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FORMAL RECOGNITION TO ADVANCE PRICING AGREEMENTS IN MAURITIUS: A COMPARATIVE STUDY

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Abstract: *Transfer pricing refers to the process of determining prices in transactions between related parties such as a parent and its subsidiary or associated companies within the same group of companies, or divisions within the same company. There is nothing wrong in practicing transfer pricing but when transfer prices are not concluded at arm's length, then transfer pricing abuses occur. This leads to numerous adverse effects especially on the tax revenue of countries. One of the ways to tackle transfer pricing manipulation is by concluding an advance pricing agreement (APA) with the tax authorities of the countries concerned prior to determining the transfer price of a particular transaction. This research aims to analyse the efficiency of APAs in combatting transfer pricing abuses and seeks to bring in recommendations which may be of help to Mauritius stakeholders. The method used for the research comprises of the black letter approach whereby analysis is made on the laws of Mauritius, the UK and the USA to analyse the transfer pricing rules in each country. Also, the doctrinal approach will be used so as to critically analyse studies carried out by eminent scholars on the efficiency of APAs in reducing or eliminating transfer pricing abuses. The paper is amongst the first researches conducted on transfer pricing in Mauritius. It aims at responding to the research objectives set out above. In particular, it is recommended that Mauritius laws need amendments to create a legal framework that will give formal recognition to APAs and suggest an appropriate regulatory framework for the APA process.*

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1. INTRODUCTION

Transfer pricing refers to the process of determining prices in transactions between related parties such as a parent and its subsidiary or associated companies within the same group, or divisions within the same company. The manipulation of transfer prices between related parties is a major problem in the world. Chowla (2005) indicates that numerous efforts are being undertaken by the developing world to create the right investment climate with a view to attracting foreign direct investment and for investors to start new projects. However, in an attempt to induce foreign investments, host developing countries usually oversee the protective measures in order to minimise the financial risks of operations in their local environments.

Pleune (2017) states that transfer pricing techniques have adverse consequences on countries where the MNEs operate and further goes on to state that by shifting income to another country, the tax revenue of the host governments of the multinational entities (MNEs) reduces. This results in a loss of profits available to local shareholders. The other negative effects of transfer pricing manipulations to the host country where the MNE branch, subsidiary or permanent establishment is based, have been identified as, inter alia:

- low remuneration to local staff because of distorted operating results,
- poor balance of payment situation,
- a reduction in the market competition since low-profit levels act as a deterrent for other local businesses to engage in the respective field.

Rahman and Scapens (1986) further showed that MNEs based in Bangladesh over-priced imports from affiliates by between 78 percent and 600 percent, thereby leading to low profitability of MNEs in that country. Aid (2008) estimates that developing countries may be losing over US $160 billion of tax revenue yearly mainly through transfer pricing malpractices, which represents a loss of government revenue that could be potentially utilised for the provision of basic public services.

A recent study conducted by the United Nations University World Institute for Development Economics Research (UNU-WIDER) published in 2017 estimates global tax losses of around $500 billion a year due to profit shifting practices by MNEs. Losses are now estimated to be even higher because of the increasing amount of intra-firm trade which is said to constitute around more than 70 percent of global trade (Murphy, 2017).

The aforesaid studies and the harmful effects of transfer pricing manipulation as a tax avoidance tool indicate that the international transfer pricing problem will need to be curbed effectively so as to maximise revenue collection in developing countries. As such, it is necessary to investigate the factors that contribute to transfer pricing abuses in order to come up with the appropriate preventive and corrective measures in the context of developing countries such as Mauritius. It is against this background that this research will focus on the use of advance pricing agreements (APAs) concluded between different countries to regulate the determination of transfer prices for the purpose of curbing transfer pricing manipulation. An APA is an agreement that determines in advance of a transaction between related parties an appropriate set of criteria such as method, comparable and appropriate adjustments, assumptions amongst others for the determination of a transfer price over a fixed period of time. Whilst Mauritius laws are silent on the legality of APAs, other countries such as the UK and the US have expressly provided for APAs in their respective domestic tax laws.

The method used for the research is in essence comprised of the black letter approach whereby an analysis is made on the tax laws of Mauritius to assess the transfer pricing legal framework. In line with that, the related laws of some other jurisdictions such as the US and the UK will be examined in terms of the legality of APAs with a view to seeking recommendations that may be of use to Mauritius stakeholders. Finally, the doctrinal approach will be used so as to critically analyse studies carried out by eminent scholars on APAs.

The research paper is structured as follows: the first part has introduced the concept of APAs and the research objectives, as well as the research methodology, have also been elaborated in this part. The second part of the paper will analyse the main causes and consequences of transfer pricing abuses. Some existing literature on the use of APAs to reduce transfer pricing abuse will also be discussed. The third part of the paper will examine the laws of the UK and the US in relation to APAs. The fourth part of the research will discuss the issues underlying transfer pricing legislation in Mauritius and will assess the effectiveness of APAs to overcome problems in applying transfer pricing rule. The final part will conclude the paper and bring in some recommendations for Mauritius stakeholders based on the comparative study conducted in order to revise Mauritius laws to create a win-win situation for both the Mauritius regulator and the MNEs.

2. TRANSFER PRICING ABUSES

2.1 Reasons Behind Transfer Pricing Abuses

When associated firms trade at prices that are not at arm's length basis, that is, prices imposed are not the same as independent parties would usually determine in their transactions, this practice is referred to as transfer pricing abuse or manipulation. In essence, MNEs engage in transfer pricing for various reasons, the most obvious and recognised one is to minimise their tax liability. There are several factors that act as incentives to engage in transfer pricing abuses. Some of the examples deduced from existing literature are provided below.

2.1.1 Lack of Transfer Pricing Legislation

McLure (2003) puts forward the main problems faced by developing countries in the area of transfer pricing. The author ranks the lack of appropriate laws and regulations as the first obstacle preventing the tax authorities in developing countries to effectively monitor and sanction transfer pricing abuses. Similarly, other authors such as Rathke (2015), Pleune (2017) and Liu (2017) argue that a lack of adequate and complementary laws to regulate transfer pricing makes the environment for abusive pricing through transfer pricing easier.

2.1.2 Differences in Income Tax

Cho (2018) argues that transfer pricing abuse is the result of different corporate tax rates implemented by different countries according to their domestic legislation. Several economists such as Bartelsman and Beetsma (2003), Clausing (2002) and Eden and Rodriguez (2006) have also put forward the tax reduction motivation for countries to establish and operate part of their business activities in developing countries and to in turn engage in transfer pricing abuses. Starbucks for example had sales of £400 million in the UK in 2012 but paid no corporation tax at all (Peston, 2012). It filed losses of millions of pounds yet informed its investors that the business was successful. Starbucks has been successful in reducing its tax liability in the UK by channelling revenue through its subsidiaries located in low-tax jurisdictions. It was reported that one unit in the Netherlands was receiving royalty payments from the UK which are deductible from taxable income (Francis, 2012). No evidence could be gathered against Starbucks for breach of laws and the company defended itself by arguing that international accounting rules have been followed further to which they have paid the appropriate level of taxes. However, their contradicting reports were disclosed through an examination of the group's financial statements and the transcripts of 46 conference calls with investors and analysts (Bergin, 2012). The difference in tax rates and complication in tax codes have created loopholes to escape tax payments by MNEs.

2.1.3 Lack of Foreign Control Restrictions

Singh (2007) argues that the relaxation of foreign exchange control restrictions encourages transfer pricing. Consequently, countries have become more liberal for payments made to import capital goods, services and technologies as compared to direct profit remittances. Transfer pricing is used as a device to subtly remove profits from countries that do not have favourable conditions (such as political or economic uncertainties or high tax rates) to such jurisdictions that would preserve the value of profits.

2.1.4 Use of Various Investment Instruments

A study conducted by Osborne (2011) relates the increase in transfer pricing abuses to the changing trend in the structure of investments by MNEs. The author states that multinationals' investments comprise of a package consisting of equity, loan instruments, technological licenses and management services agreement as compared to one hundred equity investment adopted by MNEs in the past. Such measures are taken to circumvent the host country's government policies to infuse some local control over foreign investment. Diversity in investment instruments has created incentives to shift profits through excessive interest payments, royalties for using technology and management fees. As a result, the profits will go directly to the multinational group. On the other hand, if the investment comprises of one-hundred percent equity financing, then the profits will have to go in the hands of shareholders who are usually local residents of the host country and the remaining to the multinational enterprise in the form of dividends. Therefore, MNEs are inclined to resort to transferring pricing techniques to shift profits before they are distributed with the local participants.

2.1.5 The E-Commerce Industry

The United Nations (2012) has portrayed the growth of the e-commerce economy as accentuating the problems of transfer pricing. This is because there is no clarity in e-commerce transactions on the basic taxation concepts such as:

- corporate residence,
- source of business income,
- the nature of a permanent establishment, and
- on the different types of income (e.g. income from the sale of a product, provision of a service or royalties).

In addition, IFA (2000) and McLure (2003) argue that residence for tax purpose in e-commerce transaction is difficult to determine. It is, therefore, easier to locate the residence in tax havens to reduce the tax liability for the multinational group. This contradicts with the opinion of many countries for whom it is essential to properly exercise some taxing rights over intangible-related transactions such as e-commerce and web-based business models (United Nations, 2012).

2.1.6 Problems in Developing Countries

Sikka (2009) argues that where there are legal rules for monitoring transfer pricing, the developing countries may lack the necessary administrative capacity in terms of qualified and trained labour to deal with transfer pricing issues. Multinational groups engage experts on the subject matter to specifically devise means and ways to reduce tax liability through transfer pricing. To identify such mechanisms, persons of a similar or higher calibre in terms of skills and knowledge are required. McLure (2003) states that the costs of hiring such individuals are too high for the tax authorities of developing countries to afford.

Another problem faced by developing countries in the context of transfer pricing is the lack of comparable data. The underlying principle of applying the arm's length standard is to find comparable data in uncontrolled transactions. In practice, the United Nations (2012) provides that such data is difficult to obtain in developing countries due to the following reasons:

(a) there are fewer transactions in any particular sector compared to developed countries which yimply a low probability to obtain comparable data,

(b) when resources and processes are not available, the comparable information may be incomplete or are in a form which is difficult to analyse,

(c) some sectors are new to the economy and multinationals may be the first mover in the country in areas that are unexplored or unexploited.

The absence of an appropriate benchmark in the form of comparable data makes it difficult to determine transfer prices at arm's length. This provides a leeway for multinationals to fix transfer prices at non-arm's length or in a manner that suits them to decrease the group's tax liability (Dimopoulou, 2017).

3. IMPLICATIONS OF TRANSFER PRICING ABUSES

Transfer pricing abuse is a pressing issue across the globe since it is a significant threat to economic development (Forstater, 2017). The following parts will provide an elaboration of how transfer pricing abuse has negative impacts on tax revenue generation and a wider impact on development and poverty alleviation.

3.1 Tax Revenue Losses

Transfer pricing manipulations result in revenue losses for both developed and developing countries (Aid, 2009). The charges faced by Apple Inc., Starbucks, Amazon and Facebook demonstrate aggressive tax reduction schemes through transfer pricing that are seeking to amass offshore cash in a tax haven. This results in millions or billions of tax revenue lost for developed countries. Transfer pricing abuses are considered as irresponsible practices because they undermine the contributions made by stakeholders such as labour, government and minority shareholders to the success of the organisation (Addo, 2012). In other words, the multinational is benefiting from the developed country's market, public infrastructure, security, educated workforce and rule of law, all of which is supported by tax money. However, they avoid paying for these benefits by engaging in profit shifting practices.

Transfer pricing abuses also cause harmful effects on smaller enterprises on the market (Wychen, 2016). By artificially reducing their taxes, multinationals benefit from an unfair competitive advantage over smaller businesses. The latter usually operate in only one country and are not in a position to shift profits in the same manner as multinationals. In this way, small enterprises find themselves compensate for tax reduction manoeuvres by multinationals through higher taxes, reduction in public services or utilities or increases to the governmental debt.

In the context of developing countries, one early study carried out by Vaitsos in 1977 analysed the pharmaceutical industry in Columbia and revealed that MNEs had overstated transfer prices by rather extraordinary margins. As a result, the additional cost of imports for the pharmaceutical industry alone was estimated at $20 million annually, thereby giving rise to a substantial loss in government revenue by $10 million per year. A study by Global Financial Integrity (2008) estimates the average tax revenue loss to all developing countries was between $98 billion and $106 billion annually during the years 2002 through 2006. This is equivalent to a loss of around 4.4% of the entire developing world's government revenue. Another study conducted by Mold (2004) estimates that governments of developing countries lose approximately $35 billion a year due to transfer pricing.

A recent study conducted by the United Nations University World Institute for Development Economics Research (UNU-WIDER) in 2017 and published by Tax Justice Network reveals that the estimated amount of global tax losses due to transfer pricing abuses amount to approximately $500 billion annually. The methodology published by researchers at the International Monetary Fund in 2016 has been adopted for the new estimates research and the data shows that countries like Pakistan lost 40% of their Gross Domestic Product (GDP) due to non-compliance with ALP.

Developing countries bear the severest burden of the impact of revenue losses due to the fact they are already in dire need of financial resources to cater for the basic necessities of the people (Addo, Salia and Ali-Nakyea, 2017). In other words, transfer pricing abuses negatively affect the capacity of the country to mobilise resources for development (Sundaram, 2012). Consequently, Wychen (2016) states that developing countries suffer from:

- reduced investments in infrastructure,
- low educational facilities,
- fewer job opportunities,
- poor public health, and
- safety problems.

Sikka and Willmott (2010) further supports this view and extends the argument to demonstrate that transfer pricing practices enrich a few people but also deprive millions of people of the developing countries of clean water, sanitation, pensions, security, transport and public goods. Ikeda (1992) states that the taxation of multinationals represents a large part of total tax revenue in developing countries. It is therefore not only a matter of tax equity but an economic necessity to be able to tap the tax potential of MNEs.

3.1.1 Ineffective Redistribution Policy

One amongst the purpose of taxation is to redistribute resources from high earning persons to the less well-off ones of the society. Economists such as Adam Smith and John Stuart Mill advocate strongly for an equitable tax system whereby the burden of tax weighs much higher on the rich than the poor. Transfer pricing manipulations are contrary to this principle. Addo (2012) argues that multinationals have the ability to minimise their costs through economies of scale but instead, they prefer to report losses to avoid paying tax. The effects of enabling such practices are two-fold. Firstly, public confidence in government and tax authorities is diminished because large wealthy corporations are allowed to escape from their tax liabilities using ways that smaller or average businesses cannot. Secondly, for countries that rely mainly on tax revenues for expenditure, a fall in tax revenues may compel the government to impose higher taxes on persons in the country whose incomes may not be high. This, in turn, accelerates poverty in developing countries and gives rise to an inequitable situation. Reduction in labour bargaining capacity

The profit level in an enterprise is the basis of negotiations for salary increase between management and employee (Heskett, 2007). When transfer pricing manipulations result in an overstatement of expenses such as materials or interest payments, fewer profits are left. Employees then do not have a proper basis to negotiate for fair wages. With the excuse of high overheads, Addo (2012) states that multinationals oppress workers with unreasonable performance targets. Therefore, employees work under tremendous pressure to meet targets but do not earn the corresponding remuneration to their efforts made. This demotivates employees who have to struggle with a low salary to cater to their living expenditure and that of their dependents. Low pay implies low savings, the long-term effect of which is poverty.

3.1.2 Reduction in Foreign Exchange Reserves

Singh (2007) states that transfer pricing manipulations may create a substantial loss of foreign exchange. By over-pricing imports and under-pricing exports, multinationals seek to circumvent governmental restrictions on profit repatriation. This, in turn, results in drainage of foreign exchange. For example, a parent company that holds a profitable subsidiary in another country and who does not want to re-invest the profits can over-price the cost of raw materials purchased by the subsidiary from the same parent company. In this way, profits are remitted to the parent.

3.1.3 A Threat to Entrepreneurial Development and Investment

The profitability of an enterprise is a factor implying a good business environment and provides a signal to other entrepreneurs or investors to invest in the country. Transfer pricing abuses challenge the credibility of information on a multinational company. Addo (2012) argues that the reporting of false profits by multinationals sends wrong signals on the success of businesses in the economy. New and potential investors may rely on such information and construe the country to have a hostile environment that is not conducive to good business practices. Consequently, they have the tendency to relocate their businesses or investments in countries that have good records of successful foreign companies. A reduction in business activities in the economy accompanies a loss of employment and a fall in national income.

4. THE USE OF APAS AS A METHOD TO REDUCE TRANSFER PRICING ABUSES

In a transfer pricing scenario, there are different parties such as the associated enterprises and the revenue authorities of each enterprise concerned that are involved in the process of implementing the ALP. This gives rise to problems of interpretation. Schon and Konrad (2012) argue that using the ALP to determine transfer price is a length process which creates an administrative burden. If the tax authority believes that the transfer price is over-priced or under-priced, it may challenge the basis of determination of the prices by the associated enterprises. This can lead to litigation process which is costly and time-consuming. The delays may be prolonged if countries do not have any legal basis to determine the transfer price, that is, no reference is made to calculate transfer prices in their legislation (Ndirangu, 2013).

The ALP application involves an evaluation of comparable transaction between unrelated parties which are difficult to identify due to unique characteristics of some transaction and products. Where the relevant information is not readily available, the revenue authority sets the transfer price using an approximation which may not be accurate to determine the price (Kersten, 2008). The MNE may be required to review its transfer price to a higher value and this results in conflict between the associated enterprises and the tax authority.

To reduce the potential disagreement between MNEs and tax authorities of the countries in which they operate, some scholars such as Holtzman and Nagel (2014), Ndirangu (2013), Miller and Oats (2012) and Markham (2005) advocate for the use of APAs. OECD (2010) defines an 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 the transfer price for those transactions over a fixed period of time*".

An APA is, therefore, an agreement which provides the underlying basis for determining an arm's length price in dealings between related parties. APAs create certainty for both the taxpayer and the tax authority since the parties know in advance the terms and conditions for determining the transfer price. If these terms are adhered to by each party, there will be no reason for a dispute to arise (Markham, 2005). In other words, APAs act as an alternative to litigation (Aaron and Slemrod (2004)). It is often referred to as a cooperative form of negotiation (Kortebusch, 2014).

The use of APAs is on the rise with a view to creating certainty in transfer pricing determination. Konrad (2012) argues that an APA concluded with one country can be used as a basis for agreeing on the transfer prices with the revenue authority in another jurisdiction, especially for comparable transactions. Paisey and Li (2012) also state that for the comparable transaction, the terms set out in an APA concluded with another country may serve as a model for assessing the arm's length transfer prices in dealings with domestic associated enterprises.

However, some enterprises are sceptical regarding the efficiency of APAs concluded by tax authorities of different countries. Givati (2009) attributes the infrequent use of APAs in the US to the strategic disadvantages of an APA request such as:

a) long wait to complete the procedures and formalities of an APA;

b) the requirement to have expert knowledge since the transfer prices are examined by a special APA team; and

c) the likelihood of a detailed examination of the transfer pricing method.

According to the author, these disadvantages outweigh the benefits of an APA. In addition, Beker, Davies and Jakobs (2014) state that APAs may create an information problem because firstly, they are concluded before profits are realised and secondly, they are negotiated by governments or tax authorities and not by firms. The latter may have better information on future profits or other parametres that determine transfer prices such as cost, market prices amongst others. This, in turn, causes APAs to be complex and negotiations on parameters may take a long time and are likely to incur costs.

Nevertheless, despite the drawbacks, the use of APAs is on the rise, with an increase from 1252 APAs in European countries in 2015 to 2053 in 2016, representing 64% rise (EU Joint Transfer Pricing Forum, 2018). Some countries such as the UK and the US have recognised the effectiveness of APAs in reducing transfer pricing abuses.

5. LEGAL PROVISIONS ON APAS IN OTHER JURISDICTIONS

5.1 APAS in the UK

APAs are available in the UK under part 5 of the Taxation (International and other Provisions) Act 2010 (**TIOPA**) and Her Majesty's Revenue and Customs (**HMRC**) has also issued a statement of practice on the APA process. APAs apply to the following:

- transfer pricing,
- the attribution of profit to a permanent establishment, and
- the question of whether income arises in the UK or in any other country.

For the purpose of transfer pricing, an APA may either cover a specific transaction or the taxpayer's entire transfer pricing arrangements. An APA can be multilateral, bilateral and unilateral. In the case of a bilateral or multilateral APA application, if a counterparty to the relevant transaction is someone from a country with which the UK has a concluded a treaty, then HMRC calls for the revenue authority of that country to participate in the process.

5.2 The Initiation of the APA Process

UK does not charge any fee for APA applications and does not seek to recover its expenses. HMRC accepts application only where there is significant uncertainty in the appropriate tax treatment and then expect to agree to each individual case on its facts. The APA process in the UK follows a four-stage process which begins firstly with an expression of interest, then a formal application is made. Thereafter, HMRC evaluates the application by discussing with the taxpayer or the competent authority of the treaty party and then a formal agreement is reached. Once an application has been filed, the average time taken in the UK is approximately 26 months.

An APA may be submitted at any time either prior or after the transaction to which it relates by any of the following persons:

(a) a UK business including a partnership with transactions to which provisions of Part 4 of TIOPA apply,

(b) non-resident trading in the UK through a permanent establishment, or

(c) a UK resident trading through a permanent establishment outside the UK.

Usually, the APA process is initiated by the business but HMRC strongly recommends that an enterprise interested in applying for APA contact it first to informally discuss its plans before presenting a formal application. Some basic details about the transaction have to be given to HMRC such as the parties involved, the pricing strategies, transfer pricing methods used, the products or services involved amongst others. This is to ensure that the resources of the business are not wasted on an unsuitable application and to ensure that the detailed work that will need to be undertaken by the business in finalising the application is focused on relevant issues. It also gives HMRC an opportunity to provide an anticipated timetable for agreeing on an APA based on past experience or to advise the relevant parties on some practical procedures with the application.

5.3 Consideration of the APA Request

After the informal interaction, each APA request is considered on the basis of its particular facts and circumstances, but in general, HMRC looks for the following characteristics:

- transfer pricing issues are complex rather than straightforward. The complexity involved implies that there is a doubt on the application of the arm's length standard,
- the taxpayer's transfer pricing policies or issues are regarded as high risk and there is a high likelihood for double taxation,
- the taxpayer has used a method which is highly tailored to its own particular circumstances. In this case, HMRC will want to consider an innovative proposal provided that is compliant with OECD Guidelines.

Where HMRC indicates that it is willing to consider the APA proposal and the business wishes to proceed, then it should submit a formal written application. The application needs to be made before the start of the first chargeable period to be covered by the APA but sometimes, HMRC may exercise discretion to grant an extension to allow the business more time to lodge its application.

The examination of the application is a co-operative process between HMRC and the parties to the transaction where transfer pricing issues are discussed openly and access to relevant supporting information is made available. Thereafter, the agreement is made subject to the following terms being observed:

- a commitment from the business to adhere to the agreed method for dealing with transfer pricing issues during the term of the APA and this is evidenced by a regular compliance report, and
- the identification of critical assumptions bearing materially on the reliability of the method and which if subject to change may render the agreement invalid.

In practice, the person signing the APA agreement is the one responsible to sign the tax return provided that he has been authorised to act in such capacity by the MNE. HMRC expects the enterprise to cooperate in ensuring that the formal agreement and any associated procedural paperwork are finalized shortly after finalization of the transfer pricing method. The whole APA process is expected to be completed within 18-21 months from the date of the formal submission and unilateral APAs are completed more quickly than that (HMRC Statement of Practice, 1999).

Where an agreement cannot be reached with respect to the terms of the APA, HMRC will issue a formal statement precising the reasons and then HMRC may terminate any discussion beyond the point at which it has determined that the agreement cannot be reached. A business may also withdraw an APA request at any time before the final agreement is reached.

5.4 APA Monitoring and Review

The annual report of the business will accompany the business' tax return and the report needs to be sent to HMRC. The particulars of each report are set out in the finalized agreement and focus narrowly on the issue covered by the APA. The aim is that the reports should evidence in a concise format whether the business has complied with the terms and conditions of the APA.

It is to be noted that an APA may be revoked by HMRC in case of non-compliance with the terms and conditions of the agreement. Usually, HMRC will consult with the business and the revenue authority of the treaty partner involved in order to consider whether a change in the agreement may be possible. In some cases, the APA may provide for amendments provisions in specific circumstances, for instance, the agreement may provide that where the agreed methodology becomes impractical to apply then the terms of the agreement may be changed with the consent of the parties to resolve that difficulty.

Renewal of the APA may also be requested by the business but not later than six months before the expiry of its term. The renewal application should expressly consider any changes or anticipated changes in facts and circumstances since the existing agreement was reached or whether the proposed methodology is still appropriate. Where HMRC agrees that the transfer pricing issues remain the same and the methodology can continue as before but with details updated to ensure continued adherence to the arm's length principle, then the agreement will simply be amended and extended for a further term. On the other hand, if transfer pricing issues have changed or a different method is being proposed, then the business will be required to make a fresh APA application. HMRC will then apply the four-stage process to consider the new APA application.

Sometimes an APA may be nullified if false or misleading information has been supplied in the course of the application or the monitoring. Penalties may also be applied in accordance with sections 226 and 227 of TIOPA. The business has the right to apply against the amount of any additions to profits arising as a result of the revocation or cancellation of an APA.

The HMRC Statement of Practice on APA sets out some advantages of having an APA in its introductory parts by emphasising that an APA brings certainty. In other words, the self-assessment provision of the taxpayer for the transfer pricing in the tax returns will not be part of an enquiry by HMRC for the relevant period to which an APA applies. In addition, HMRC has also found that where there is difficulty or doubt with respect to the method of calculating the arm's length principle, the transfer pricing issues can be more efficiently dealt with in real time as they arise rather than retrospectively years later when for example, key personnel in the business may have moved on.

5.5 APAs in the US

The US is amongst the first country to establish an APA programme back in the year 1991. The programme is now part of the Advance Pricing and Mutual Agreement Program (APMA) which provides the opportunity for taxpayers, the IRS and foreign tax administrators to avoid transfer pricing disputes. An APA may be:

- unilateral, where the agreement is concluded between the IRS and the US taxpayer;
- bilateral, where the agreement is concluded between the IRS, one foreign tax administrator and one or more taxpayers; or
- multilateral, where the agreement is concluded between the IRS, two or more foreign tax administrators, and one or more taxpayers.

Bilateral and multilateral APAs are referred to as Bilateral APAs (BAPAs) which are administered by the APMA. Initially, the APA office in the US considered all intercompany transaction involving transfer pricing involved in global dealing. Global dealing transactions are generally conducted by banks through branches and they usually involve a market for customers to engage in derivative transactions. The IRS then expanded the jurisdiction of the APA Office to cover all intra-company transactions that involve the application of transfer pricing principles.

5.6 The APA Process

The US has a well-elaborated process for initiating an APA process. The first step involves requesting for a pre-filing conference to assess the appropriateness of an APA. The IRS is likely to request for information on the taxpayer's business activities, its past transfer pricing practices, the transfer pricing method used amongst others. Following the pre-filing conference, a formal APA process is initiated by filing a written APA application. The application requires an explanation and functional analysis of the transaction, the transfer pricing method adopted and an illustration of its application to the prior 3 years' financial and tax data. Other information to be submitted along with an APA request are:

- the names, addresses, telephone numbers, taxpayer identification numbers and taxable years of the parties for which the APA is requested,
- the organisation, trades and transactions that are subject to the APA,
- a description of the business operations, organizational structure, ownership and capitalization of each party to the transaction,
- representative financial and tax data of the parties for the last 3 years,
- the functional currency of each party to the APA,
- a description of the accounting methods applied,
- an explanation of significant statutory provisions, court rulings or tax treaties as applicable.

In addition to the above, other information is required to establish the arm's length nature of the proposed transfer pricing method such as:

- a pertinent measure of profitability and return on investment such as gross profit margins, return on assets,
- a functional analysis of the economic activities performed, assets employed, risks assumed by the related parties,
- a list of competitors and a discussion of any uncontrolled lines of comparable business,
- a detailed presentation of criteria used to identify possible comparable transactions or similar businesses, and
- a detailed explanation of any adjustment factors.

5.7 Consideration of the APA Request

The APMA Program then assigns a team leader and an economist to review the APA application and negotiate with the taxpayer. Around two or three meetings are held with the taxpayer to receive additional information and to finalise the agreement. For a unilateral APA, once a common consensus is reached on the transfer pricing method, the taxpayer and the IRS execute the agreement. In the case of a BAPA request, the APMA Program drafts a position paper which is circulated to the relevant foreign tax authority and the taxpayer. Following amendment and once a final agreement is reached, the competent authorities sign a mutual agreement. An implementing APA which is consistent with the mutual agreement is then negotiated and ultimately executed by the APMA Program and the taxpayer.

Upon execution, the APA is considered to be a binding agreement between the taxpayer and the IRS. In this light, the court held in the case of *Eaton Corporation and Subsidiaries v. Commissioner 2013 140 T. C. No. 18* that the APA is a binding agreement and it should be cancelled only according the terms of the revenue procedures. The revenue procedures define material facts as those if known by the IRS, would have resulted in a significantly different APA or no APA at all. The case involved the cancellation of two APAs by the IRS entered into by Eaton Corporation and Subsidiaries and IRS. After the APAs were executed, Eaton found out a number of transfer pricing computational errors which it then corrected by amending APA annual report filings and amended tax returns. The IRS used computational errors as one basis for cancelling the APAs. Following the cancellation, the IRS requested to make income adjustments in the amounts of $102 million and $266 million plus penalties for the tax years 2005 and 2006 respectively. These amounts were determined by methods that the IRS had considered but not adopted during the APA negotiations. The Tax Court held that the IRS abused its discretion in cancelling the two APAs and advanced that the IRS failed to demonstrate that a factual predicate exists to cancel the contract.

5.8 APA Monitoring and Review

It is compulsory for each taxpayer to file an annual report which describes the taxpayer's actual operations for the year and demonstrates good faith compliance with the terms and conditions of the APA. The content of the annual report is determined by the IRS and the taxpayer at the time the APA is executed.

Upon examination of the annual report, the IRS may require the taxpayer to prove the following:

- that he has complied in good faith with the APA,
- that the material representations in the APA and the annual reports remain valid and accurately describe the taxpayer's operations,
- that the supporting data and computations used in applying the transfer pricing method were correct,
- that the critical assumptions underlying the APA remain valid, and
- that the taxpayer has consistently applied the transfer pricing method and critical assumptions.

6. MAURITIUS LEGAL FRAMEWORK ON TRANSFER PRICING

6.1 The Legal Framework

Mauritius Double Taxation Avoidance Agreements (**DTAAs**) are based on the OECD Model Convention of Income and Capital and contains articles that are important for transfer pricing, namely Article 9 (Associated Enterprises), Article 25 (Mutual Agreement Procedure) and Article 26 (Exchange of information). Since Article 9(1) of the OECD Model Convention sets out the arm's length principle as the basis for applying transfer pricing legislation of each country, MNEs operating in Mauritius are expected to deal at arm's length prices in their dealings between related parties. It is to be noted that Mauritius does not have a direct application or implementation of treaties that are concluded with other countries. The country will first have to domesticate the provisions of the bilateral or multilateral agreements first so that the relevant authorities (courts and the revenue authorities mainly for tax matters) are able to rely on those provisions. This is done by the ratification of the agreements by the Mauritius parliament through a specific piece of legislation and by providing a date on which the relevant treaty is in force. Up to the year 2018, four treaties await ratification namely the DTAAs concluded between Mauritius and Cape Verde, Gabon, Ghana, Jersey, Kenya, Morocco, Nigeria and Russia.

As explained in the earlier chapter, Article 9 of the OECD Convention does not elaborate on the definition of “associated enterprises” apart from referring to the direct or indirect participation in the management, control or capital. In such cases, reference is made to the domestic laws of each signatory country to the treaty but the laws of Mauritius do not define such terms. The absence of definition makes it difficult to have an insight as to when the threshold is met for an entity to fall under the scope of Article 9 of the DTAAs.

From a reading of section 75(1) of the Mauritius Income Tax, the arm’s length principle is said to apply for:

- corporations that are controlled by non-residents, or
- corporations that are held by non-resident by more than 50%.

The Mauritius Income Tax Act does not define “control”, but the Mauritius Financial Services Act 2007 in its section 71(4)(b) provides some guidelines to assess whether an enterprise is being managed and controlled in Mauritius:

- two directors are resident in Mauritius,
- the principal bank account of the company is maintained in Mauritius,
- the accounting records are kept at the registered office in Mauritius,
- the financial statements are prepared and audited in Mauritius, and
- all meetings of directors include at least 2 directors from Mauritius.

The above criteria are considered by the Financial Services Commission of Mauritius (which is the regulator for the financial services sector in Mauritius) to assess whether decisions of a company are being made in Mauritius. This is important for the validity of a certain type of global business licence namely category 1.

Section 75(2) of the Mauritius Income Tax Act empowers the Director General of the MRA to determine whether the prices involved in the transactions are wholly at arm’s length. In the case that the Director-General believes in his opinion that prices are not at arm’s length, he has the power to adjust the net income to such amount as may be determined in his sole discretion in a manner that would otherwise have been derived from that business or activity if all its commercial and financial transactions and relations are at arm’s length. Section 75(2) of the Mauritius Income Tax Act, therefore, gives the Director General of the MRA the power to adjust prices where he considers the transfer price to be artificially high or low. Section 75(3) of the Mauritius Income Tax Act further empowers the Minister of Finance and Economic Development of Mauritius to make such regulations as he deems appropriate for the purposes of section 75 of the act. However, as of now, no regulation or guidance has been provided in this section.

Also, section 90 of the Mauritius Income Tax Act provides for some circumstances in which the general anti-avoidance rules shall apply. Subsection 1(f) of the same provision refers to tax benefit obtained where the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm’s length under a transaction of the kind. The term “tax benefit” is further defined in section 90(3) as the avoidance or postponement of liability to pay income tax or the reduction in the amount thereof.

In such a circumstance, Section 90(2) of the Mauritius Income Tax Act gives the Director General of the MRA the power to assess the tax liability of the taxpayer and then take the appropriate action:

(a) as if the transaction or any part thereof had not been entered into or carried out; or
(b) in such other manner as the Director-General considers appropriate to counteract the tax benefit which would otherwise be obtained.

6.2 Loopholes in The Present System

It is important for business enterprises to know who will be affected by section 75 of the Mauritius Income Tax Act, the types of transaction that are concerned by this provision, what will be classified as high-risk transactions and what are the acceptable transfer pricing methods that can be used. In the absence of clear explicit official guidance and clarity on the aforesaid factors, practitioners or stakeholders face difficulty in applying the arm's length standard to determine transfer prices that are provided for under section 75 of the Mauritius Income Tax Act. For instance, there is no mention of the factors that the Director-General takes into consideration to conclude whether prices are at arm's length. Also, legal provision or administrative guidance is missing with respect to the procedures that the MRA follows to challenge an arm's length price fixed by the taxpayer. It is not sure whether the taxpayer will be afforded with an opportunity to make representations before the Director-General asks for adjustment in the taxable income.

Moreover, the law is silent as to the acceptable transfer pricing method used to arrive at an arm's length price and on the documentation required to evidence such determination. This can lead to a possible clash between taxpayers and the MRA. The Uncertainties regarding the arm's length standard, in turn, creates ambiguity in the business world since there is the risk that the MRA does not agree with prices imposed by the taxpayer. The MRA may call for adjustments to the taxable income and the taxpayer may find himself with a higher tax liability that was not forecasted for. This situation demotivates investors and is not conducive to a favourable business climate.

Furthermore, the absence of explicit and elaborated transfer pricing rules provides leeway for tax avoiders based in Mauritius to unjustifiably over-price imports and under-price exports. Without a proper monitoring framework by the revenue authority, such practices will not be identified. This, in turn, leads to low taxable income and less income for the MRA and the Mauritius government. All these loopholes in the Mauritius legal and regulatory framework call for a more detailed definition and scope of transfer pricing.

7. CONCLUSION

This paper concludes that there is limited legal provision on transfer pricing in Mauritius despite the growing number of companies located in Mauritius that deal with related parties located in other parts of the world. Section 75 of the Mauritius Income Tax Act provides for prices fixed in transactions between related parties to be at arm's length but there is no guidance as to the scope of application and terminology of the terms of the said provision. In addition, section 75(2) of the act empowers the Director-General of the MRA to make an adjustment to the taxable if he believes that prices are not at arm's length. The lack of transparence in the determination of the arm's length result by the MRA leaves doubt that a subjective approach is adopted by the MRA with each case being judged on its particular facts.

8. RECOMMENDATIONS

Based on the comparative study conducted for this research, some recommendations to counter the uncertainties emanating from transfer pricing rules in Mauritius are hereby suggested:

- the laws of Mauritius should be amended to give formal recognition to APAs so that the MRA should be allowed to enter into APAs with the tax authorities of other countries or with taxpayers themselves to agree on a common front on the method of calculating the transfer prices in related party transactions;
- the MRA should provide for a proper regulatory framework to initiate an APA process in the same manner as the UK HMRC has established through its Statement of Practice; and
- once an APA has been agreed upon and executed by the parties, the law should provide for a monitoring mechanism such as the filing of an annual report that demonstrates compliance with the terms and conditions of the APA in the same manner as the US has provided for in its tax laws.

The above-mentioned recommendations support the implementation of an APA process in Mauritius as a means of tackling transfer pricing abuses and are thus non-exhaustive. This study has considered only one means of combatting transfer pricing manipulation amongst many other methods. Further scope of research may be conducted may be undertaken on the other methods such as the enactment of an elaborated transfer pricing legislation or endeavours to enhance international cooperation amongst states.

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