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TITLE

ADVANCE PRICING AGREEMENTS AND THEIR POSSIBLE APPLICATION IN ARMENIA

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LIST OF ABBREVIATIONS

OECD	Organization for Economic Co-operation and Development
MNC	Multi-national company
MNE	Multi-national enterprise
APA	Advance Pricing Agreement

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INTRODUCTION

The importance of regulating transfer pricing is premised on the phenomenon that in the era of new technologies, where transportation and communication are more accessible, the number of MNCs dramatically increases, which, among other things, provides MNCs with flexibility to place their affiliates and activities anywhere in the word.[1] The influence of multi-national companies has increased to the extent that their share in cross-border transactions across the world makes up 60 percent[2]. The necessity of using advance regulations and mechanisms such as Transfer Pricing thus becomes vital.[3] Transfer pricing rules are slightly different across tax jurisdictions, and this creates some level of complication and uncertainty for both the taxpayer and the tax authority.[4] Transfer pricing is the setting of the price for a cross-border transaction between related parties, *i.e.* multinational enterprises within their corporate group, as well as individuals with legal entities under their control or with close family members.[5] MNCs use transfer prices for intra-group transfers of goods and services, and these intercompany prices are the key aspect of transfer prices.[6] Transfer Pricing is itself a legal process, but in some circumstances it can become a tool for tax avoidance[7]. The mechanism of avoidance is the manipulation with transfer prices (transfer mispricing) in a way that multinational corporations allocate their profit from high-tax jurisdiction to law-tax

[1] Informal Meeting on Practical Transfer Pricing Issues for Developing Countries, *Practical Manual on Transfer Pricing for Developing Countries,* 2 (2011), http://www.un.org/esa/ffd/tax/2011_TP/TP_Chapter1_Introduction.pdf.
[2] *BEPS: why you're taxed more than a multinational*, OECD Insights (Feb. 13, 2013), http://oecdinsights.org/2013/02/13/beps-why-youre-taxed-more-than-a-multinational.
[3] MARC M. LEVEY, STEVEN C. WRAPPE & KERWIN CHUNG, TRANSFER PRICING RULES AND COMPLIANCE HANDBOOK 1 (2006).
[4] Markus Brem, *Globalization, Multinationals and Tax Base Allocation: Advance Pricing Agreements as Shifts in International Taxation?* (Jan. 20, 2014), https://tax.network/mbrem/globalization-multinationals-and-tax-base-allocation-advance-pricing-agreements-as-shifts-in-international-taxation.
[5] BRIAN J. ARNOLD & MICHAEL J. MCINTYRE, INTERNATIONAL TAX PRIMER, SECOND EDITION 55 (2002).
[6] *Id.*
[7] Kenneth Klassen, Petro Lisowsky, Devan Mescall, *Transfer Pricing: Strategies, Practices, and Tax Minimization*, 34 Contemporary Accounting Research, 455-493 (2017), http://onlinelibrary.wiley.com/doi/10.1111/1911-3846.12239/full.

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jurisdiction.[8] Tax authorities in many countries deploy strict transfer pricing enforcement, penalties, and documentation requirements to ensure better compliance by taxpayers with transfer pricing laws.[9]

On 4 October 2016, the Parliament of the Republic of Armenia adopted the new Tax Code (hereinafter the Tax Code)[10] which will enter into force from 2018. For the first time, the Tax Code includes a whole chapter on Transfer Pricing regulations. Chapter 73 (Transfer Pricing Regulations) of the Tax Code covers several methodologies for adjusting the prices of transactions between related parties. However, the Tax Code fails to address issues related to Advance Pricing Agreements. This might create an atmosphere of uncertainty between taxpayers and tax authorities, which can further shape tax obstacles for cross-border transactions. This paper argues that one remedy to the situation could be the introduction of Advance Pricing Agreement.

Advance Pricing Agreements provide taxpayers with some level of certainty during tax planning and minimize risks.[11] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter the OECD Transfer Pricing Guidelines) defines Advance Pricing Agreement (APA) as an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparable and appropriate adjustments thereto, critical assumptions as to future events) for the determination of transfer pricing for those transactions over a fixed period of time. An advance pricing agreement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.[12] In many countries competent authorities try to renew their legislation by including provisions on APAs and improving the APA processes. The number of requests of taxpayers for APAs reflects the increased desirability of such agreements between the taxpayers and tax authorities.

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[8] *Transfer Pricing,* Tax Justice Network (last visited Feb. 13, 2017), http://www.taxjustice.net/topics/corporate-tax/transfer-pricing.
[9] ANUSCHKA BAKKER & MARC M. LEVEY, TRANSFER PRICING & DISPUTE RESOLUTION: ALIGNING STRATEGY AND EXECUTION 1 (2015).
[10] Tax Code of the Republic of Armenia, *adopted* Nov. 4, 2016, http://www.arlis.am/DocumentView.aspx?DocID=109017.
[11] PricewaterhouseCoopers, *Transfer pricing: Advance pricing agreements*, 2017, http://www.pwc.com/gx/en/services/tax/transfer-pricing/advance-pricing-agreements.html.
[12] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 23 (2010), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2010_tpg-2010-en#.WQaFbYVOJPY#page25.

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This research is aimed to discuss the issue of absence of provisions on Advance Pricing Agreement in the Tax Code, indicating some possible complications and positive developments in the relationships between taxpayers and tax authorities that can be associated with the introduction of APAs. To achieve this objective, the research will attempt to conduct a cross-country analysis of law and practice in the area in countries, such as UK, Malaysia, Poland, Hungary, having incorporated provisions on Advance Pricing Agreements in their domestic legislations.

This paper consists of an introduction, two chapters, a conclusion, and a bibliography.

Chapter 1 is structured to study the Transfer Pricing framework established by the Tax Code. Particularly, the paper will provide an analysis of the main concepts, including controlled and uncontrolled transactions, related parties, financial indicators, arm's length principle and transfer pricing methods for determination of the arm's length price. Each of the five transfer pricing methods defined in the Tax Code will be analyzed through hypothetical scenarios. Chapter 1 will also discuss some possible issues which might arise when applying transfer pricing methods, pertinent risks related to double taxation and to the atmosphere of uncertainty between taxpayers and tax authorities.

Chapter 2 will attempt to describe and analyze the scope of MAP and APAs, their nature, types, objectives, advantages and risks, outcomes as well as some key aspects of the process of concluding an APA. The Chapter starts with a sub-chapter offering a discussion on Mutual Agreement Procedure, which is a well-designed means through which tax administrations consult to resolve disputes regarding the application of double tax conventions[13]. The next sub-chapter presents the differences between unilateral, bilateral and multilateral Advance Pricing Agreements in terms of their purposes and effectiveness. Further, this Chapter contains information on possible advantages of APAs, such as mitigation of uncertainty, reduction of the cost of tax compliance, decrease in the cost of administration for tax authorities, as well as some risks, such as problems which might arise in the event of concluding APAs or signing an APA based on unreliable prediction on changing market conditions without adequate critical assumptions.

The paper will be concluded with a discussion on the introduction of Advance Pricing Agreements in the Armenian law, providing a debate on its effectiveness and practicablity. The conclusion offers a discussion on the mechanism defined by the Tax Code for choosing

[13] *Id*. at 97.

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the appropriate transfer pricing method, from the perspective of advantages and disadvantages for the taxpayer and the tax authority. Further, the research presents the benefits of the APA system vis-à-vis its imminent risks, ultimately proposing the introduction of the APA in the Tax Code as a means of ensuring a higher level of certainty and predictability in the application of transfer pricing methods.

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CHAPTER 1. TRANSFER PRICING FRAMEWORK IN ARMENIA

Under part 5 of Article 363 of the new Tax Code of Armenia, transfer pricing rules apply, if the sum total of all the controlled transactions of the taxpayer within the tax year exceeds AMD 200 million. The Tax Code defines Transfer Pricing as procedure for determination of financial indicators in controlled transactions. This definition implies that in order for transfer pricing rules to apply, it must be established that a transaction — supply of goods, sale of intangible property and/or provision of services — is controlled. Under part 1 of Article 363 of the Tax Code, a transaction is considered controlled if it is carried out between related taxpayers. The fact of relatedness, under part 3 of Article 363 of the Tax Code, is irrelevant in case a transaction is concluded between a resident taxpayer and taxpayers in offshore zones. Taxpayers, according to part 1 of Article 362 of the Tax Code, are deemed related in two cases: (1) one of the taxpayers is directly or indirectly involved in the management, control of the other taxpayer or has a participation in the authorized or share capital of the other taxpayer; (2) the same taxpayer is directly or indirectly involved in the management, supervision of two or more taxpayers or has a participation in their authorized or share capital. A more practical view of the meaning of transfer pricing, as defined under the new Armenian tax regulation, can be provided through a hypothetical scenario. ACo, an Armenian company, directly possesses 25 percent shares in the authorized capital of BCo, company operating in Georgia. ACo produces keyboards and sells them to BCo. Under point 1 of part 2 of Article 362 of the Tax Code, if one taxpayer has 20 or more percent shares in the authorized capital of another taxpayer, it is considered to be involved in the management, control of or to have participation in the authorized capital of the other taxpayer. Thus, the Armenian tax authority will have the grounds prescribed by the Tax Code to apply the rules of transfer pricing and determine the financial indicators in the transaction. Under point 2 of part 1 of Article 361 of the Tax Code, financial indicator is the price, mark-up, gross, operating or net profit margin which is analysed when applying the transfer pricing methods. According to part 1 of Article 364 of the Tax Code, the financial indicators are determined using the arm's length principle to determine the profit tax base. Assume that in the scenario described above the transfer takes places at AMD 30 000 per item; however, when this transaction is reported to the

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Armenian tax authority, the latter reveals unrelated companies usually sell keyboards of the same quality and level of reliability at AMD 40 000 per item. The tax authority will have to determine the profit tax base using the arm's length principle. According to point 6 of part 1 of Article 361 of the Tax Code, arm's length principle is a principle of assessment of transactions in accordance with which the financial indicators applied in controlled transactions are not different from the financial indicators applied in comparable uncontrolled transactions. This analysis will take place using the transfer pricing methods.

There are five transfer pricing methods, which are defined in Article 368 of the Tax Code. By part 4 of the Article, conformity of the terms of controlled transaction with the arm's length principle is established by applying the transfer pricing method most appropriate for the given circumstances. The most appropriate transfer pricing method is chosen from the transfer pricing methods, having regard to the strengths and weaknesses of the relevant transfer pricing method; conformity of the method, having regard to the characteristics of the controlled transaction; availability of reliable information required for the application of the relevant transfer pricing method. The exact procedure for applying the transfer pricing methods will, according to part 7 of Article 368 of the Tax Code, defined by the Decision of the Government of the Republic of Armenia. It is expected that the respective Governmental Decision will be submitted to the Staff of the Government of Armenia in late May, as it is envisaged by Decision of the Prime Minister of the Republic of Armenia No 35 of 19 January 2017. In the absence of exact rules for applying the transfer pricing methods under the Armenian legislation, in the hypothetical scenarios below the application of transfer pricing methods will be explained using the rules contained in Chapter II of the OECD Transfer Pricing Guidelines.

The first method described in point 1 of part 1 of Article 368 of the Tax Code is comparable uncontrolled price (CUP) method, where the price of the subject-matter of the controlled transaction is compared with the price of the uncontrolled transaction. According to point 1 of part 2 of Article 368 of the Tax Code CUP method is applicable, in particular, where the controlled transaction implies supply of goods, alienation of an intangible asset or a financial transaction. Pursuant to the OECD Transfer Pricing Guidelines, CUP method can apply if there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the

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controlled transaction[14]. This method can apply to the situation where, assumingly, ACo, an Armenian company, produces keyboards at a price AMD 20 000 per item, and sells them to FCo, an unrelated foreign company, with the transfer price of AMD 25 000 for each. ACo also sells keyboards of the same quality and level of reliability to BCo, a related company operating in Hungary, at AMD 22 000 each, and BCo resells the keyboards to an unrelated buyer at a price AMD 40 000 per item. Since the conditions of transfers with FCo, unrelated foreign company, and BCo, related company, are essentially the same, the Armenian tax authorities will compare the transaction price of the two transactions and, if the price is outside the arm's length range, the tax authorities will fix the transfer price of transaction between ACo and BCo at AMD 25000 per item. This means that the main element that the tax authority will consider in applying the CUP method is the cost of transaction between uncontrolled parties. The analysis of the Hungarian Transfer Pricing regulation, which is generally compliant with the OECD Transfer Pricing Guidelines, shows that in Hungary, the fair market price is determined by comparative price method, where fair market price means the price used by independent parties in connection with the supply of comparable products or services in an economically comparable market.[15]

The second method, described in point 2 of part 1 of article 368 of the Tax Code, is the resale price method, where the mark-up derived from the resale of the subject-matter of the controlled transaction is compared with the mark-up derived from the resale of the subject-matter of the uncontrolled transaction. In accordance with point 2 of part 2 of article 368 of the Tax Code, this method may be applicable, in particular, where the reseller has not added a surplus value to the resalable goods during the resale of goods purchased under the controlled transaction. In Hungary, the resale price method is defined as one, in which the fair market price means the price used in connection with the supply of products or services in an unaltered form to an independent party, less the reseller’s costs and fair profit.[16] In accordance with OECD Transfer Pricing Guidelines, the resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the “resale price”) is then reduced by an appropriate gross margin (the “resale price margin”), determined by reference to gross margins in comparable

[14] *Transfer Pricing Methods*, OECD Secretariat, 2 (2010), http://www.oecd.org/ctp/transfer-pricing/45765701.pdf.

[15] See point “a” of part 2 of section 18 of Act LXXXI of 1996 on Corporate Tax and Dividend Tax of Hungary.

[16] See point “b” of part 2 of section 18 of Act LXXXI of 1996 on Corporate Tax and Dividend Tax of Hungary.

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uncontrolled transactions, representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in light of the functions performed (taking account of assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises[17].

This method can apply to the hypothetical scenario where, assumingly ACo, an Armenian company, produces keyboards in Armenia at a price AMD 20 000 per item, and sells them to FCo, an unrelated foreign company, with the transfer price of AMD 25 000 for each. ACo also sells keyboards of the same quality and level of reliability to BCo, a related company operating in Hungary, and BCo resells the keyboards to an unrelated buyer at AMD 40 000 per item. Since the conditions of transfers with FCo, unrelated foreign company, and BCo, related company, are essentially the same, the Armenian tax authorities will compare the transaction price of the two transactions, and the arm's length price on sale to BCo would be fixed at AMD 25 000. In such scenario, profit of ACo would be AMD 5000 (25 000 – 20 000), and BCo might have profit of AMD 15 000 (40 000 – 25 000). However, there is possibility that ACo does not sell keyboards to unrelated company, thus there is no comparable sale. Assume also that the main activity of BCo is reselling keyboards in a foreign market. In such case, the resale price method might offer the appropriate arm's length price. After determination of the common mark-up percentage of a supplier engaged in activities similar to ACo's activity, the resale price method might be applied. Assume that independently functioning distribution companies get 30-percent commissions on the purchase and sale of products comparable to the keyboards, a 30-percent mark-up figure might be used in calculating the arm's length price on sales from ACo to BCo. Accordingly, if BCo resells keyboards to an unrelated foreign costumer at AMD 40 000, then, under the resale price method, the arm's length price of controlled transaction between ACo and BCo would be AMD 28 000 (40 000 – 20 percent of 40 000). Consequently, under resale price method, ACo would have a profit of AMD 8000 (28 000 – 20 000) and BCo would have a profit of AMD 12 000 (40 000 – 28 000). This means that the main element that the tax authority will consider in applying the Resell Price Method is the common mark-up

[17] Transfer Pricing Methods, *supra* note 14, at 4.

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percentage of a transactions of unrelated suppliers engaged in activities similar to activities of related parties.

The third method described in point 3 of part 1 of Article 368 of the Tax Code is the cost plus method, where the mark-up on the direct and indirect costs incurred during the supply of the subject-matter of the controlled transaction is compared with the mark-up on the direct and indirect costs incurred during the supply of the subject-matter of the uncontrolled transaction. Pursuant to point 3 of part 2 of Article 368 of the Tax Code, the cost plus method may be applicable, in particular, where the supplier has not used valuable tangible assets or assumed material risks with regard to the goods supplied or the service provided under the controlled transaction. The Hungarian tax act defines this method as a cost and income method, in which the fair market price consists of the original costs of the products or services and the fair profit[18]. The OECD Transfer Pricing Guidelines explain the cost plus method as one which begins with the costs incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to an associated enterprise. An appropriate mark-up, determined by reference to the mark-up earned by suppliers in comparable uncontrolled transactions, is then added to these costs, to make an appropriate profit in light of the functions performed and the market conditions. Such arm's length mark-up may be determined by reference to the mark-up that the same supplier earns in comparable uncontrolled transactions (an "internal comparable"), or by reference to the mark-up that would have been earned in comparable transactions by an independent enterprise ("external comparable"). In general, the mark-up in a cost plus method will be computed after direct and indirect costs of production or supply, but before the operating expenses of the enterprise (e.g. overhead expenses)[19]. This method can apply to the hypothetical scenario of previous method where, assume that ACo sells keyboards to BCo without any logo printed to the keyboards, BCo printed its well-known logo to the keyboards and resells it to buyers in foreign markets. In such circumstances, the cost plus method may provide the appropriate arm's length price, Assume, for example, that the standard gross profit margin practice in the keyboards producing business is 20 per cent of the cost of production. ACo's average cost of production keyboards, determined under generally accepted accounting principles, is AMD10 000. Under these assumptions, the arm's length price under the cost

[18] See point "c" of part 2 of section 18 of Act LXXXI of 1996 on Corporate Tax and Dividend Tax of Hungary.
[19] Transfer Pricing Methods, *supra* note 14, at 5.

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plus method on sales of furniture by ACo to BCo is AMD12 000 (10 000 + 20 percent of 10 000). This means that the main element that the tax authority will consider in applying the cost plus method is gross profit earned by supplier in transactions with unrelated company or gross profit earned in comparable transactions by independent companies.

The fourth method, described in point 4 of part 1 of Article 368 of the Tax Code, is the transactional net margin method (TNMM), where the net profit realized from the controlled transaction with regard to the appropriate base, in particular, costs, sales, assets is compared with the net profit realised from the comparable uncontrolled transaction with regard to the same base. In compliance with point 4 of part 2 of Article 368 of the Tax Code, when applying the net margin method, the financial indicator most appropriate for the characteristics of the controlled transaction must be calculated. In particular, net profit margin is calculated against the costs, where the controlled transaction implies production or provision of a service; against the sales, where the controlled transaction implies supply of goods; and against the assets, where it implies large involvement of assets. By applying the net margin method, only incomes and expenses pertaining to controlled transactions must be considered, excluding incomes and expenses not related to controlled transactions. Pursuant to the OECD Transfer Pricing Guidelines, the transactional net margin method examines a net profit indicator, i.e. a ratio of net profit relative to an appropriate base (e.g. costs, sales, assets), that a taxpayer realises from a controlled transaction (or from transactions that are appropriate to aggregate) with the net profit earned in comparable uncontrolled transactions. The arm's length net profit indicator of the taxpayer from the controlled transaction(s) may be determined by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions (internal comparables), or by reference to the net profit indicator earned in comparable transactions by an independent enterprise (external comparables)[20].

Though transactional net margin method contains the term "transactional" in the name, TNMM is not a transaction method for determining arm's length transfer prices[21]. Instead, TNMM is based on profits of the company from a group of transactions and not on the prices for particular transactions, which is the focus of the traditional transfer pricing methods.[22] A good illustration is provided in the International Tax Primer. Assume, that an unrelated person has taxable income of 80 and invested capital of 800, and that invested capital is the economic

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[20] Transfer Pricing Methods, *supra* note 14, at 6.
[21] ARNOLD & MCINTYRE, *supra* note 5, at 64.
[22] *Id*. at 65.

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indicator used in applying TNMM. The ratio of taxable income to invested capital for the unrelated person is 80:800, or 10 percent. If the tested party, *i.e.* the taxpayer or its related party, has invested capital of 500, then under the simplified version of TNMM, its arm's length profits will be 50 (500 X 80/800)[23].

The fifth method, described in point 5 of part 1 of Article 368 of the Tax Code, is the profit split method, where each of the associated taxpayers participating in the controlled transaction is allocated the share of the profit generated or the loss incurred from the given transaction which the person not considered to be associated could anticipate when participating in the comparable uncontrolled transaction. The profit generated from the transaction means the positive difference between the profit generated and the costs incurred with regard to the given transaction. Under point 5 of part 2 of Article 368 of the Tax Code, the profit split method may be applicable, in particular, where the controlled transactions are highly integrated and cannot be analyzed separately, and/or both parties to the controlled transaction have used valuable intangible assets for the execution of the transaction. When applying the profit split method, it is important to specify the joint profit which has been generated within the framework of controlled transactions, in particular the combined profit can in some cases be the gross profit generated as a result of execution of controlled transactions, or balance of the gross profit which cannot be attributed to each of the parties to the controlled transaction on a reasonable basis. This method, too, is defined in the OECD Transfer Pricing Guidelines, which states that the transactional profit split method first identifies the combined profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. In some cases, the combined profits will be the total profit from the controlled transactions in question. In other cases, the combined profits will be a residual profit intended to represent the profit that cannot readily be assigned to one of the parties from the application of another transfer pricing method, such as the profit arising from valuable, unique intangibles. It should be noted that the combined profits may be a loss in some circumstances[24].

This method can apply to the situation where, assumingly, two related companies within the same corporate group (ACo and BCo) are involved in the production and sells of keyboards. ACo involved in design and manufacturing of keyboards, which costs AMD 7000. ACo after

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[23] *Id*. at 65.

[24] Transfer Pricing Methods, *supra* note 14, at 8.

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production sells keyboards to BCo. BCo, itself printing BCo's logo on keyboards, which cost for BCo AMD 3000. After all, BCo sells them in the market by AMD 30 000. In such case, the related companies would have net profit of AMD 20 000 (30 000 – cost of production incurred by ACo and BCo). Since ACo's input in the final product is 70 percent, BCo's input in the final product is 30 percent, then split of the profit would be according to the input share. Thus, ACo would have profit of AMD 14 000 (70 percent of AMD 20 000) and BCo would have profit of AMD 6000 (30 percent of AMD 20 000) profit. Assume, ACo does not sell keyboards to unrelated parties, and in the market, there are no comparable sales with ACo's product. Taking account of all the conditions mentioned above, the profit split method might help find proper transfer price for the keyboards.

The transfer pricing methods are generally designed in a way to prevent related parties from mispricing their transactions for the purpose of allocating their profits and avoiding paying domestic taxes[25]; however, the use of transfer pricing adjustment methods might cause certain problems in terms of double taxation. Two countries, in the absence of tax treaties on international double taxation, might apply different methods for calculating the transfer price, which might place undue tax burdens on parties to the transaction and will create an atmosphere of uncertainty in terms of prediction of tax implications of various transactions. Transfer pricing rules are new to the Armenian reality, which means that it is hard to make predictions on how the tax authority will apply the methods. Advance Pricing Agreements might be one possible tool for deciding in advance the tax implications of individual transactions or a set of transactions between related parties, thus increasing the predictability for doing business and the level of confidence in the relations between the taxpayers and the tax authority. However, this solution still has to be discussed from various perspectives with the view to providing an analysis of both the advantages and the possible problems associated with the Advance Pricing Agreements.

[25] *Should you consider an Advance Pricing Agreement*, KPMG (March 12, 2016), https://home.kpmg.com/us/en/home/insights/2016/02/2016-issue1-article2.html.

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CHAPTER 2. ADVANCE PRICING AGREEMENTS

A. Mutual Agreement Procedure

Mutual Agreement Procedure (hereinafter MAP) is a process of negotiation to resolve matters of taxation between two competent authorities, in accordance with the particular tax treaty and to attempt to avoid double taxation[26]. This procedure, described and authorized by Article 25 of the OECD Model Tax Convention (hereinafter MTC), defines MAP as a dispute resolution process, which addresses the difficulties arising out of the practice of the double taxation convention[27]. Article 25 defines three different areas where MAPs are generally used [28]. The first area includes instances of "taxation not in accordance with the provisions of the Convention" and is covered in paragraphs 1 and 2 of the Article[29]. The other two areas, which do not necessarily involve the taxpayer, are regulated under paragraph 3 of Article 25 and involve questions of "interpretation or application of the Convention" and the elimination of double taxation in cases not otherwise provided for in the Convention[30]. Paragraph 9 of the Commentary on Article 25 makes clear that Article 25 is intended to be used by competent authorities in resolving not only problems of juridical double taxation but also those of

[26] Ernst & Young, *Worldwide Transfer Pricing Reference Guide 2015-16*, 9 (2016).
[27] Commentaries on the Articles of the Model Tax Convention, OECD, 354 (2010), http://www.oecd.org/berlin/publikationen/43324465.pdf.
[28] OECD Transfer Pricing Guidelines, *supra* note 12, at 139.
[29] *Id.*
[30] *Id.*

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economic double taxation arising from transfer pricing adjustments[31]. Paragraph 2 of Article 9 of MTC specifically recommends that the competent authorities consult each other if necessary to determine corresponding adjustments[32]. This demonstrates that the mutual agreement procedure of Article 25 may be used to consider corresponding adjustment requests; however, the overlap between the two Articles has caused OECD member countries to consider whether the MAP can be used to achieve corresponding adjustments where the bilateral income tax convention between two Contracting States does not include a provision comparable to paragraph 2 of Article 9[33]. Paragraphs 11 and 12 of the Commentary on Article 25 of the MTC now expressly state the view of most OECD member countries that MAP is considered to apply to transfer pricing adjustment cases even in the absence of a provision comparable to paragraph 2 of Article 9[34].

Armenia has tax treaties with 45 countries for eliminating double taxation which envisage MAP[35]. Article 378 of the Tax Code includes provisions concerning MAP, which may apply, where in accordance with a ratified international tax treaty, the resident legal or natural person is informed that the taxation of the controlled transaction may not be in conformity with the provisions of the international tax treaty as a result of the activities of the tax authority or the resident partner of the country considered to be a party to the international tax treaty. In that case the resident legal or natural person may submit an application to the tax authority and request that the matter be disposed of through mutual agreement procedure[36]. A practical example is the UK/Armenia Double Taxation Convention signed in London on 13 July 2011[37]. The Convention includes Article 26 on MAP, part 1 of which states that where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or a national. Moreover, the UK

[31] *Id*. at 140.
[32] *Id* at 141.
[33] *Id*.
[34] *Id*.
[35] See International Treaties, Tax Service of Republic of Armenia, http://taxservice.am/Content.aspx?itn=TLInternationalTreaties.
[36] See part 1 of Article 378 of Tax Code of the Republic of Armenia.
[37] Convention between the Government of the Republic of Armenia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital, *signed* in London on July 13, 2011, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/496632/uk-armenia-dt_-_in_force.pdf.

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Act (TIOPA) 2010, part 1 of section 124 titled "Giving effect to solutions to cases and mutual agreements resolving cases"[38] and Article 25 of the OECD Transfer Pricing Guidelines have almost the same wording. It can be inferred that Article 378 of the Tax Code, and the tax treaties of Armenia with different countries might provide solution to economic double taxation of MNCs. The tax authority of Armenia may endeavor to reach agreement with the tax authority of a foreign country in a way as to eliminate double taxation. The co-operation of the taxpayer and the tax authority, under MAP, might increase the level of certainty between them. Nonetheless, negotiations and disputes between taxpayers and tax authorities in advance might serve as a guarantee that the MNCs will not face double taxation. The possible solution to above-mentioned problems might become the Advance Pricing Agreement, which will be further discussed in detail in this paper.

B. Objectives, Advantages and Disadvantages of Unilateral, Bilateral and Multilateral APAs

The possibility of discussing and settling substantive tax issues voluntarily, before the transactions occur, and to reach agreement on the tax treatment is the distinctive feature making APAs a unique procedural device in the tax system[39]. According to the OECD Transfer Pricing Guidelines, APAs are an effective tool for reducing the uncertainty, time and administrative cost as well as a mechanism for preventing disputes from arising. The objectives of an APA process are the facilitation of principled, practical and co-operative negotiations, expeditious resolution of transfer pricing issues, more efficient use of the resources of the taxpayer and the tax administration, as well as the predictability for the taxpayer[40]. The OECD Transfer Pricing Guidelines list several advantages of APAs[41]. First, they minimize the uncertainty for taxpayers through enhanced predictability of tax treatment in international transactions as well as allow for consultation and cooperation between taxpayers and the tax administration in a non-adversarial spirit and environment. Moreover, APAs prevent costly and time-consuming examinations and litigation of major transfer pricing issues. APAs concluded with the tax administrations of more than one country reduce

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[38] Taxation (International and Other Provisions) Act, UK, 2010, http://www.legislation.gov.uk/ukpga/2010/8/pdfs/ukpga_20100008_en.pdf.

[39] Diane M. Ring, *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation,* 21 Mich. J. Int'l L. 159 (2000).

[40] Transfer Pricing Guidelines, *supra* note 12, at 338.

[41] *Id.* at 173-174.

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or eliminate the possibility of juridical or economic double or non-taxation, since all relevant countries participate. Finally, APAs provide tax administrations with an insight into complex international transactions through disclosure of information by the taxpayers.

Apart from the advantages above, the OECD Transfer Pricing Guidelines also outline some disadvantages associated with APAs[42]. First, the Transfer Pricing Guidelines refer to the risk of unreliable prediction on changing market conditions without adequate critical assumptions as a limitation to the flexibility of APAs. Another disadvantage described by the Transfer Pricing Guidelines is the administrative issue that might arise due to the conflict between the demands of the taxpayer seeking earliest possible conclusion of APAs and the insufficient resources of the tax authority to process efficiently both the APAs and other equally important work. Further, the Transfer Pricing Guidelines mention the potential disadvantage that because of the nature of the APA procedure, it will interest taxpayers with a good voluntary compliance history, thus diverting audit resources and expertise to those taxpayers and away from the investigation of less compliant taxpayers. Another possible concern expressed in the Transfer Pricing Guidelines is that an APA may allow the tax administration to make a closer study of the transactions at issue than would occur in the context of a transfer pricing examination, depending on the facts and circumstances. Consequently, problems might arise if tax administrations misuse information obtained in an APA in their examination practices, especially if this information include trade secrets and other sensitive information and documentation. Finally, the OECD Transfer Pricing Guidelines underline that not all taxpayers can use an APA, because the procedure can be expensive, small taxpayers generally might not be able to afford it, and APAs might therefore only assist in resolving mainly large transfer pricing cases. The subsequent discussion of types of APAs will provide a better insight into the overall significance, objectives, advantages and risks of APAs.

APAs can be concluded unilaterally, bilaterally or multilaterally, depending on the number of taxpayers and tax authorities involved in the APA[43]. A unilateral APA involves an arrangement between a tax authority and a taxpayer within the jurisdiction of that authority[44]. Article 20a of the Tax Ordinance Act of Poland[45] specifically describes three transactions

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[42] *Id.* at 174-178.
[43] Ernst & Young, *supra* note 26, at 8.
[44] Advance Pricing Arrangements, Initial draft Oct. 2012, OECD Secretariat, http://www.oecd.org/ctp/tax-global/4.%20Advance_Transfer_Pricing_Arrangements.pdf.
[45] Tax Ordinance Act of Poland, *adopted* Aug. 29, 1997, https://supertrans2014.files.wordpress.com/2014/06/the-tax-ordinance-act.pdf.

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which might be covered by a unilateral APA. These are the transactions between two related domestic entities; a domestic entity and a related foreign entity; two domestic entities related to the same foreign entity. Article 20j of the Tax Ordinance Act defines that unilateral APAs must be completed without unnecessary delay, but not later than within six months from the day of its initiation. The same period of six to twelve months for completion of the process of unilateral APA is provided in Section 138C of the Income Tax Act 1967 of Malaysia. Article 20m of the Polish Tax Ordinance Act sets a fee for submitting an application for unilateral APAs, which must amount to one per cent of the value of the transaction being the object of the agreement. However, in the case of APAs referring to domestic entities only, the fee must be at least PLN 5 000 (equal to approximately USD 1 278) and no more than PLN 50 000 (equal to approximately USD 12 775), whereas in the case of agreements referring to a foreign entity, the fee must amount to no less than PLN 20 000 (approximately USD 5 110) and no more than PLN 100 000 (approximately USD 25 553). Decree No. 38/2006 of the Ministry of Finance of Hungary defines that the application fee for unilateral APAs is between HUF 500 000 (approximately USD 1742) and HUF 5 million (approximately USD 17420); namely, for traditional transfer pricing methods, the application fee is HUF 500 000 (approximately USD 1742), and for profit-based methods, the fee is HUF 2 million (approximately USD 6968). It can be concluded that the minimum fees for application for unilateral APAs in both Poland and Hungary do not differ much; the only difference is that in Poland, the fee increases based on whether it involves a foreign entity, and in Hungary, the increase is conditioned by the transfer pricing method used. Thus, for example, to conclude a unilateral APA with the Income Tax Department of Poland, a company, operating in Poland and having concluded transactions with a related foreign company, might have to pay around USD 25 000, to submit numerous documents and explanations required by Article 20f of the Polish Tax Ordinance Act, to wait 12 months for the completion of the process, but in the end it will have an agreement with the competent authority covering a period of up to five years with the possibility of extending it for another five years. This example is aimed to show that the time and resources spent by both the taxpayer and the tax authority might eventually prevent time-consuming examinations and litigation of major transfer pricing issues for an extensive period.

It should be noted, however, that unilateral APAs may also pose certain problems for both tax administrations and taxpayers; namely, from the point of view of other tax administrations,

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problems arise because they may disagree with the APA's conclusions, and from the point of view of the related enterprises involved, one problem is the possible effect on the behavior of the related enterprises[46]. The latter case concerns the issue of corresponding adjustments, as the flexibility of an APA might provide incentives for the taxpayer and the related party to accommodate their pricing to the range of permissible pricing in the APA[47]. Moreover, as it is highlighted in the OECD Transfer Pricing Guidelines, "the use of unilateral APAs may not lead to an increased level of certainty for the taxpayer involved and a reduction in economic or juridical double taxation for the MN group" [48]. These risks make bilateral and multilateral APAs more favorable vis-à-vis unilateral APAs[49].

A bilateral APA seeks to address the transfer pricing of a particular transaction from the perspective of both tax authorities concerned[50]. A multilateral APA has the same effect as a bilateral APA, but involves more than two countries[51]. According to paragraph 1 of Article 20b of the Tax Ordinance Act of Poland, the authority competent for an agreement, at the request of a domestic entity, carries out the process of a bilateral APA by obtaining the consent of the competent tax authority for a foreign entity affiliated with the requesting party, and declaring the correctness of the selection and the application of the method for setting the transaction price between the domestic entity affiliated with a foreign entity and that foreign entity. Paragraph 2 of the same Article defines a multilateral APA as an agreement which concerns a transaction concluded by a domestic entity with foreign entities from more than one country, and the consent of all foreign entities' tax authorities is required to conclude such an agreement. Article 20j of the same Act envisages that the bilateral APA process is to be completed without unnecessary delay, but not later than one year from the day of its initiation, and for multilateral APAs, not later than within 18 months from the day of its initiation. Section 138C of the Income Tax Act 1967 of Malaysia provides that an application for bilateral or multilateral APAs may be completed within a period of one to two years. The fee paid in Poland for bilateral or multilateral APAs application amounts to no less than PLN 50 000 (approximately USD 12 775) and no more than PLN 200 000 (approximately USD 51

[46] Transfer Pricing Guidelines, *supra* note 12, at 174.
[47] *Id*. at 175.
[48] *Id* at 174.
[49] *Id*. at 178.
[50] Advance Pricing Arrangements, *supra* note 44.
[51] *Id*.

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100)[52]. The fee for a bilateral APA application in Hungary, as defined in Decree No. 38/2006 of the Ministry of Finance of Hungary, is between HUF 3 million (approximately USD 10435) and HUF 8 million (approximately USD 27835), which is significantly lower than the fee in Poland. For a multilateral APA application, the fee is between HUF 5 million (approximately USD 17420) and HUF 10 million (approximately USD 34840). As showed above, in both Poland and Hungary, the time period for completion of bilateral and multilateral APAs is longer and the respective fees are higher than in the case of unilateral APAs. Despite this, in case a foreign related entity is involved, the conclusion of bilateral and multilateral APAs will provide more benefits to the related taxpayers, will provide more certainty in terms of application of transfer pricing by the competent authorities of the countries involved and will prevent disputes between taxpayers and respective tax authorities, at the same eliminating the risk of double taxation[53]. It should be noted, however, that bilateral and multilateral APAs are normally possible only if treaties or relevant multilateral agreements are in force between the countries involved[54]. Another disadvantage would be the case where one tax authority undertakes a number of bilateral APAs which involve only certain of the related enterprises within an MNE group[55].

In order to be successful, the process of unilateral, bilateral as well as multilateral APAs needs significant involvement by the taxpayer or taxpayers, whose primary responsibility is providing the participating tax administrations with sufficient information for conducting the mutual agreement negotiations[56]. In some countries there are different ways of ensuring that the competent authorities get the necessary information: by making the proposal directly to the competent authority or making available a copy of any domestic APA proposal to the other participating jurisdictions[57]. The content of the proposal as well as the extent of the necessary supporting information and documentation will depend on the facts and circumstances of each case and the requirements of the individual participating tax authorities [58].

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[52] Article 10 of the Tax Ordinance Act of Poland.
[53] Transfer Pricing Guidelines, *supra* note 12; EU Joint Transfer Pricing Forum, *Another potential disadvantage could occur where one tax administration has undertaken a number of bilateral APAs which involve only certain of the related enterprises within an MNE group*, Doc. JTPF/016/2005/EN, https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/14th_comments_apas_issues.pdf.
[54] Advance Pricing Arrangements, *supra* note 44.
[55] Transfer Pricing Guidelines, *supra* note 12, at 175.
[56] *Id*. at 344.
[57] *Id*. at 346.
[58] *Id*.

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To increase the reliability of the APA methodology, taxpayers and tax administrations should attempt to identify critical assumptions that are, where possible, based on observable, reliable and independent data[59]. A critical assumption is any fact, whether or not within the control of the taxpayer, related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the transfer pricing methodology proposed by the taxpayer[60]. These critical assumptions should not be drawn so tightly as to jeopardize the certainty ensured by the agreement, but should cover as wide range of variation in the facts underlying as the parties feel comfortable with[61].

Meanwhile, the taxpayer is not protected from normal and routine examinations by the tax authority on its transfer pricing activities[62]. The taxpayer may still have to prove the following: it has complied in good faith with the terms and conditions of the APA; the material representations in the APA remain valid; the supporting data used in applying the methodology were correct; the critical assumptions underlying the APA are still valid and are applied consistently; and the methodology is applied consistently[63]. Tax authorities should, therefore, seek to ensure that APA procedures are not unnecessarily complicated and that they do not make more demand of taxpayers than are strictly required by the scope of the APA application[64].

In the finalization step, by reviewing the APA proposal, the tax authorities may undertake whatever steps they deem appropriate in the relevant circumstances to conduct the mutual agreement procedure[65]. These include, but are not limited to: requests for further information deemed relevant to review and evaluate the taxpayer's proposal, the carrying out of fieldwork and the engaging of necessary experts[66]. Tax administrations may also have recourse to information collected from other sources, including information and data on comparable taxpayers[67]. There should be cooperation between competent tax authorities involved in the process for maximizing the efficiency of the process, which will help avoid unpleasant surprises during the process[68].

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[59] *Id*. at 349.
[60] Internal Revenue Service, *Internal Revenue Cumulative Bulletin 2007-1 January-June,* 787 (2007).
[61] Transfer Pricing Guidelines, *supra* note 12, at 349.
[62] *Id.* at 177.
[63] *Id.*
[64] *Id.*
[65] *Id*. at 353.
[66] *Id.*
[67] *Id.*
[68] *Id.* at 355.

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CONCLUSION

Each year more countries initiate active transfer pricing enforcement, inevitably increasing the number of transfer pricing disputes[69]. Parts 3-6 of Article 368 of the Tax Code of Armenia provide safeguards for application of the transfer pricing method most appropriate for the given circumstances. To this end, the following standards are defined in part 3 of Article 368 based on which the tax authority will decide on the appropriate method: strengths and weaknesses of the relevant transfer pricing method; conformity of the method, regard being had to the characteristics of the controlled transaction; availability of reliable information required for the application of the relevant transfer pricing method; degree of comparability of

[69] *Are you considering an Advance Pricing Agreement?*, Tax Executive (Feb. 23, 2016), http://taxexecutive.org/are-you-considering-an-advance-pricing-agreement.

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controlled and uncontrolled transactions, including the reliability of comparability adjustment. Moreover, part 4 of the same Article defines that if the CUP method and other transfer pricing methods can be applied with an equal level of confidence, the CUP method should be applicable when establishing the conformity with the arm's length principle. Finally, part 6 of the same Article defines that if the taxpayer has applied a transfer pricing method, then the tax authority establishes the conformity of the controlled transaction with the arm's length principle based on the transfer pricing method applied by the taxpayer, provided that the choice of the transfer pricing method by the taxpayer has been made in accordance with the provisions of Article 368. For this purpose, the taxpayer is required, under point 4 of part 1 of Article 376 of the Tax Code, to submit to the tax authority the description of the transfer pricing method chosen and justification for choosing that particular method.

Thus, the Tax Code establishes a mechanism for choosing transfer pricing methods, which provides some level of certainty for both the taxpayer and the tax authority. The taxpayer will have the opportunity to choose, based on valid assessments, a transfer pricing method, which it considers most appropriate. Additionally, if the taxpayer properly justifies the application of a particular method, the process of deciding on the application of transfer pricing methods might become less time-consuming for the tax authority, which in turn might reduce the tax administration cost. However, the tax authorities often request information that requires the taxpayer to spend significant time and money providing great quantities of information, only some of which may ultimately be relevant to the transfer pricing issues[70]. The process of choosing the appropriate transfer pricing method might involve complex factual and economic issues requiring subjective judgment. Thus, the mechanism established by Article 368 of the Tax Code might fall short of the benefits, which could be ensured by APAs. Namely, an APA would give the Armenian taxpayer an opportunity to predict in advance which transfer pricing method is to be applied for a set of transactions within a certain period. Besides, an APA process would create an atmosphere of cooperation through negotiations between the taxpayer and the tax authority, which will enhance the mutual confidence. During the negotiations, the taxpayer will voluntarily submit a huge volume of information and explanations, which would otherwise not be accessible for the tax authority. This in turn will significantly reduce the administration cost and help the tax authority better perform its administrative functions. Besides, the APA process is intended be more focused and take less

[70] KPMG, *supra* note 25.

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time than a transfer pricing examination and dispute resolution efforts[71]. In the long run, a bilateral APA may be the most effective way to eliminate the exposure to a transfer pricing examination in all the countries involved[72]. Finally, the possibility of extending the period covered by an APA ensures significantly less administration and compliance costs and high degree of certainty for several years.

On the other hand, a successful APA process requires a country to have highly skilled tax officials and resources necessary to engage in the process of negotiating an APA[73], which could last from eight to eighteen months. Some authorities prefer to allocate limited technical resources in the early years of transfer pricing regimes on what they may see as taxpayers less likely to be compliant[74]. The Ministry of Finance of Armenia has not considered the possibility of incorporating provisions on APA in the Tax Code when drafting it. Moreover, the tax authorities are not inclined to engage in an APA process due to the lack of respective staff, impracticability of the process, the possible complications as well as the imbalance between required resources and benefits which could be achieved through an APA process[75]. In fact, there might be cases, where the tax authority invests significant administrative resources to conduct the APA process, but due to some circumstances, the taxpayer and the tax authority eventually fail to reach an APA, which will be a waste of resources[76]. Despite the concerns of the Armenian tax authority and the imminent risks of an APA process in terms lack of resources, the research concludes that the Armenian Tax Code should envisage a possibility for taxpayers to opt for an APA, if they consider that it is the preferable and reliable way of settling in advance certain transfer pricing issues related to controlled transactions.

[71] *Id.*
[72] *Id.*
[73] Committee of Experts on International Cooperation in Tax Matters, *Coordinator's Report on Work of the Subcommittee on the Mutual Agreement Procedure—Dispute Avoidance and Resolution*, 5 (Oct. 11-14, 2016), http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP4_Disputes.pdf.
[74] *Id.*
[75] Interview with Hrachya Muradyan, Head of Department for Taxes and Statutory Fees, State Revenue Committee of the Republic of Armenia (Apr. 23, 2017).
[76] *Id.*

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