

TRANSFER PRICING LAW AND PRACTICE IN DOMINICAN REPUBLIC

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The Dominican Republic has shown substantial progress with respect to the law and practice of transfer pricing. The bases for their application are established in the Tax Code since 2006 with a more specific legislation enacted in 2011. Both provisions are complemented by the authority of the Tax Administration (Dirección General de Impuestos Internos-DGII) contained in the Tax Code, which together provide the taxpayers and the Administration the legal certainty necessary; with rules adapted to international standards. And in parallel, the creation of a Department for Controlling Transfer Pricing in 2011; as a result of a sectorial audits process, carried out by the DGII, which demanded its formalization.

Transfer Pricing Legislation

Legislation for the treatment of transfer pricing is in effect in the Dominican Tax Code (DTC) since 2006. Although since the inception of the DTC in 1992, the arm's length principle was conceived, by Article 281, which states:

"Legal acts concluded between a local company with foreign capital and a natural person or legal entity domiciled abroad, that directly or indirectly controls it, will be considered, in principle, to be done between independent parties when the provisions are consistent with normal market practices between independent entities ... "

The amendment to Article 281 in 2006, by Law 495-06, introduced elements that were necessary for the determination and evaluation of transfer pricing between related companies; stating the following on the matter:

- a) The income from Dominican sources of branches or other permanent establishments of foreign companies operating in the country will be determined based on actual results achieved in its management in the country.

- b)* When the accounts of these companies do not allow establishing the actual results obtained, the DGII, will be able to determine the taxable income by applying to the gross income of the establishment located in the country, the proportion between the total income of the parent company and the gross income of the establishment located in the country. It may also determine the taxable income, applying to the assets of the establishment in the country, the ratio of total income of the parent and total assets of this.
- c)* When prices that the branch or permanent establishment charge to its parent or another subsidiary or related company of the parent, do not comply with values charged for similar transactions between independent enterprises, the tax authorities may challenge them. The same procedure shall apply to prices paid or owed on goods or services provided by the parent company, its agencies or related companies, when those prices do not meet the normal market prices between unrelated parties.
- d)* When the parent company distributes corporate expenses to the branch or establishment in the country, and these do not match the price or value of these costs charged for similar services between independent enterprises, the tax authorities may challenge them. These expenses must be required to maintain and preserve the income of the permanent establishment in the country.
- e)* The DGII may challenge an expense not necessary to produce and preserve the income, the excess determined by the amounts due or paid on account of interest, commissions and other payments, arising from financial lending or held with the parent or company related to it. Such excess shall be determined by checking the value in excess of interest, commission or other payment, arising from similar transactions between independent enterprises and financial institutions in the country of the parent company.
- f)* In the case of all-inclusive hotel industry, whose business has particular links with related parties abroad, the tax authorities may define Advance Pricing Agreements (APA) on the prices or rates that will be recognized on the bases of comparability parameters by area, cost analysis and other variables with impact on all-inclusive hotel business. For the signing of the APA, the

industry will be represented by the National Association of Hotels and Restaurants (ASONAHORES). The agreements will be published by resolution and will be valid for eighteen (18) months. Subsequent agreements will be valid for up to 36 months. In cases where an agreement has expired and there is not a new agreement, the previous agreement shall continue in effect until the new APA is approved.

- g) The prices or rates shall apply for purposes of liquidation and/or determination of the taxable income for the Value Added Tax (VAT) and operating income for income tax. The tax authority may challenge, to taxpayers reached by the APA, the declared value when it does not meet the criteria included in it and apply the penalties established in the Tax Code. Further provides that equal treatment may be given to other sectors which processes are linked to overseas, such as: Insurance, Energy and Pharmaceuticals.

These elements underpin the basis for transfer pricing determination; authorizing the jurisdiction to rule on specific aspects to the Tax Authorities. In 2011, the DGII issued regulations for the proper implementation of Article 281, primarily based on the OECD Guidelines. These regulations included the following elements:

1. Definition of a related party.
2. Definition of comparable transactions and criteria to be considered for comparability analysis.
3. Definition of the methods to be used and its priority order.
4. Adjustments to comparable transactions.
5. Specifications for contemporaneous documentation.

The Dominican legislation also contained provisions on the economic reality of transactions (substance over form)¹; assessments of income from exports and imports²; as well as the ability to estimate ex officio³, the taxable income based on averages, coefficients and other indexes, which complement the transfer pricing regulations.

¹ Dominican Republic Tax Code (CTD), Article 2

² CTD, Article 273. Reglamento para la Aplicación del Título II del CTD del Impuesto Sobre la Renta

³ CTD, Article 35, 64, 65 and 66.

Transfer Pricing Practice

The practice of auditing and monitoring related party transactions is carried out by the Transfer Pricing Department, which was established in 2011 for such purposes, but also to centralize the transactions between taxpayers and related parties abroad audits.

The Department was created in parallel with the development of regulations for the application of transfer pricing, after a process of training and capacity building for staff, which started in 2009.

Although, it was not until 2011 that the Transfer Pricing Department was created within the Tax Administration, the practice of transfer pricing audit had its initial stages in 2009 when the DGII, based on a sectorial strategy of control, started a process of auditing the all-inclusive hotel sector. The audits were carried out by the Department in charge of external audits.

The selection of the all-inclusive hotel sector was due primarily to its high external linkage. This linkage facilitated the use of transfer pricing for purposes of relocating returns in other jurisdictions, among other elements which emphasized the abuse of transfer pricing, such as:

1. The use of a related company for sales purposes (market intermediaries), located in most cases in countries known as a tax haven or a country with very low tax rates.
2. Constant losses and high debt to related market intermediaries; over 10 years of reported losses in a sector taxpayer's financial statements and affidavits.
3. The guest per night rate or income declared to the DGII, were lower than the operating cost per guest on their Affidavits.
4. The advertised rates were more than one hundred percent higher than the rates declared to the DGII.

The verifying process began following the submission of sworn affidavits from companies who operated hotels on the beach during the fiscal periods of 2007 through 2010, including a few cases from 2005 and 2006. The process was outlined in the provisions of Article 281 related to transfer pricing and Articles 64, 65, and 66 of the Tax Code, which allow the DGII to discard the affidavits that did not deserve faith, since they are not credible nor truthful; and empower the DGII in such cases, to determine ex officio the tax liability, even though the taxpayer had organized and up-to-date accounts and records.

Taking in consideration the above elements, the DGII issued for each of the audited taxpayers, a resolution of determination ex officio on the basis of estimated tax liabilities, by which the Affidavits of Income Tax (ISR) and ITBIS-Impuesto a la Transferencia de Bienes Industrializados y Servicios (analog to the VAT) were adjusted.

The tax base for the determination of taxable income from Dominican sources was determined from the per person nightly rate paid for each hotel from overseas consumers, according to the following procedure:

1. For attaining per night rates, 7 night packages prices/rates were selected⁴, discounting transportation⁵, for specified dates and by season. Rates were obtained from different countries, where demand for Dominican hotel service is higher and from several tour operators and retailers.
2. Rates so obtained were segmented according to the hotel's category, location and zone in order to obtain a standard and simplified method for the sector; taking into account the following:
 - a) 5 hotels categories were identified by zones 1, 2A, 2B, 3A and 3B, with 1 being the lowest hotel category and 3B being the highest hotel category. These categories were provided by the National Association of Hotels and Restaurants (ASONAHORES).

⁴ The prices/rates were provided by a market research firm hired by the DGII.

⁵ The hotel package might include air and ground transportation.

- b) Seasons were divided into two: high season (December to April) and low season (May to November). For each season, 2 to 4 nightly rates were obtained for different dates.
- c) The zones were defined based on the hotels' location, characteristics, and conditions of the geographic area where the hotels are located. ASONAHORES defines 3 areas:
- Zone A: Bávaro-Punta Cana
 - Zone B: La Romana, Bayahibe, Uvero Alto
 - Zone C: Puerro Plata, Sosua, Cabarete, Rio San Juan, Samaná, Boca Chica, Juan Dolio, San Pedro de Macorís.
3. Samples were discounted 16% to account for ITBIS and 10% for compulsory legal Tipping Service⁶, as published prices includes these percentages.
4. The rates obtained from the above sources were discounted by 20% and 25% for marketing margin⁷ (markup).

Using the process described, in the period 2009-2011 were carried out 73 audits for fiscal years 2005 to 2010.

Table No. 1
Audits Performed, according to the fiscal year
2005-2010; Quantity

Fiscal Year	Quantity
2005	1
2006	1
2007	16
2008	3
2009	32
2010	20
Total	73

⁶ Labor Code, Law 16-92, Article 228.

⁷ Refers to the profit margin charged by the intermediaries, commercialization firm, Tour Operators or wholesaler and travel agents. The markup is the sum of these three.

The hotels audited represented 50% of all registered all-inclusive hotels in the country and 87.5% of the hotels located in Zone A: Bávaro-Punta Cana and Zone B: La Romana, Bayahibe and Uvero Alto; on which audits were performed in at least one fiscal year.

Table No. 2
Audited Taxpayers, according to the fiscal year
2005-2010; Quantity

Audited Periods	Taxpayers
1 periodo	5
2 periodos	14
3 periodos	12
4 periodos	1
Total	33

Once the resolution of determination ex-officio to determine the tax liability was issued, audited hotels proceeded to appeal the resolution. All such appeals were rejected in its entirety by the DGII.

Thereafter, the taxpayer filed an administrative appeal on the Supreme Administrative and Contentious Court, in order to obtain the dissolution of the determination adopted by the DGII. The judges of the court analyzed the case and issued a statement that supports and upholds the legal and appropriate performance of the DGII, both in form and substance, and ratified the amounts determined.

The judgments of the Supreme Administrative Court marked a precedent in relation to the performance of the DGII and transfer pricing. The court reaffirmed the fact that all parts of the resolutions issued by the tax authorities highlight the practical and analytical capacity of the DGII on the subject of transfer pricing.

Concluding Remarks

Transfer pricing is a matter of global importance. Therefore, having the appropriate regulations and a functional structure for their control generates benefits for the tax administration and for the branches or other permanent establishments of foreign companies operating in the country. In the field of transfer pricing, progress has been made in order to create a legal framework that has been adapted from international best practices, but also providing new alternatives to the existing set of rules for the control of the abusive use of transfer prices between multinational groups.