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REQUEST FOR OPINION: TRANSFER PRICING LEGAL REGIME

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REQUEST FOR OPINION: TRANSFER PRICING LEGAL REGIME

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The issue under examination:

The Corporate Income Tax ("IRPC") Code foresees the application of rules on transfer pricing in the context of the corrections for the purposes of determining the tax base.

In this context, the draft Decree approving the Transfer Pricing Legal Regime will be presented to the Council of Ministers for consideration and approval, which regulates the conditions for applying the rules on transfer pricing, in particular with the aim of ensuring the right of the Tax Administration to make corrections to the determination of taxable profit in the context of combating tax evasion and tax avoidance.

The proposal under analysis contains some general lines which characterize and aimed at, among other objectives, the adoption of appropriate procedures to carry out adjustments to the taxable income in related-party operations, the definition of the methods for the determining transfer pricing and the forecasting of ancillary tax obligations, either documentary in nature or declaratory, enabling the effective control by the Tax Administration.

Having been prepared a draft Decree approving the Transfer Pricing Legal Regime , we have examine its contents, from a technical and legal point of view and in the light of the objectives that this diploma aims to pursue, proposing, as appropriate, the changes and improvements that are appropriate for purposes of assessment and approval by the Council of Ministers.

From a methodological point of view, this Opinion includes general considerations on the legislation under review, namely regarding the systematization of the diploma, as well as the summary of the main points which, for the lack of a better opinion, deserve a particular reflection, all of which are contained in a table for better visualization and identification.

Part I: General

The term "transfer pricing" has been generally used to identify the control over commercial or financial transactions carried out between entities which find themselves under a situation of special relations (hereinafter referred to as "Related Parties").

Due to the peculiar circumstances existing in operations carried out between Related Parties, the conditions prevailing in such operations can sometimes be artificially laid down and, consequently, differ from those conditions which would be agreed, accepted or practiced between entities which are not in a situation of special relations, under similar conditions, i.e. conditions that would be agreed, accepted or practiced in normal market conditions, in accordance with the principle of full competition.

Therefore, it is understood that the control of transfer pricing is of special relevance to avoid the loss or reduction of tax revenues, in particular (but not exclusively) in the context of international transactions in such a way as to prevent the artificial relocation of revenues (tax) and expenses (deductible) in acquisition and/or sale of property, rights or services transactions.

Simultaneously, the creation of necessary conditions for the effective control and supervision by the Tax Administration should take into account the compliance costs imposed on the Related Parties, in order to avoid that the rules on transfer pricing constitute a negative factor in attracting investment and in the development of the economy.

We must emphasize the fact that the Draft would only implement the legislative provision already contained in Article 49 of the IRPC Code, following changes introduced by Law no. 19/2013, of 23 September. In accordance with paragraph 1 of the aforementioned Article 49, "*The Tax Administration can make any necessary corrections in the determination of taxable profit whenever, by virtue of the special relationship between the taxpayer and the other person, subject or not to IRPC, conditions different to those that would be normally agreed between independent persons have been laid down, leading to a situation where the profit earned on the base of accounting differs from the established profit in the absence of such relationships."*

Number 2 of the same article adds that these rules are also applicable "*whenever the profit established through accounting, concerning entities that do not have their headquarters or effective management in Mozambican territory, differs from that which would be established if it were a distinct and separate company engaged in identical or analogous activities, in identical or analogous conditions and acting with total independence*" while in the light of paragraph 3 of the same Article, the rules on transfer pricing apply also "*to those persons undertaking simultaneously activities subject and not subject to the general regime of the IRPC, when identical deviations concerning such activities are verified* ".

With regards to the subjective scope of application of the transfer pricing rules, it is clear from numbers 1, 2 and 3 of Article 49 of the IRPC Code, that covered by this regime are:

a) The relations between taxable persons subject to IRPC;

b) The relations between taxable persons subject to IRPC and "other people" – to be understood legal or natural persons;

c) The relations between resident and non-resident taxable persons, for tax purposes, in Mozambican territory.

In material or objective terms, it is also clear that subject to these rules are both the income subject to taxation and the income not subject (and even more so, also the income subject, even though exempt from tax), whenever deviations from the principle of full competition are found.

Finally, Article 49 paragraph 5 of the IRPC Code determines that the application of the transfer pricing rules occurs whenever there are "special relations" between two or more entities, i.e. whenever an entity "*has the power to exercise, directly or indirectly, a significant influence on the management decisions of the other*".

Adding to the above mentioned, is the interaction between the rules of internal nature - as the IRPC Code - with the rules of international nature- such as the Agreements to avoid Double Taxation and international best practice in the field of transfer pricing. We shall see that the Draft already considers this need of articulation.

A. Draft conceptual inaccuracies

The Draft being considered is structured in a way as to systematize the transfer pricing rules and its practical application.

Thus, we highlight some aspects which, in our opinion, deserve some reflection and, possibly, recasting.

Given the particular complexity of transactions in presence (aforementioned above), it is of particular relevance to clearly and precisely define the scope of application of these rules, in particular regarding the designation of the taxable persons covered by the transfer pricing rules (Related Parties), the related-party operations (i.e. operations carried out between Related Parties) and the applicable methods for the determining the of the fiscally acceptable transfer price.

In this respect, it seems to us that the Draft reveals itself as particularly complex and deserves some review, under penalty of overlapping some rules.

On the one hand, in systematic terms, the diploma is not always consistent in the definition of "key concepts" for the implementation of the transfer pricing regime, particularly in:

a) Multiplying the definitions of one same concept (for example, the concept of "Related Parties" is defined in Article 1 subparagraph a) as in Article 5);

b) Using general and abstract concepts, or terms undefined in the draft or the Law in general (for example, the definition of "related parties" (Article 1, subparagraph f)) can be confused with that of "special relationship" (Article 1, subparagraph i));

c) Defining the concepts without technically materializing them (see the definitions laid down in Article 1 and the references contained in Article 5, paragraph 1)

d) Confusing legal concepts with mere criteria for the application of the law (under the heading "significant influence", Article 6 contains, in fact, the definition of the criteria against which to assess the special relationship existing between related parties).

B. Principle of full competition

In accordance with Article 49, paragraph 1 of the IRPC, it first clarifies that the rules relating to transfer pricing apply whenever "*conditions different from those that would be normally agreed between independent persons have been established*". On the other hand, Article 4 paragraph 1 of the Draft refers to the terms and conditions which are “agreed*, accepted and practiced*". For reasons of systematic and interpretative order, it would be preferable to opt for a similar wording in both texts, in order to avoid discussing, in the future, if Article 4 paragraph 1 of the Transfer Pricing Legal Regime went beyond the rule which serves as its framework (the IRPC Code).

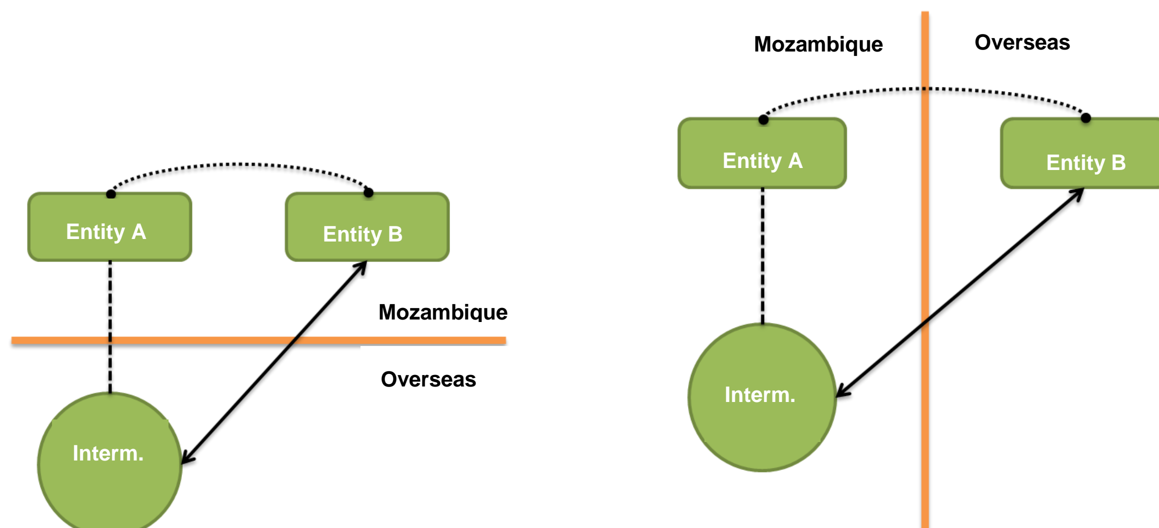
C. Territorial Scope of application

As seen above, Article 49 of the IRPC Code begins by subject to transfer pricing rules the relationship between “*the taxpayer and the other person, subject or not to IRPC*" (pursuant to Article 49, paragraph 1 of the IRPC Code). Only in paragraph 2 has been expressly provided that in paragraph 1 are included the "*entities that do not have their headquarters or effective management in Mozambican territory*". To that extent, the Mozambican tax legislator seems to have intended to word the rule incidence with a very broaden scope, not resulting in any "preference" for Related-Party Operations of international nature.

In contrast, the text of the Draft seems unclear as to the range of operations covered by the Transfer Pricing Legal Regime. This is because, in accordance with the terms laid down in Article 1, subparagraph d) of the Draft, the definition of "operations" refers exclusively "*commercial and financial transactions,* ***on import and export*** *...*" (emphasis added). Given this definition, the domestic transactions seem to be excluded from the scope of the Draft.

However, in the opposite direction, several other rules contained in the Draft seem to refer to the application of the transfer pricing rules on merely internal transactions, including transactions between taxable persons (wholly or partially) exempt and non-exempt (see article 3, paragraph 1, last part). It is important, therefore, to clarify the material scope of the diploma.

Similarly, the allusion to the operations carried out “by *means of an intermediary (...), which operates with another, abroad*" (Article 3, paragraph 2, subparagraph d)) raises significant difficulties of interpretation, as illustrated in the following examples.



Still to be understand if the rule refers to related—party operations between two resident taxable persons, through an "intermediary" abroad (in which the "intermediary" operates offshore, for example on a fiduciary basis) - in which case it would be facing a "simulation" of an international business - or if we are dealing with operations between two Related Parties (one resident and other non-resident), but in which the non-resident entity acts as the "intermediary" - in which case it would be facing a "simulation" of a domestic business.

This rule (Article 3, paragraph 2, subparagraph d)) raises relevant doubts from the outset due to its unclear territorial scope of application, but also because it seems to assume a link between the transfer pricing regime and an anti-abuse specific rule which allows for disregarding the legal transaction between the Related Party and the "intermediary". This is a topic that deserves to be reconsidered and, where appropriate, improved in the text of the Draft.

D. Methods for determining transfer pricing

In view of the need to establish a comparison between the transfer price practiced by the Related Parties and the terms and conditions that would normally be agreed, accepted or practiced, it is of the utmost importance to identify which methods are eligible for this analysis.

Given the complexity of the matter and, therefore, of the methods that can be used to establish the comparability between related-party operations and unrelated operations, the study of the methods for determining transfer pricing has been particularly developed within the Organization for Economic Cooperation and Development ("OCDE"), through the publication (and continuous improvement) of the *Transfer Pricing Guidelines*. The internationally recognized methods are, firstly, the so-called "traditional methods", namely (i) the comparable market price method, (ii) the reduced resale price method, and (iii) the cost-plus method, considering that OCDE advises, whenever possible, the preferred application of the first of these two methods (i.e., the comparable market price method).

The taxable person may also adopt (i) the method of splitting the profit, (ii) the net margin of operation method, or (iii) another method appropriate to the facts and the specific circumstances of each operation which respects the principle of full competition, when the "traditional methods" mentioned *above* may not be applied, or if they may be so, do not make it possible to obtain the most reliable measure of the terms and conditions that independent entities would be willing to agree, accept or practice.

In order to clarify the scope of application of each method, we allow for the brief explanation of the characteristics of each of them.

a) Comparable Market Price Method

The comparable market price method compares the price charged for the transfer of goods or services in a Related-party Operation with the one practiced in an Unrelated Operation, when the both are in similar circumstances.

In fact, given its reliability, the application of this method is preferable to other methods. However, in practice, its application is considerably restricted, because it may be difficult to identify a transaction between unrelated parties sufficiently similar to a Related-party Operation in such a way that the differences do not have a material effect on the practiced price. However, the existence of significant differences, either in amounts paid or in geographic markets or in the contractual terms agreed, for example, limits the scope of application of this method.

It is possible to make some adjustments to make separate operations comparable. In spite of this, in some cases it may be difficult to carry out accurate enough adjustments to eliminate the effects exerted on the practiced price. The OCDE proposes a more flexible approach to using the method, in order to make it easier. Nevertheless, the reliability of the data used is an essential requirement, which may not be questioned in benefit of the flexibility introduced into the application of the method. In this way, the differences shall have a secondary nature. In cases in which there are differences that do not have a mere secondary nature, other methods shall be used.

The comparable market price method, when likely to be used, must take into consideration, primarily, the factor of transacted product, service or good comparability. However, other comparability factors, as other terms and conditions of the operation as part of a functional analysis, also are important.

b) Reduced Resale Price Method

This method is based on the resale price practiced by the taxable person in an operation carried out with an independent entity, having as its object a product purchased from an entity with which it is in a situation of special relationships, to which the gross profit margin, practiced by a third entity in an operation comparable and with equal level of commercial representativeness, is subtracted.

In other words, this method compares the gross profit margins (the difference between the net proceeds of sales and the cost of the products or services sold) in sales carried out

between related and unrelated parties. The differences identified in this comparison must be properly adjusted.

This method is mainly used to determine the transfer price of tangible goods. Its application is especially valid in cases involving resellers or distributors, specifically when these entities acquire products to related entities and then resell them to third parties without adding substantial value to these products.

The price of a transaction complying with the principle of full competition can be determined by means of a transaction comparison, when taking as a basis of reference the margin on the resale price practiced in a comparable related-party operation carried out by an entity belonging to the same group or by an unrelated party.

It is worth underscoring that the comparability of tangible goods is less relevant in this method than the comparable market price method.

c) *The Cost-Plus Method*

The application of the cost-plus method is based in the amount of costs incurred by a supplier of a product or service provided in a Related-party Operation, to which is added the gross profit margin practiced in a comparable unrelated operation, in which the functions performed and the conditions of the market are remarkably close, reaching, in such way, a value in accordance with the principle of full competition.

In this sense, as in the reduced resale price method, some adjustments may be required to suit a comparable unrelated operation in such a way as to make it comparable with the Related-party Operation. Again, both transactional and functional comparisons may be taken into account, and the first shall preferably be used.

This method is widely used in cases involving transfer of intangibles between Related Parties, in which the producer of the intangible plays limited productive functions and incurs in reduced risk and is justified by the fact that, on this hypothesis, the costs presented are likely to reflect more adequately the value added to the product and consequently provide more aid to the definition of market value.

On the other hand, this method is also usually applied to intra-group provision of services.

d) *Method of Splitting the Profit*

Both the method of splitting the profit, and the net margin of operation method should be used only when the traditional transactional methods, above mentioned, do not produce a reliable result with regards to the price adequacy between the Related Parties to the principle of full competition.

The method of splitting the profit is used to split the overall profit derived from complex operations or series of Related-party Operations carried out in an integrated manner between the entities involved. In this sense, the functions performed, assets used and risks taken by

each of the parties must be taken into consideration, using as reference external reliable data able to indicate the way how Independent Entities, exercising similar functions, using the same type of assets and taking identical or similar risks, would evaluate their contributions.

It is important to mention that in the event of any entity having residual injury, you may proceed to the splitting of profits and losses between each of the entities, depending on the relative value of its contribution, observing the same assumptions mentioned above.

The reliability of this method, with regards to the use of comparable, depends on some accounting aspects, among them: (i) how the costs, revenues and assets are accounted for between the relevant negotiating activities and other activities of the parties involved, which will influence the determination of the amount of "operating profit"; (ii) the feasibility of obtaining information concerning only Related-party Operations carried out between related entities; (iii) the consistency between accounting methods used by the various related entities and the identified comparable.

e) Net Margin of Operation Method

This method is based on the calculation of the net profit margin obtained by a taxable person in an operation or a series of Related-party Operations taking as reference the net profit obtained in a comparable unrelated operation.

The main peculiarity of this method consists in the fact that it involves the use of an indicator to test the net margin of the less complex party involved in the operation.

In this peculiarity resides its main advantage. It shall be noted, on the one hand, that this method is not as dependent of a functional analysis as, for example, the method of comparable market price. On the other hand, net margins do not vary as much as a result of some functional differences which may arise between Related-party Operations and unrelated operations.

In addition, according to the OCDE Transfer Pricing Guidelines, when this method is used it is not necessary to demonstrate, for example, the tasks performed and the responsibilities assumed by an entity other than the one proceeding to the application of the method, with a view to ascertaining the obedience to the principle of full competition. This fact can represent a great advantage when the other parties involved in the transaction are very complex and present many interrelated activities or when it is difficult to obtain information concerning one of the parties involved.

In contrast, there are some disadvantages in applying this method which justify the recommendation of its use only as an alternative. In essence, the unfavourable argument to using this method refers to other factors that can influence the net margin of two different operations, leading to considering it as comparable, when in fact they are not.

f) The methods for the determination of the transfer price provided for in the Draft

Considering the preceding framework, it seems to us quite positive that the Draft welcomes all five methods above mentioned, differently from what is sometimes the option of the tax legislator in some countries (preferring to introduce a smaller number of admissible methods).

In this respect, it is important to note that the international experience shows that in the face of difficulty in finding direct comparable, the generality of taxable persons - as well as Tax Administrations - tend to adopt indirect comparison methods such as the splitting the profit and net margin of operation methods, at the expense of "traditional methods". This is why the OCDE attempts to promote the application of "traditional methods" through its relative loosening. On the other hand, the fact that the "non-traditional" methods use indirect comparable (i.e. the profit or the net margin of operation), assumes a more important requirement on the reliability, expertise and detail of the accounting records of the taxable persons. In other words, the correct adoption (and supervision) of indirect methods (subparagraphs d) and e) *above*) depends, to a large extent, the accounting regime and obligations to which they are subject as taxable persons.

Part II. Specific Comments

<table>
<tr><th>Reference Article</th><th>Heading</th><th>Comment</th></tr>
<tr><td>1</td><td>Definitions</td><td>Given the option by the inclusion of a specific article on "Definitions", it is important to ensure that there is no overlapping of definitions in respect to the other rules of the Draft. That said we can see that Article 5 and 6 contains new definitions of concepts that generate an overlap between the main concepts of the transfer pricing regime - in particular the concepts of "Related Party" and "Special Relationships".

In addition, some of the concepts defined in Article 1 are unnecessary, since they are already understood / covered by other concepts.

For example:

a) Any "entity belonging to the same group" will necessarily be qualified as "related party", by which the first concept is unnecessary

b) While it is true that "Related Parties" are those between which there are "special relationships", the definition of "related parties" should not contain a definition of "special relations" ("(...) whenever one has de power to exert, directly or indirectly, a significant influence on the management decisions of the other"). Shall only refer to the definition of "special relationships".

In our opinion, Article 1 must be completely rewritten, or possibly eliminated, since the main concepts</td></tr>
</table>

		are more explicitly defined in Articles 5 and 6. We refer to the suggested changes in the revised and commented version of the Draft (Annex). We also call attention to the need to clarify the territorial scope (Article 1 subparagraph d)) in such a way as to not interpret the concept of "Operations" as limited to import and export transactions. We refer to the suggested changes in the revised and commented version of the Draft (Annex).
2	*Object*	In our opinion, for the sake of legislative technique, this should be the first article of the Draft.
3	*Scope*	We propose some precisions and rewording of paragraph 2 subparagraph d), in agreement with the revised and commented version of the Draft (Annex).
4	*General Rules*	We refer to the suggested changes in the revised and commented version of the Draft (Annex).
5	*Related Party*	In our opinion it would be useful to have a significant reduction of this rule and eventually its merger with the Article 6. This suggestion follows the fact that the current Article 5 of the Draft resorts to factual situations (such as the "control", or the existence of an "interest"), which are not legally typified. In fact, this happens because the situations provided for in the various subparagraphs of Article 5, paragraph 1, of the Draft correspond to situations in which special relations are verified as legally defined in Article 6. There are described the legal criteria, such

		as the participation in the capital, the holding of voting rights, etc.).
6	*Significant Influence*	For the lack of a better view, the concept the legislator seeks to define in this rule is that of "special relationships" and not the "significant influence". Significant influence is a condition for the existence of special relations, but in itself it is not a concept to define. Therefore, we suggest the redenomination of the rule, the heading referring to "special relationships". In addition, the forecast contained in Article 6, paragraph 2, subparagraph g) deserves, in our opinion, careful consideration. This because the rule appeals to the existence of an economic and financial dependence on a third party (that would characterise as "Related Party"). Considering the peculiarities of the Mozambican economy, in which some large companies represent all or most of the volume of sales of small suppliers, it may make sense to reduce the scope of this rule, under penalty of the large taxpayers becoming "Related Parties" of many small suppliers, increasing exponentially the compliance costs. In this sense, we suggest (at least) the elimination of subparagraph g) iii) and v).
7	*Adjustments to the taxable profit*	For reasons of systematization we propose the deletion of paragraph 2 and the simplification of the provisions of paragraphs 4 and 5, with their fusion into a single paragraph. We refer to the suggested changes in the revised and commented version of the Draft (Annex).

28	*Entities covered by differentiated tax regimes*	In line with the foreseen in Article 7, we propose the inclusion of a specific reference in Article 28 (renumbered to 29 in the revised version) to the effect that there must be no negative corrections to the taxable profit – only corrections which will increase the tax base and the tax due.