Comments for OECD on Transfer Pricing and Safe Harbors

If our goal is to lay the foundation for a wide-ranging and creative approach to trade mispricings, then we need to give careful thought to safe harbors and best practices that developing countries can follow.

The urgency of this subject cannot be underestimated. We cannot wait for an ideal world when the Arm’s Length Standard would no longer be needed. That would only happen when tax rates become similar across countries, when low-tax jurisdictions are few or non-existent, when interest rates are relatively consistent across borders, when companies are not subject to any significant currency risk, and multi-national companies are assured protection of their capital and technology whenever they invest overseas.

Since we do not expect to live in such a perfect world in the near term, we need to increase opportunities for developing countries to adopt safe harbors that are consistent with market practices and which an help stem trade mispricing as it effects their economies. We need to also learn from the best practices that have worked in certain developing countries and see if they can be applied to other countries. That is the purpose of these comments.

The advantages of safe harbors are as follows: They reduce administrative burdens, they offer predictability for both taxpayers and the revenue authorities, they reduce or eliminate the possibility of litigation, and they can help boost foreign direct investment. These safe harbors are already common practices in many advanced countries as well as in some developing countries. Their use needs to be expanded significantly.

Let us consider some examples of safe harbor regimes that commonly work in other countries. On inter-company services, Australia allows a mark-up of 7.5%. In New Zealand, for intra-group core services, a recharge of cost plus 7.5% is acceptable. Switzerland has a safe harbor for interest charged on inter-company loans, with different rates for loans financed through equity and loans financed through debt. If taxpayers can prove that the arm’s length amount varies from the safe harbor it will be accepted. In the US, for inter-company financing, a company can apply the US Government AFR (Applicable Federal Rate), which is published by the IRS every month.

Mexico has the ‘Maquiladora’ rules that effect Mexican subsidiaries of foreign companies involved in manufacturing. There is a formula based on costs incurred and assets employed. That can be followed by other developing countries which rely heavily on manufacturing. While India does not have a safe harbor for the outsourcing sector, this is certainly an area that should be considered. The average cost mark-up that is agreed upon audit of such companies is cost plus 22%, and a typical audit lasts about three years. To avoid the economic cost of delay, it may be worthwhile to consider a safe harbor regime based on experience, say something in the range of 20 to 25%.

There also needs to be proper planning for safe harbor implementation. We need to avoid double taxation, such that the tax in one country using a safe harbor is also not subject to tax on the same income in another country. Where safe harbor provisions are adopted based on the cost plus methodology, countries need to clearly define what costs are included in the cost base. Documentation
should also be clearly specified for taxpayers opting for the safe harbor rules and be less stringent than for other transactions. We also need to assure that if a company adopts a safe harbor, there is no exposure to earlier years when no safe harbor was adopted. And if a company opts out a safe harbor, then it should not be subject to safe harbor mark-ups for subsequent years.

As discussed above, safe harbors can work for manufacturing, outsourcing, non-core services, and inter-company financing. The two areas where there are challenges, and some thoughtful planning may be necessary, are for services and intangibles.

At its most fundamental level, for a service that is charged there needs to be a benefit. If a company has profit of 10% of sales, one cannot justify paying a 10% or more service charge. The question needs to be asked – Did the MNC meet the benefit test for the services?

Generally, a management fee of 2% or less should be acceptable and built-in as a safe harbor. Developing countries can consider a policy that any service charge above 2% would be subject to audit. And a country can further specify that no deduction would be allowed if the transaction for services is with a related party in a tax haven, unless the business purpose and economic substance test has been met.

Let us now turn our attention to intangibles. These are generally of two types: normal, regular type of intangibles, and super intangibles such as software. On the former, developing countries can set a threshold say of 5% for the normal intangibles. A practice that some countries follow is to cap the charge for services and intangibles at say 8%. Above that, the transaction would be subject to audit. For software, the cost of goods sold is the royalty, and can be as much as 40-50% of sales. In summary, developing countries can set a simple standard of a royalty of 5% or less that would be automatically allowable, and a combined royalty and service charge of up to 8% would also be allowed. Anything above that could be subject to audit. And for super intangibles a safe harbor of a fair royalty rate can be adopted based on market practices, or experience of other countries.

In addition to the above safe harbors, there are a number of best practices that developing countries can follow. These are listed below;

- Related party transactions with tax havens would not be deductible unless proven otherwise.
- Rules similar to the Dictaman Fiscal rule in Mexico could be adopted. Under this, there is one requirement at the company level and one at the statutory auditor level. The company is required to file an information return for all transfer pricing transactions above a certain amount, say $1 million. This would require details on the party with which one is trading, where the affiliates are located, and the business rationale for the same. The requirement for the statutory auditor is to attest that the company representation on both internal documentation and information return is reasonable and valid to the best of their knowledge. If trading with a tax haven, no deduction is allowed unless one can prove that it is backed up with a transfer pricing study.
- It is not uncommon for many developing countries to maintain a black-list of tax havens, so as to ensure that any transactions with those havens are automatically subject to audit or disallowance.

- Information returns as a variation to the amounts above, as also attestation by auditors are also best practices that should be considered.

In summary, one can suggest the following as guidelines for developing countries: Codify the law regarding transfer pricing, and build in as many safe harbors as are feasible; have specific rules for services and intangibles, as that is an area where there is likelihood of abuse or misuse; follow best practices regarding transactions with tax havens and subject them to audit or disallowance; invest in trained staff that can audit companies; build or acquire a data base of comparables (some of which can be acquired at a relatively low cost); ensure that there is good governance within the tax administrations; and communicate freely and frequently with other country tax offices to share best practices.

The best dollar a developing country can collect is one that is collected through voluntary compliance. By following safe harbors for most transactions that affect their economy, and by adopting best practices that relate to tax havens and attestations by auditors, a developing country can collect significantly more revenue than it does at the present time. Clarity of rules will diminish or help stem trade mispricing, and reduce the administrative cost of audit. This, over the long run, can also provide a degree of certainty to the multi-national company and thereby result in more foreign direct investment into the developing country.

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