to have been incurred on a yield to maturity basis, to prevent schemes designed to avoid tax.
- Section 25B(2A), which includes an amount in income where residents acquire a vested right to an amount representing the capital of a non-resident trust.
- Section 31, which provides transfer pricing rules to counter abusive practices.
- The value-shifting arrangements contained in paragraph 11(1)(g) of the Eighth Schedule to the ITA and dealing with capital gains tax (CGT). Value shifting involves the effective transfer of value from one entity to another without constituting an ordinary disposal for CGT purposes. The mischief that the anti-avoidance provisions contained in the Eighth Schedule are aimed at combating is the situation where entities manipulate the value of assets to obtain a CGT benefit.
- Paragraph 16 of the Eighth Schedule to the ITA, which provides for certain capital losses to be disregarded where they arise from intangible assets acquired before 1 October 2001 from a connected person or as part of a business. The mischief that paragraph 16 is aimed at combating is the abuse of the valuation of intangible assets on the acquisition of a business.
- Paragraph 19 of the Eighth Schedule to the ITA, which deals with extraordinary dividends and losses from dividend stripping.
- Paragraph 38 of the Eighth Schedule to the ITA, which deals with donation or disposals to connected persons and which are not priced on an arm's length basis. This paragraph applies deemed market value treatment to both purchaser and seller.
- Para 56, which disregards capital losses linked to the disposal of debts owed by connected persons.

24. IDENTIFY AND DISCUSS ANY CASE LAW OF INTEREST CONCERNING GAAR AND ANY OTHER CASES DEALING WITH ABUSIVE TAX AVOIDANCE IN YOUR JURISDICTION.

Current case law relevant to abusive tax avoidance

There have been no important cases dealing with the application of the of the current GAAR contained in sections 80A to 80L of the ITA. However, there were several cases that dealt with the earlier versions of the GAAR, which have assisted in the interpretation of certain terms of the new GAAR.

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