BEPS TRANSFER PRICING WORKSHOP

TRANSFER PRICING DOCUMENTATION – RISK ASSESSMENT AND SAFE HARBOURS

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11. Overview of Existing Safe Harbours and Simplification Measures

OECD
BETTER POLICIES FOR BETTER LIVES

Types of Safe Harbours in Practice

- ✓ Full or partial exemption from transfer pricing rules
- ✓ Optional proxy for arm's length pricing
- ✓ Mandatory proxy for arm's length pricing
- ✓ Safe harbours providing relief from administrative requirements

Different Safe Harbours may have different goals

- Services
- Small and Medium Sized Enterprises
- Small transactions
- Risk Assessment
- Interest deductions / Thin Capitalisation

SERVICES

European JTPF Paper

- Low Value Adding Intra-Group Services
  - Documentation "narrative"
  - In cases where it is appropriate to use a mark up, this will normally be modest and experience shows that typically agreed mark ups fall within a range of 3-10%, often around 5%. However that statement is subject to the facts and circumstances that may support a different mark up.

European JTPF Paper

- 2011 paper providing guidance on treatment of low-value services within the EU
- Does not constitute a safe harbour, but …
- However, it does contain substantial guidance beyond that in the OECD TPG as to how taxpayers and governments should approach compliance and audit review with regard to low value adding intra-group services
- Has been well received in the business community.

European JTPF Paper

- Key Provisions
  - A clear statement that all costs are to be allocated and deducted subject to local law rules on the deductibility of expenses
  - Confirmation of the benefit requirement – but with a clear statement that indirectly allocated low-value costs do generally provide a benefit to MNE Group members
  - Confirmation of shareholder cost principles, including a reasonably comprehensive listing of types of costs that are normally shareholder costs

European JTPF Paper

- Key provisions (cont.)
  - Description of information taxpayer should provide with regard to low value adding services which is more limited than typical documentation rules
  - Essential information usually includes a narrative describing costs included; identification of shareholder costs; allocation methodology; governing agreements; invoicing; and information on the calculation.
  - Guidance on typically utilised allocation keys for certain specific classes of low value service costs

European JTPF Paper

- Key provisions (cont.)
  - Recognition that mark-up should not be a contentious issue and that experience suggests that arm's length mark-ups fall in the 3 – 10 % range with 5% being a common figure
  - **Cost is more important than the mark-up**
  - Listing of intra-group services that "may or may not" fall under the rubric of low value services

India

- IT Development services: OP/OE 20 or 22 % depending on whether the quantum of transactions does not or does exceed INR 500 crores (USD 80 million)
- Provision of information technology enabled services (ITES) services: OP/OE 20 or 22 % depending on whether the quantum of transactions does not or does exceed INR 500 crores (USD 80 million)
- Provision of Knowledge Process Outsourcing services (KPO): OP/OE 25 %
- Financial transactions and provision of intra-group loans: base rate State Bank of India on 30th June of the relevant previous year plus 150 or 300 basis points depending on whether the amount of loan does not or does exceed INR 50 crores;

India

- Provision of corporate guarantee: 2 % or 1.75 % per annum depending on whether the amount guaranteed does not or does exceed INR 50 crores
- Provision of certain software R&D: OP/OE 30 %
- Provision of certain Pharmaceutical R&D: OP/OE 29 %
- Manufacture and export of core auto components: OP/OE 12 %
- Manufacture and export of non-core auto components OP/OE 8.5 %

India

- Some features of the SH regime
  - Even where a taxpayer opts for the safe harbour, it should continue to maintain contemporaneous documentation and furnish the transfer pricing certificate from a chartered accountant in Form 3CEB.
  - Where a taxpayer opts for safe harbour scheme, it is precluded from seeking recourse to Mutual Agreement Procedure.
  - Safe harbour rules would not apply if the eligible international transaction is entered into with an associated enterprise located in notified jurisdictions or low tax country (i.e. where the maximum rate of income tax is less than 15%)

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Japan

- Certain intra-group services: at cost
- drafting and management of budgets; accounting, tax, and legal tasks; management and collection of credit; operation, maintenance, and management of information and communications systems; management of cash flow and solvency; management and raising of funds; hiring, assignment, and training of employees; administrative tasks related to employee compensation and insurance, etc.; certain advertising; and other general administrative tasks.

Japan

- Other conditions:
  - the service does not comprise a substantial proportion of the business activities of the service provider or recipient;
  - the expenses required for the provision of the service do not comprise a "substantial portion" of the expenses of the service provider;
  - the service provider does not use its intangible assets in providing the service; and
  - the calculation of direct and indirect costs of providing the service is based on rational allocation factors, such as the ratio of assets used or of personnel involved, etc

Mexico

- Maquiladora SH operational since 2000
- A profit representing at least 6.9 % of the assets used in the maquila activity (both its own and those owned by the non-resident) (Return on Assets or ROA) or
- A profit representing at least 6.5 % of the costs and expenses incurred by the maquiladora

Singapore

- Benchmarking study in principle required, however …
- In practice: 5% mark-up for routine and low-risk service transactions

United States Approach

- Benefit test / shareholder activity definitions generally consistent with OECD TPG definitions
- Attempt is made to identify routine or low-value services which are permitted to be charged either at cost or with an arm's length markup at taxpayer's option

  -- "Black" list of services that do not qualify

  -- "White" list of services that do qualify

  -- Low margin test for services on neither list
- Overriding requirement that taxpayer must conclude that the low value services do not "contribute significantly to key competitive advantages, core capabilities, or fundamental risks of business success or failure."

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United States Approach

- “Black”list of non-qualifying services includes:
  - Manufacturing
  - Production
  - Extraction, exploration or processing of natural resources
  - Construction
  - Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement
  - Research, development or exploration
  - Engineering or scientific
  - Financial transactions including guarantees
  - Insurance or reinsurance

United States Approach

- “White”list is quite long
- Focuses on corporate overhead items
- Intermediate class of non-listed low-value services constitute anything with a lower than 7% median cost plus margin determined through reference to comparables

United States Approach

- Broad and inclusive definition of costs

"Total services costs means all costs of rendering those services for which total services costs are being determined. Total services costs include all costs in cash or in kind (including stock based compensation) that, based on analysis of the facts and circumstances, are directly identified with, or reasonably allocated … to the services. In general, costs for this purpose should comprise provision for all resources expended, used, or made available to achieve the specific objective for which the service is rendered. Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not necessarily be conclusive regarding inclusion of costs in total services costs. Total services costs do not include interest expense, foreign income taxes, or domestic income taxes."

United States Approach

- Shared service arrangements
  - US regulations (Treas. Reg. Section 1.482-9(b)(7) permit shared service arrangements for the same class of services qualifying for charge at cost
  - Rules essentially allocate shared service costs, without a mark-up, to all group members reasonably expected to benefit from the pool of shared costs
  - Limited administrative requirements
  - Allocation to be based on reasonably anticipated benefits

Other Country Experiences

- Several countries expressly prohibit deduction of management fees based on an allocation of head office costs.
- Others impose sufficient administrative / documentation hurdles that business believes deduction of head office costs is precluded as a practical matter.
- Virtually all countries require fact based demonstration of actual benefit to service recipient
- Several countries identified having a safe harbour or other special provision for low value added services in OECD survey of safe harbours
- Many countries list service fees as an issue often addressed in MAP
- Many business commentators identify headquarters cost charges / fees for routine services as an issue consuming inordinate compliance resources and leading to double taxation

SMALL AND MEDIUM SIZED ENTERPRISES

Taiwan

- Where
  - a company's annual operating and non-operating revenue is less than TWD 300 million or
  - the absolute value of total related-party transactions does not exceed TWD 200 million,

  the company may be exempt from preparing transfer pricing documentation
- However, companies are still required to provide "other supporting documentation", such as public tendering documentation, market price information, valuation reports, etc., sufficient to justify arm's length transfer pricing

United Kingdom

- Exemption from transfer pricing rules for the vast majority of transactions carried out by a business that is a small or medium sized enterprise
- Exceptions:
  - Transactions with parties in non-qualifying territories
  - SME elects to remain subject to TP rules
  - HMRC issues a TP notice
  - Patent box

European Union

- JTPF Guidance: Members States are invited to actively develop simplification measures to reduce administrative and SME compliance burden
  - consider the simplification measures already introduced by others and where possible introduce similar measures in their own Member States
  - Adapted documentation requirements

European Union

– inappropriate to impose documentation related penalties arising from an audit requirement to provide documentation that was not required pre-audit, if the taxpayer was acting in good faith, relying on the streamlined approach, and is not able to supply the required documentation
– ensure that when SMEs are audited for transfer pricing purposes they receive appropriate treatment. Internal peer group reviews or structural organisation of audit resource are put forward as cost effective means of achieving that objective

European Union

- Dispute resolution and SME
  - Tax Authorities are requested to make use of their authority to act unilaterally in resolving transfer pricing double tax in SME cases
  - Fast track dispute resolution processes are encouraged in resolving non complex low value SME claims to relief from double tax
  - Alternative approaches to dispute resolution including auditor to auditor contact and de minimis limit rules should be explored and implemented by tax administrations where appropriate in the framework of MAP and Arbitration process

SMALL TRANSACTIONS

Indonesia

- Exemption from documentation requirements
  - Related party transactions with a cumulative value < IDR 10 billion (880,000 USD – 640,000 EUR)

RISK ASSESSMENT

Luxembourg

- No TP analysis for transactions under 25 million EUR if the taxpayer reports a profit (Luxembourg)

United Kingdom

- Will be considered low risk in RA process:
  - Low value services provider with a mark-up around 5-10 %
  - Simple distribution functions for overseas manufacturers with a Return on Sales (ROS) of 3 – 5 %

Uruguay

- Interquartile ranges: 5 % tolerance margin to median
  - Exempt from adjustments if margin falls within tolerance margin

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INTEREST DEDUCTIONS / THIN CAPITALISATION

Argentina

- Thin capitalisation ratio 2:1 for related party loans (in the non-banking sector)
- the interest accrued on the excess part of the loan is non-deductible, and re-characterized as a dividend.
- Interest paid to foreign beneficiaries subject to a final 35 % withholding tax is excluded from the thin capitalization test and deductible without restrictions.

Albania

- Thin capitalisation 4:1 ratio
- Not applicable to banks, insurance companies and finance lease

Cameroon

- Overall debt to equity ratio with regard to such shareholders must not exceed 1.5:1; and
- Interest payments must not exceed 25% of the gross operating profit
- Excess: not deductible

People's Republic of China

- 5:1 ratio for financial enterprises
- 2:1 ratio for any other enterprises
- Interest paid to related parties below the threshold are allowed as deductible expenses
- Calculated on a monthly average basis

Czech Republic

- 6:1 ratio for banking and insurance companies
- 4:1 ratio for other enterprises
- The thin capitalisation rules also apply to financing costs with regard to credits and loans between related parties arranged through a third-party intermediary.
- The deduction of financing costs accrued on profit-participating credits and loans is fully disallowed.
- Loans used for the acquisition of fixed assets and any interest-free loans are not treated as debt for thin capitalisation purposes.

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France

- Cumulative three-step test:
  - the overall indebtedness (related party debt-to-equity ratio) of 1.5:1.;
  - the total amount of interest paid to associated companies exceeds 25 % of its income (before taxation); and
  - the amount of interest paid to associated companies exceeds the amount of interest received from such associated companies.
- Interest exceeding the higher of the above limits is not tax deductible, but can be carried forward within certain limits. Further, the interest deduction is reduced by 5 % annually from the second year of the carry-forward period.
- As a safe haven measure, interest is fully deductible if the company can demonstrate that its own total debt (related and third-party) does not exceed the worldwide group's debt. Also, the interest limitations do not apply to certain financial transactions and to small transactions the non-deductible interest of which is less than EUR 150,000.

Gabon

- 0.5:1 ratio with respect to joint-stock companies and limited liability companies, interest paid to partners or shareholders who, de jure or de facto, manage the enterprise may only be deducted insofar as the overall indebtedness, with regard to such partners or shareholders, does not exceed half of the paid up capital.
- 1:1 ratio - excess interest is deductible up to an amount computed with reference to the central bank rate increased by 2 percentage points and provided that the company's share capital is fully paid up.

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Japan

- 3:1 ratio; also on
  - back-to-back loans from overseas controlling shareholders through third parties;
  - debts from a third party with a guarantee by overseas controlling shareholders; and
  - debts from a third party by providing bonds borrowed from overseas controlling shareholders as collateral for the debts.
- Interest on excess amount of loans is not deductible
- In lieu of the 3:1 ratio, a company may use the debt-equity ratio of a comparable resident company if a higher ratio is available. A non-resident company engaged in trade or business in Japan through its branch is also subject to the thin capitalisation rule.

Latvia

- Ratio 4:1
- The ratio does not apply to interest paid:
  - To credit institutions resident in Latvia or elsewhere in the EEA or in a country with which Latvia has a tax treaty in force, from the World Bank Group, the Latvian state treasury, the Nordic Investment Bank, the European Bank for Reconstruction and Development, the European Investment Bank or the Council of Europe Development Bank;
  - by credit institutions or insurance companies; and
  - on loans from financial institutions that (i) are resident in Latvia, another EEA country or a country having a tax treaty in force with Latvia, (ii) provide borrowing or financial leasing services, and (iii) are under the supervision of the regulatory authorities of their state of residence.

Papua New Guinea

- 3:1 ratio for mining, petroleum and gas businesses

Peru

- 3:1 ratio
- Excess interest not deductible

South Africa

- No safe harbour, but reference to what an arm's length lender would be likely to have been willing to lend to the borrower

South Korea

- SH interest rate between resident taxpayers

Tanzania

- 7:3 ratio
- Excess interest disallowed

Turkey

- 3:1 Ratio
- Re-characterisation of interest into hidden profit distribution (dividend)

Uganda

- Debt-to-equity ratio of more than 2:1, any deduction of interest payments to its foreign controller or foreign associates will be disallowed to the extent that they are above the allowed ratio
- No re-characterisation of interest

United Kingdom

- Arm's length capitalisation

Q & A

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