The **BEPS** Monitoring Group

Submission to the

Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing
of the
United Nations Committee of Experts on International Cooperation in Tax Matters

on

REVISION OF THE UN PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES

These comments have been prepared by the BEPS Monitoring Group (BMG) in response to the invitation from the co-chairs of this Subcommittee. The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organisations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Sol Picciotto, with contributions and comments from Alexander Ezenagu, Tatiana Falcão, Jeffery Kadet, Tovony Randriamanalina and Attiya Waris.

We appreciate the opportunity to provide these comments, and we are happy for them to be published.

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SUMMARY

We suggest that the Subcommittee should give high priority to a study of possible simplified transfer pricing methods. A large number of developing countries have enacted regulations on transfer pricing very recently. Many, especially least developed countries, are still considering how to formulate an enforcement strategy. Transfer pricing is an important area for developing countries, which are particularly dependent on corporate income tax revenues, especially from multinational enterprises (MNEs) that conduct activities integral to their worldwide operations within these countries' borders and use local infrastructure and government services. Yet the application of transfer pricing rules requires considerable resources of skilled staff, which are often non-existent or at best in short supply in developing countries. This problem is greatly exacerbated by the approach adopted in the OECD Transfer Pricing Guidelines, which requires an individual 'functional analysis' of each enterprise. This requires expert understanding of each company's business model and international structure, as well as of the transfer pricing rules. This is a daunting task for tax authorities even in rich countries, let alone those which are poor and less developed. The UN

Practical Manual currently does include several mentions of some simplified methods, but this has not been done comprehensively or systematically.

The first section of this paper outlines the background of the development of transfer pricing rules, aiming to explain the reasons for current approaches, and analyzes the problems they create. The second section discusses the experience with simplified methods especially of some leading developing countries, and it puts forward some other suggestions which should be explored.

A. General Comments

1. Aims of the Manual

We note that the mandate of the Subcommittee states that its work should reflect 'the realities for, and the needs of, developing countries, at their relevant stages of capacity development (...) and the issues and options of most practical relevance to them', and particularly 'the special situation of least developed economies'. These needs are especially acute in the area of transfer pricing at this juncture, for two important reasons.

First, many least developed countries have very recently introduced regulations on transfer pricing, and they are greatly in need of practical guidance on how to implement them. For example, in Africa 17 out of 54 countries have specific transfer pricing laws, although of those only 4 have transfer pricing regulations. Ten have set up transfer pricing units, while some, like Rwanda, have decided not to have a dedicated unit. Some, such as Kenya, have had considerable support in capacity building, but need to reflect on their experience so far, and help others draw on this experience. Others are at an even earlier stage, and they need to design an enforcement strategy. We may take the example of Madagascar, which enacted such regulations in 2014, but has not yet formulated an enforcement strategy. It has made explicit reference to the arm's length principle and included the 5 different methods embodied in the OECD Transfer Pricing Guidelines (TPGs), worded in very broad terms. Following this, the Malagasy Revenue Authority set up a department on international taxation composed of 6 tax inspectors, none of whom have specialist skills in transfer pricing. In 2015, the Authority trialed its first transfer pricing cases, and requested external technical and legal support in 2016. Practical guidance is clearly lacking and there is great need for an enforcement strategy.

Secondly, there have been major changes in international tax rules, mainly resulting from the G20/OECD project on base erosion and profit shifting (BEPS), including substantial revisions of the OECD TPGs. We note here that the mandate states that the Manual must 'reflect[s] the operation of Article 9 of the United Nations Model Convention, and the Arm's Length Principle embodied in it, and [be] consistent with relevant Commentaries of the U.N. Model'. It should be recalled that although the 2001 version of the Commentary to the UN model recommended following the OECD TPGs, ensuing versions have not. Instead, it has included sections explaining the approach adopted by some leading developing countries. These include Brazil, which has applied transfer pricing rules which OECD countries regard as not fully aligned with the TPGs. Yet, Brazil's methods were designed to be compatible with article 9, and they are widely regarded as being so, even if they are regarded by OECD countries as out of line with the TPGs.

Hence, the Subcommittee is free to consider approaches outside those approved in the OECD TPGs, as long as they are compatible with article 9. It is nevertheless also important that the subcommittee should 'draw[s] upon the work being done in other fora', and 'give due

consideration to the outcome of the OECD/G20 Action Plan on Base Erosion and Profit Shifting as concerns transfer pricing', as stated in its mandate.

The Subcommittee has been instrumental in bringing to attention what in the past were considered to be 'alternative approaches', such as the Brazilian approach cited above and the commodities price method (also known as the sixth method). This has resulted in some revision of traditional practices, even if only in a modified manner (for example, the commodities price method is currently accepted as an OECD method under the CUP). The Subcommittee should continue to fulfill that role and instruct the tax policy debate on transfer pricing through its mandate.

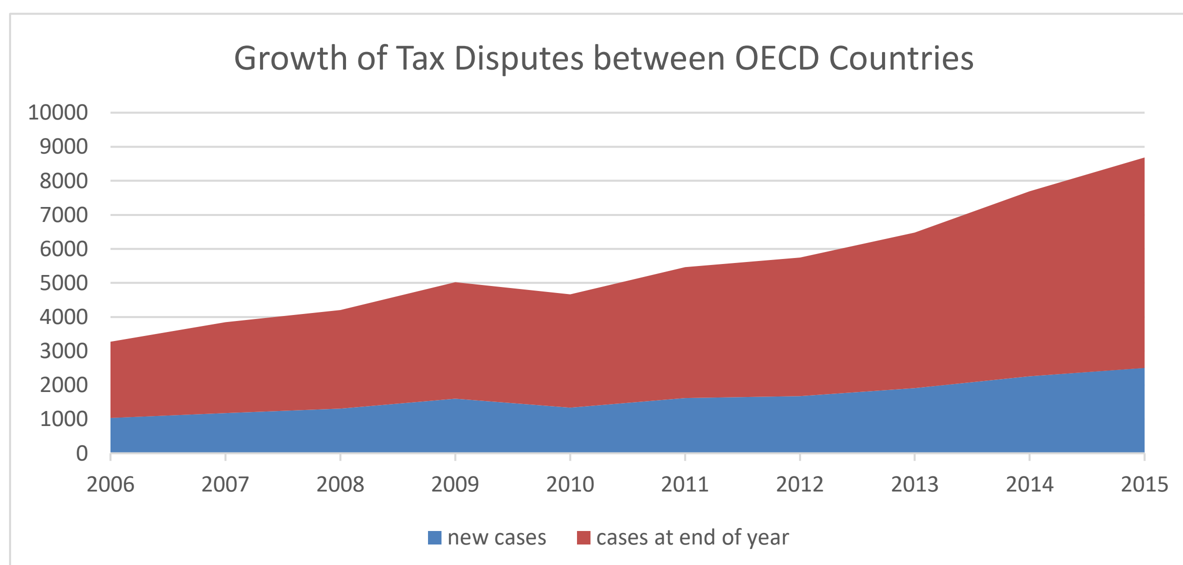
The Subcommittee should also reach out to regional intergovernmental tax bodies such as CIAT and ATAF in order to inform its work-flow and match the policy development process to the real issues currently being faced by developing countries.

In our view, it is essential that the UN Committee both consider alternative approaches and continue to perform its role of reflecting on the work of the OECD, and subjecting it to critical scrutiny, from the perspective of its practical suitability for developing and particularly least developed countries.

2. Remedying the Defects of the OECD Guidelines

The OECD TPGs were adopted in 1995, following major disagreements about the application of article 9 among OECD countries. Consequently, they embody many uneasy compromises. They endorse five different transfer pricing methods, which are discussed at some length, but they include little or no practical guidance on how to develop an enforcement strategy. Indeed, an effective strategy is made very difficult by the basic approach adopted. The TPGs are founded on the need to carry out an individual 'facts and circumstances' analysis of the functions performed, assets utilized and risks assumed, not only for each entity within an MNE group, but also for each product or line of business that each entity conducts. This ad hoc approach depends on subjective judgment, leaving great room for discretion, and creating considerable potential for conflict as well as uncertainty for taxpayers. It is notable that there has been a continuing rise amongst OECD countries during the past 20 years in tax disputes, the bulk concerning transfer pricing, and an even greater increase in the time taken to deal with them (see Figure 1).

Figure 1



Source: OECD MAP statistics, available at http://www.oecd.org/tax/dispute/map-statistics-2006-2015.htm Data collected for years from 2016 separate transfer pricing from other disputes, showing that of the 8002 cases open at the start of 2016, 56% concerned transfer pricing, and these disputes take on average around twice as long to resolve; see http://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm

The approach also creates enormous administrative burdens for both taxpayers and tax administrations. However, relatively speaking, the compliance costs fall far more heavily on tax authorities, due to information asymmetry. A company will always know more about its own business and its sector than any outsider, especially tax authorities who have little background in the industry of the MNE and no detailed knowledge of the taxpayer's operations. Although the formal legal burden is often on the taxpayer to justify its accounts (see Manual section B.8.6), in practice the reverse is the case. If the taxpayer prepares and documents a transfer pricing structure, usually with the help of a specialist team of advisers, the tax authority cannot challenge it without producing a credible alternative. To apply functional analysis, tax authorities need staff who not only are familiar with the legal and economic techniques needed to interpret and apply the transfer pricing rules, but also have sufficient background to understand the taxpayer's industry segment and business model well enough to analyze the documented transfer pricing model, choice of method and selection of comparables. Matching the resources available to MNEs is impossible for tax authorities even from developed countries (which are often under-resourced), let alone poor developing countries.

Unfortunately, the changes in the TPGs resulting from the BEPS project have exacerbated this problem, making them more complex and in many respects more obscure and difficult to apply.[1] The starting point for transfer pricing audits is still the contracts executed between associated enterprises. Such agreements have most typically been specifically drafted in a self-serving manner meant to implement carefully thought-out tax structures that minimise reported income in medium and higher tax countries and maximise it in tax havens and low-taxed countries. These agreements are still the starting point under the TPGs, even if such transactions are not seen between unrelated parties.[2]

The focus on these self-serving, often artificial agreements allows MNEs to make formal transfers of capital, ownership of intangibles and the responsibility for managing risk, to different group entities. Although the revised TPGs now give powers to disregard those contracts, to do so the tax authorities must conduct a factual analysis to determine if the actual conduct of the parties diverged from the formal contractual arrangements, and they must show that the transactions were commercially irrational. These requirements create such a Herculean task that tax authorities will seldom be able to effectively utilise this ability to disregard agreements and transactions within the terms of the TPGs.

The most authoritative account yet published of the effects of the BEPS project revisions to the TPGs is by Joe Andrus (head of transfer pricing at the OECD during most of the BEPS work) and Richard Collier (an experienced practitioner).[3] Their analysis shows how, due to disagreements among participants in the BEPS project, the TPGs have become even more uncertain and obscure. They conclude that the result has been to make the transfer pricing

[1] The report on BEPS Actions 8-10 (OECD, 2015) included revisions to chapters I, II, VI, VII and VIII of the TPGs, which were incorporated into the version issued in 2017, which is now over 600 pages. All the final reports on the BEPS Action Plan are available at http://www.oecd.org/ctp/beps-2015-final-reports.htm.

[2] 'Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised' (OECD TPGs 2017: para. 1.122); see the criticisms by Andrus and Collier 2017 (note 3 below): paras. 6.14, 7.43).

[3] J. Andrus and R. Collier, *Transfer Pricing and the Arm's Length Principle After BEPS*, (Oxford University Press, 2017).

process 'far more complex', mostly due to the 'level of factual detail' now required for the functional analysis.[4]

The TPGs accept that this approach creates practical administrative problems. They stress from the outset that 'the objective [is] to find a reasonable estimate of an arm's length outcome', and that 'transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer' (OECD 2017: para. 1.13). However, the TPGs do not include any practical suggestions for simplified approaches which could reduce the administrative burden, because of their rigid adherence to the need for a case-by-case functional analysis. Chapter IV includes a section on 'safe harbours', which were considered 'not compatible … with the arm's length standard' until this chapter was revised in 2013. The present version still has a very restricted view of safe harbours. In particular, it emphasizes that they should be elective for the taxpayer, and they should be negotiated bilaterally or multilaterally. Strict compliance with these conditions makes safe harbours impractical or ineffective in all but a few situations.

The UN Manual also echoes this view (para. B.8.8.1). It includes a short account of India's safe harbour regime introduced in 2013, but does not discuss India's experience with this regime, nor the revisions made in 2017. This clearly needs updating. It also lacks discussion and analysis in the body of the Manual of the experience of other developing countries, such as Brazil, Mexico and the Dominican Republic. OECD Working Party VI is conducting a review of chapter IV, which may include revision of the section on safe harbours. In our view, the Subcommittee should also review these parts of the Manual, although as part of a wider consideration of simplified approaches, which we will discuss in Part II of this submission.

3. Restoring the Primacy of Article 9

Article 9 originated from the report of a study carried out for the League of Nations Fiscal Committee coordinated by William B. Carroll in 1932-33. The Carroll report on *Methods of Allocating Taxable Income*,[5] found that many countries had enacted broad powers for their tax authorities to adjust the accounts of related companies in a multinational group, while others used general anti-avoidance rules for that purpose. Hence, the Fiscal Committee proposed treaty provisions to authorize such adjustments. They were aimed at preventing 'diversion' of profits due to the close relations between entities under common control. Since these were seen as creating 'conditions different from those which would have been made between independent enterprises', the article authorized restoration of any such diverted profits. The wording of article 9 remains substantially the same today. It should be noted that this wording does not require related entities to be treated *as if they were independent*. On the

[4] Andrus and Collier 2017 (op. cit.), paras. 7.70-71. They trace in detail how, due to these disagreements the TPGs have been made more complex and unclear on the key points. These include (i) the notion of control of risk ('very complex', ibid., para. 6.35; 'most confusing' para. 7.32; imposing 'only limited burdens on MNEs desiring to transfer risk to tax advantaged locations' para. 7.13, and leaving 'clear potential for heated disagreement' para. 7.16); (ii) the returns which can be attributed to a cash-box entity ('quite mysterious' para. 6.46, 'most confusing' para. 7.32, will 'give rise to substantial amounts of controversy' para. 7.31, and leaving 'a rather confused muddle, at least for now' para. 7.42); and (iii) how to allocate the difference between projected and actual returns from an intangible ('far from clear, para. 7.56, 'manifestly inadequate' para. 7.58). They conclude that the result has been to make the transfer pricing process 'far more complex' (para. 7.70), mostly due to the 'level of factual detail' now required for the functional analysis (para. 7.71).

[5] *Taxation of Foreign and National Enterprises. Volume 4: Methods of Allocating Taxable Income*, (League of Nations, Document No. C.425(a).M.217(a). 1933. II.A1933), available at http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=cartaxa.sgml&tag=law&images=acdp/gifs&data=/usr/ot&part=0 .

contrary, the rationale for the power to adjust accounts is the understanding that associated enterprises are not independent because of the close relations amongst them.

The aim of Article 9 was, and remains, to ensure an appropriate *level of profit*. Carroll's survey showed that national tax authorities used two methods to evaluate whether the level of profit of a PE or an affiliate was appropriate. One was by comparing the level of profits with those of other companies engaged in similar business activities, which he termed 'empirical' methods. Usually, this meant applying a standard profit margin as a percentage of turnover. The second was by allocating a suitable proportion of the overall profits of the MNE, which Carroll termed the 'fractional' method. The fractional apportionment method was explicitly permitted for attribution of profits to permanent establishments (PEs) in the League's model convention. This was removed from the OECD model only in 2010, but remains in article 7(4) of the UN model, and in many current treaties.[6] Neither of these methods entailed comparing the prices charged between related entities with comparable transactions between independent parties. The focus was on the appropriate level of profits: the adjustment of accounts was a means to that end, and it did not necessarily involve transaction prices. The broad powers of adjustment in national legislation also focused on the level of profit, and they did not refer to transaction pricing. These provisions have also remained largely unchanged in some countries to this day.[7]

The shift towards focusing on transaction pricing originated in the US regulations of 1968. At that time, however, other OECD countries rejected this approach.[8] Renewed concern in the 1970s about profit-shifting by MNEs led the Committee on Fiscal Affairs, at the request of the OECD Council, to produce its report on Transfer Pricing in 1979. This report recommended the adoption of rules largely based on the US regulations of 1968, specifying use of the comparable uncontrolled price (CUP), cost-plus and resale-minus methods. However, it acknowledged that these would often be impracticable due to 'the complexities of real life business situations', so that other methods may have to be used to 'produce a figure which is acceptable for practical purposes' (para. 13).

Indeed, US experience of the application of the 1968 regulations confirmed the lack of comparables and the need to resort to 'other' methods. This was shown by studies done by the US Treasury in 1973, the Congress in 1981 and the IRS in 1984.[9] Due to these problems, the US Treasury proposed in 1988 to restrict use of the CUP to exact comparables, and put forward a comparable profit method, to apply a benchmark rate of return to capital assets or another suitable base.[10] However, this would attribute relatively low profit margins to foreign affiliates of US MNEs, so it led to conflicts at the OECD in 1992-4. The issues were resolved

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[6] R. S. Avi-Yonah and Z. P. Tinhaga (2014) *Unitary Taxation and International Tax Rules*. International Centre for Tax and Development: ICTD Working Paper 26.

[7] The US provision enacted in 1928, allowed adjustments 'in order to prevent evasion of taxes or clearly to reflect the income' of the company concerned; this remains in s.482 of the tax code, with only one revision in 1986. The French provision of 1933, empowering the adjustment of accounts of entities under common control to restore profits which have been 'indirectly transferred', also remains in article 57 of the tax code. Similar provisions were enacted in francophone countries, although in recent years there has been a tendency to refer more explicitly to the OECD TPGs, or the methods it specifies.

[8] A report by a working party consisting of the UK and the Netherlands pointed out that deciding on whether a transaction is truly comparable would always depend on a wide range of factors specific to each case. It concluded that it would not be possible to propose 'rules of general application for determining an arm's length price' (OECD 1967, *Report on the Apportionment of Profits of Permanent Establishments and Associated Enterprises,* document FC/WP7 (67) 1).

[9] Data summarised on p. 198 of S. Picciotto, *International Business Taxation* (1992), available at http://taxjustice.blogspot.be/2013/06/international-business-taxation.html.

[10] See MC Durst and RE Culbertson, 'Clearing Away the Sand; Retrospective Methods and Prospective Documentation in Transfer Pricing Today' (2003) *NYU Tax Law Review* 57: 37-136

by a compromise. The TPGs finally produced in 1995 included a version of the US comparable profits method, named the transactional net margin method (TNMM). They also provided for a profit split method, which could be used especially where comparable transactions between independent parties could not be identified, or the related party operations were highly integrated.

The 1995 TPGs stated (para. 3.55) that due to lack of experience with these methods in many countries, and concerns about them, the Committee on Fiscal Affairs would 'undertake an intensive period of monitoring' of both the traditional transaction methods and the profit methods. However, although work was done on other issues (including intangibles, cost contribution arrangements, and business restructurings), the profits-based methods were not revisited until 2007-8, and then only cursorily.[11] It was noted that these methods were being used far more frequently than expected, and a recommendation was made that they should no longer be considered a last resort. No effort was made to develop these profits-based methods. Instead, further work was done on refining the procedures for analysing comparability.

The focus on the pricing of transactions based on comparables is particularly unsuitable for intra-firm relations which do not involve transfers of physical goods: intangibles, services, finance and risk. For an integrated firm, capital, technology, central services and risk management are shared factors of all business activities. Such factors should be treated as overhead costs to be shared. These issues continue to present the biggest problems in transfer pricing,[12] since they are core centralized functions in MNEs. For example, MNEs have a central Treasury function which closely controls the allocation of funds within the group. Research and development, though often taking place throughout the firm, is closely coordinated, and technology and know-how are shared. Risk is ultimately borne by any reasonable economic measure by the parent company and its shareholders. In practice, MNEs virtually always in practice stand behind the debts of wholly-owned subsidiaries, even if they close down their operations.

As regards finance, the BEPS project Action 4 recommended an approach outside the arm's length principle to deal with interest deductibility: a fixed cap coupled with a group ratio rule. The OECD is currently consulting on revisions of the TPGs on complementary transfer aspects of intra-group finance. Many developing countries still apply thin capitalization rules, specifying a debt/equity ratio; but since this ratio is easily adjustable for a wholly-owned affiliate, they can be circumventedfs. Although consideration of interest deductibility may be beyond the scope of work of this Subcommittee, consideration should be given to revising the references to thin capitalization in the Manual, and perhaps to related aspects of intra-group finance, including the interest cap and group ratio rule described in BEPS project Action 4.

Unlike the OECD TPGs, the UN Manual includes an excellent introductory section (Part A), discussing the theory of the firm and organizational structures, including value chains, and the relationship of firm structures to transfer pricing. However, we suggest that the Subcommittee should consider some redrafting of the first sections of Part B, to clarify the relationship between this discussion of the business structure and transfer pricing rules dealt with in the remainder of the Manual. At present, Part B begins by focusing immediately on the pricing of transactions, whereas the primary purpose of article 9 is to ensure an appropriate allocation of income, and the adjustment of transaction prices is only a means to that end. Revisions to the first section of Part B could include discussion of differences in

[11] OECD, *Transactional Profit Methods. Discussion Draft for Public Comments,* Centre for Tax Policy and Administration (OECD, 2008).
[12] See Andrus and Collier, 2017, ch. 6.

treatment between the allocation of joint or overhead costs and the pricing of actual transfers of physical goods or provision of services. For example, in our view if apportionment of some central service costs is considered acceptable, this should be considered as an allocation charge and not as a transaction, so it is not appropriate to add a profit mark-up. Generally, however, it is not appropriate to apportion joint costs if one-sided methods are used to attribute profits.

Another aspect which could be clarified, which is particularly important for the development of simplified methods, is the relationship between the selection of the most appropriate method and deductions for intra-firm transactions. Where the method chosen is a one-sided method or a simplified method, which aims to establish a benchmark profit margin, both deductions and scrutiny of transactions will often be unnecessary, depending on the choice of benchmark. Indeed, the central aim of simplified methods should be to avoid the need for the time-consuming and often illusory search for comparable transactions.

In the second part of this paper we sketch out some possible simplified methods which the Subcommittee could consider for inclusion in the Manual. These would offer a range of possibilities which developing countries could consider adopting as part of a transfer pricing enforcement strategy. Selection of one or more appropriate methods, and its refinement, would of course depend on each country's own circumstances, depending on the characteristics of its economy, the type of presence of MNEs, and its level of capacity in international tax and transfer pricing. We hope that regional groupings of countries as well as the members of the Platform for Collaboration on Tax will encourage the adoption of these simplified methods.

B. SPECIFIC TOPICS

1. Safe Harbours

We suggest that the Subcommittee should update the discussion of Safe Harbours in the Manual (sections B.1.7.5 and 6, and B. 8.8). The current version follows the current OECD TPGs in stressing that safe harbours must be elective for the taxpayer. Largely as a consequence, the main type of safe harbours envisaged in the TPGs relate to documentation requirements and exemptions from transfer pricing rules for small enterprises or low-value transactions. The Manual rightly points to the great advantages of safe harbours, for both tax administrations and taxpayers, in both reducing compliance costs and providing certainty. However, it emphasizes the need to balance these advantages against the disadvantages, and the general tone of the discussion is very discouraging.

In our view, there is a need to rethink the approach to safe harbours, and to help facilitate their use. This could include, importantly, relaxing the strict requirement that they should only be optional or elective for taxpayers, which very much undermines their effectiveness. Where a taxpayer decides that a particular safe harbour will cost too much in extra tax, it will apply a normal transfer pricing method, thereby forcing the tax authority back into the morass of detailed fact finding, functional analysis, and the issues that local tax authorities are simply not able to deal with due to resource constraints.

This seems to have been the experience of India, which is mentioned briefly in para. B.8.8.8. The scheme introduced by India in 2013 had very little take-up, resulting in its redesign in 2017. It is perhaps too early to tell whether the new version will be more successful, but the signs suggest that there may again be a low acceptance rate.

The design of safe harbours should be viewed as a collective action problem. A properly designed safe harbour should be of general benefit to those taxpayers it covers, as well as the

tax authority. The experience of countries such as India, Mexico and the Dominican Republic shows that an appropriate safe harbour should be designed to apply presumptively, though applying on an opt-out basis. The possibility of opting out should cater solely for exceptional or unusual cases. The taxpayer would thus be allowed to rebut the presumptive safe harbour method, but only on grounds which should be strictly defined. This possibility is mentioned in the OECD TPGs, which mention that 'a rebuttable presumption might be established under which a mandatory pricing target would be established by a tax authority' (para. 4.104).

This is the approach adopted by some developing countries, notably Mexico and the Dominican Republic. These involve a kind of hybrid of safe harbours and sectoral Advance Pricing Arrangements, and they will be discussed in the next section.

2. Sectoral Advance Pricing Arrangements as Safe Harbours

Mexico has adopted with some success a combination of safe harbours and a sectoral Advance Pricing Arrangement (APA) for its maquila sector. A blanket or sectoral APA, unlike a program to grant individual APAs, can help a tax administration use its scarce resources more effectively. This is particularly so when it is applied on an opt-out rather than an opt-in basis.

So-called maquilas or maquiladoras are sub-contracting export-processing firms generally owned by foreign MNEs, mostly from the USA. They date back to the 1960s, but received a boost from the NAFTA, with their number climbing from 1,920 in 1990 to 3,630 in 2001, falling back to 2,810 in 2006, and rising again to 5,055 by 2012, by then employing 2m workers.[13] They became established due to tax incentives, with exemptions from import duties for temporary import of machinery, equipment, parts and material, and from VAT if the finished goods are exported. Commonly maquilas use imported machinery, equipment and inventories owned by the foreign parent corporation, which ensured exemption from Mexico's asset tax (levied at 1.8%), in the proportion that the production was exported,[14] although that tax is now no longer in force.

Initially, the maquilas were taxed under the general law, apparently based on a margin of 2-5% on their operating costs, mainly payroll.[15] Since the Federal Tax Law of 1981 Mexico had a broad definition of a PE, so a maquila could be treated as an agent PE of its foreign parent, as well as being taxable itself. However, the standard for attribution of profits for such a PE was uncertain, and in view of the dependence of the sector on the US, it was hard for Mexico to determine this unilaterally.[16] The tax treaty negotiated with the US in 1992 that came into force in 1994, included a special provision (article 5(5)), that an entity could be considered an agent PE if it habitually processes goods for a foreign enterprise using assets furnished, directly or indirectly, by that or an associated enterprise. This was intended by Mexico to resolve any doubts that a maquila constitutes a PE of its US parent.[17]

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[13] S. Dorocki and P. Brzegowy, 'The maquiladora industry impact on the social and economic situation in Mexico in the era of globalization', in M. Wójtowicz and A. Winiarczyk-Raźniak (eds), *Environmental and socio-economic transformations in developing areas as the effect of globalization* (2014), pp 93-110. (Kraków: Wydawnictwo Naukowe UP).

[14] OECD (2003), *Peer Review of the Mexican Transfer Pricing Legislation and Practices*. Working Party 6, at p. 46.

[15] Ibid., p. 48.

[16] Schatan R. (2002), 'Régimen tributario de la industria maquiladora, Comercio Exterior', *Bancomext* 52: 916-926, at p. 920.

[17] P. D. Morrison (1993), 'The U.S.-Mexico Tax Treaty: Its Relation to NAFTA and Its Status', *United States-Mexico Law Journal* 1: 311-319, at p. 316.

Since there was no agreed international methodology for attributing profits to a PE, Mexico might have adopted a fractional apportionment method. Instead, in 1994 Mexico introduced special rules for the maquilas. These provided a safe harbour, allowing exemption from the PE provision, subject to a tax at 5% of all assets, including foreign owned, with the alternative of seeking an individual tax ruling or APA. Regrettably, this proved ineffective, since only labour-intensive entities opted for the safe harbour, which taxed them at a relatively low rate, while capital-intensive firms with significant assets requested an APA.[18]

Hence, in 1998 Mexico decided to phase out the safe harbour, and it negotiated an agreement with the US in 1999 under the MAP provisions of the treaty, to apply for three tax years. This provided for taxation of such entities at the higher of either (i) 6.9% of the assets used in the activity or (ii) 6.5% of operating expenses (excluding financing costs).[19] For taxpayers this also had the advantage of clarifying eligibility of Mexican taxes paid for a foreign tax credit. Taxpayers also had the alternative of applying for an advance ruling under Mexican law.[20]

In 2003, following the decline of the maquilas due to the US recession and a strong peso, Mexico dropped the requirement to seek an APA if the safe harbour was not accepted, and instead specified two alternatives, variations of the Cost Plus and TNMM methods, as well as an additional relief which would reduce the profits tax by half.[21] Following the sector's subsequent rapid growth, restrictions were reintroduced in 2014, including limitation of the PE exemption to income deriving wholly from export of products resulting from imported inputs, and ending the additional relief.[22] The tax authority also began closer scrutiny of claims to maquila status.[23] The transfer pricing rules were revised to introduce methods based on all five of those in the TPGs, and the only alternative to the safe harbours became applying for an APA, based on these methods. The resulting rapid rise in APA applications produced a backlog reaching 700 by 2016.

The Mexican tax administration therefore negotiated with the US IRS a 'framework agreement' establishing an agreed APA methodology.[24] This involved three steps: (i) distinguishing between labour-intensive and asset-intensive firms, based on a threshold of an assets/operating costs ratio of 2.08%; (ii) a detailed methodology for calculating costs, to which a mark-up should be applied (by sector, 3.49% for electrical, 4.84% for auto, and 4.25% for others); (iii) adding for labour-intensive firms 1.6% of the net book value of the machinery and equipment and inventory owned by the parent but physically in Mexico, while in the case of capital-intensive firms, an adjusted mark-up on total costs would be calculated, based on the sector, and their level of costs, expenses and operating assets, plus 2.4% of net book value of the machinery, the equipment and inventory owned by the parent but physically in Mexico. For both scenarios, the methodology agreed between Mexico and the US contemplates the exclusion of any financial effects that could distort the results of the maquila, given that the methodology was agreed on the basis that these entities in Mexico have a low risk profile.

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[18] Schatan R. (2002) 'Régimen tributario de la industria maquiladora', *Comercio Exterior. Bancomext* 52: 916-926.

[19] This is mentioned in Annex I to chapter IV of the OECD TPGs, added in 2013, as a precedent for the model Bilateral Safe Harbour MOUs that it provides.

[20] McLees J, Bennett MC and Gonzalez-Bendiksen J. (1999) 'Mexico and the United States Reach an Agreement on Maquiladora Taxation' *Tax Notes* 8 November, which provides the text of the agreement.

[21] OECD. (2003) *Peer Review of the Mexican Transfer Pricing Legislation and Practices*.

[22] Leon-Santacruz R and Lujan F. (2014) 'Implications for maquiladoras of the 2014 Mexican tax reform', *International Tax Review*, April.

[23] UN Manual 2017: 615

[24] http://www.sat.gob.mx/sala_prensa/comunicados_nacionales/Paginas/com2016_094.aspx .

This aims to provide 'fast track' approval for APAs, as an alternative to the safe harbours agreed in 1999, which remain in place. Although the APAs will be issued and monitored by Mexico, the US announcement stated that the outcomes will be accepted by the IRS. That announcement also stated that the agreement would be published, but this does not seem to have taken place.[25] It seems that the Mexican administration will offer the arrangement to companies that it considers are performing non-high value manufacturing functions within the maquila context. By retaining some control over when it is applied, the aim appears to be to prevent abuse, e.g. by sales into the domestic market.

This experience points to the importance of adopting a well-designed scheme, which is opt-out rather than opt-in, but preferably with reasonable terms that represent for taxpayers at least a small incentive for staying in. The uncertainty due to lack of a clear standard for attributing profits to a PE initially encouraged maquilas to accept the safe harbour but making it optional led to a sharp rise in applications for APAs unless the safe harbour rate is acceptable to taxpayers. The unsuitability of the single margin fixed in 1994 was corrected by the agreement of 1999 with the US, introducing a distinction between labour- and capital-intensive companies, and this was further refined in the 2016 agreement with a more detailed methodology, distinguishing between three major sectors. The bilaterally agreed safe harbour, taking the form of a bilateral APA, ensures a high level of take-up, though no doubt the agreed margins entailed some compromises between the two tax authorities. Some control is exercised over eligibility of firms for the safe harbour, to prevent abuse.

Another example which has been partly publicised is the approach adopted by the Dominican Republic to its all-inclusive or package hotel sector. The arm's length principle was enacted in 1992, and in addition the tax code had long-standing provisions (articles 65-66) allowing the tax administration, in cases where the taxpayer's declaration is false, inaccurate or unreliable, to make necessary adjustments. This was revised in 2006 to empower the tax administration to assess affiliates and PEs of foreign MNEs on the basis of the proportion of their gross revenues to those of the MNE as a whole, or in relation to their assets, and to adjust transfer prices with related entities by applying the independent entity principle.

The 2006 changes also made specific provision for the tax administration to negotiate an APA for the all-inclusive (package) hotel sector, to be represented by the National Association of Hotels and Restaurants. Enforcement of these provisions began in 2009, focusing audits especially on the all-inclusive hotels sector, which accounts for 2% of its GDP and 7% of exports.[26] The sector was selected because of its use of related marketing companies located in low-tax jurisdictions, while local financial statements and tax returns showed continued losses. Other inconsistencies included guest per night revenue rates declared which were often lower than operating costs, while the rates advertised on marketing sites were over 100% higher than these declared revenue rates.

The tax administration requested taxpayers in that sector to submit sworn affidavits, which were then subjected to verification. Where the submitted data seemed unreliable, assessments were issued, based on a methodology developed by the administration. Appropriate rates per night were obtained by an independent market research firm and, with deduction of transportation costs, were broken down by dates and season, and further by hotel categories and zones (obtained from ASANAHORES). Revenues estimated on this basis were subject to a 16% discount for sales taxes, 10% for the compulsory 'tipping' or labour cost levy, and

[25] The analysis here is based on a copy of the document, in Spanish, kindly supplied by the Mexican tax authority.
[26] CIAT (2013), *El Control de la Manipulación de los Precios de Transferencia en América Latina y el Caribe/ The Control of Transfer Pricing Manipulation in Latin America and the Caribbean*.

then 20% and 25% for the margin allowed for the marketing and tour operator intermediaries. Through this process, 73 audits, of 33 taxpayers, were carried out in 2009-11, for fiscal years 2005-10, representing half of all the registered all-inclusive hotels, mainly in zones A and B (Dominican Republic 2012: 4-6), and accounting for 83% of the revenues in the sector.[27]

Taxpayer objections to these assessments were rejected on administrative review, and an appeal went to the Superior Administrative Tribunal.[28] The administration's victory in this case enabled it to put pressure on all taxpayers in the sector to fall into line with the APA. Thus, a general framework was agreed in a memorandum of understanding (MOU) signed with the ASANAHORES in 2013 for three years, then revised in 2016.[29]

The MOU establishes three methods for pricing the all-inclusive hotel room sales (fixed rate, gross margin on costs, and net margin on costs and expenses), and a minimum effective tax rate of 2% on the income of the taxpayer, as well as reporting obligations. On this basis, each taxpayer must submit a request for an individual APA, to be valid for three years. This should specify the hotel's category (as defined by ASANAHORES), the method selected and the calculation of the room price - resulting from the application of the method - to be applied for the entire length of the agreement. The taxpayer should also provide its financial statements, number of occupancies in the previous years and any other relevant information substantiating the intra-group price determination. Taxpayers electing an APA do not need to provide detailed transfer pricing documentation. However, they must provide an annual report with sufficient information to verify compliance, including the number of rooms per type (e.g. standard, superior, suite), monthly occupancy, discount pricing strategy (e.g. children, or additional persons in a room), and total revenues from related and non-related parties.

The legislation also authorises a similar approach to other sectors with significant foreign ownership, such as insurance, energy and pharmaceuticals (República Dominicana 1992-: art. 281 Para. IV). However, this has not yet been done.

Like India and Mexico, a sectoral approach was adopted, described as a sectoral APA. In this case the negotiation was with an association representing the sector and not a treaty partner (the Dominican Republic has DTAs with only Canada and Spain). However, the tax administration put itself in a strong position by establishing a benchmark for the selected sector, which was well researched and hence survived challenge by the taxpayer in the administrative tribunal. The failure of the challenge may also be attributable to the evidence that the taxpayer had devised a structure which seemed aimed at avoidance. The approach adopted seems to have been successful, and data show a continual increase in tourist numbers and hotel rooms,[30] while government revenues from income and profit taxes increased between 2010 and 2016 from 2.7% to 4.1% of GDP, and from 22% to 29.9% of total tax revenues.[31]

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[27] Ibid. p. 62.

[28] *Inversiones Coconut, S. R. L. (Hotel Bahia Principe Punta Cana) v Dirección General de Impuestos Internos*, Sentencia nº 175-2012 de Tribunal Superior Administrativo de 5 de Octubre de 2012, available at https://do.vlex.com/vid/-505805778

[29] It was not published, this information was received from Wanda Montero, a consultant on this project.

[30] República Dominicana (2017) Estadísticas Turisticas. Banco Central, https://www.bancentral.gov.do/publicaciones_economicas/consulta/9/0/Estad%C3%ADsticas-Turisticas

[31] OECD, CIAT and CEPAL-UN (2018) *Revenue Statistics in Latin America and the Caribbean 2018*, (Paris: OECD Publishing), Table 4.5.

3. Brazil's Fixed Margin Method

A system which has also been effective is Brazil's fixed margin method, which has operated since 1996. An account has been included in the Manual, with some suggestions for how it could be adapted to suit conditions in other countries, and perhaps iron out inconsistencies with the OECD TPGs. Hence, we will not include an account here.

The Brazilian approach clearly has the advantages of simplicity, ease of application, and providing predictability and certainty for the taxpayer. On the other hand, it is a very broad-brush approach, which takes little account of differences between industry sectors or business models,[32] and ignores the actual profitability of the company concerned. However, some leeway is allowed for the taxpayer, since it can choose which method to apply and how to do so,[33] although this choice must be supported by documentation. In addition, the law provides for the Minister to authorise application of a different profit rate, in justified circumstances. These rules must also be understood in the wider context of Brazil's international tax rules, including strict limitations on deductions of royalties and fees, and strong rules on controlled foreign corporations.[34] The system seems to have been highly effective in largely eliminating transfer pricing disputes, while not deterring inward investment.

A good case can be made that the Brazilian methods are compatible with tax treaties, although not with the TPGs. In February 2018 Brazil agreed a 15-month work programme with the OECD to 'assess the potential for Brazil to move closer to the OECD's transfer pricing rules, which are a critical benchmark for OECD member countries'.[35] We hope that this will be a mutual learning process. Some suggestions have been made for modifications to the Brazilian rules which could make them sufficiently compatible with the approach in the TPGs, without losing their advantages, and these should be taken seriously.[36] This is especially important since the TPGs now have a practical effect in many countries around the world, far beyond the OECD.

4. A Simplified Net Margin Method (SNMM)

Another proposal has been put forward by Michael Durst which would establish a benchmark based on the actual profitability of the firm concerned, rather than one based on comparables or the sector as a whole.

This suggested method would require the local affiliate to earn a profit margin in proportion to that of the corporate group of which it forms part.[37] The benchmark he suggests is 25 per cent of the group's before-tax net operating margin, based on experience of attempting to apply the TNMM to a wide range of distributors, manufacturers and service providers. The

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[32] The 2012 revision introduced three profit margins for different economic sectors (20%, 30% and 40%), on the resale price for imported items subject to processing. For details on application of the rules see UN Practical Manual on Transfer Pricing 2017: Part D1; Valadão MAP and Lopes RM. (2013) Transfer Pricing in Brazil and the Traditional OECD Approach. *International Taxation* 8: 31-41.

[33] The taxpayer's right to choose the applicable statutory method has been upheld by decisions of the Administrative Taxpayers' Council, which ruled inapplicable an administrative regulation attempting to curtail such a choice: see Ilarraz M. (2014) 'Drawing upon an Alternative Model for the Brazilian Transfer Pricing Experience: The OECD's Arm's Length Standard, Pre-fixed Profit Margins or a Third Way?' *British Tax Review*: 218-235, at p. 223.

[34] Rocha SA. (2017) *Brazil's International Tax Policy*: Editora Lumen Juris.

[35] OECD Press Release 28/2/2018 http://www.oecd.org/tax/oecd-and-brazil-launch-project-to-examine-differences-in-cross-border-tax-rules.htm .

[36] See UN Practical Manual on Transfer Pricing 2017, Part D1.9.7, and Schoueri LE. (2015) Arm's Length: Beyond the Guidelines of the OECD. *Bulletin for International Taxation* 69: 690-716.

[37] Durst MC. (2016) 'Developing Country Revenue Mobilisation: A Proposal to Modify the 'Transactional Net Margin' Transfer Pricing Method', International Centre for Tax and Development, Working Paper 44.

fraction is chosen to arrive at a profit allocation which would be seen as fair by both the revenue authority and the taxpayer.

A merit of this method is that it focuses on the actual profits, or indeed losses, of the specific MNE concerned. In this respect it is very different from the Brazilian fixed margin method, which applies a single yardstick to all firms, on a broad sectoral basis. This 'simplified net margin method' (SNMM) is therefore based on the ability to pay principle which many consider foundational. However, its focus is on the profitability of the MNE as a whole, and it does not involve an analysis of the contribution of the specific local entity. For that reason, the proposal suggests applying a relatively small fraction of the firm's global profit rate in calculating the local entity's benchmark profit margin (as noted above, Durst suggests 25%).

This suggested method would require a minimum level of income, consistent with group-wide profitability, disregarding all intra-firm related party payments such as interest, royalties and fees, which are a major cause of base erosion. It would generally prevent the very low requirements of income that under current practice tend to be assigned by MNEs to 'risk-stripped' subsidiaries. This is put forward as a pragmatic solution, aimed mainly to provide developing countries with a method which is easy to administer and could adequately protect their tax base. In view of its design, it would not be appropriate to offer it as an opt-in method to taxpayers, but as a benchmark or backstop minimum tax.

An extension of this approach would be to establish a benchmark on a formulary basis, by allocating a proportion of the MNE's global income to the local entity, based on factors reflecting its presence in the jurisdiction, such as employees, assets and sales. This would revert back to the fractional method which the Carroll report found was in widespread use, and which continues to be permitted for attribution of profits to PEs in most existing tax treaties, (as mentioned in section A.2 above). Such a method of course runs counter to the transactional approach now deeply entrenched in the TPGs. However, this approach could be applied in a way which is compatible with the TPGs, using the framework of an APA, preferably on a sectoral basis to achieve the aim of simplicity. Such an approach has been suggested by Baistrocchi, modelled on the well-known example of global financial trading.[38]

5. Expansion and Standardization of the Profit Split Method

In June 2018, the OECD final guidance on the profit split method (PSM) was issued.[39] Regrettably, this guidance reflected a consensus 'lowest common denominator' approach that will seriously restrict the PSM's use and application. Further, far from simplifying the PSM, the guidance requires detailed and subjective analysis and understanding of accurately delineated controlled transactions as contemplated by the Guidelines.

The vast majority of countries have significant transfer pricing resource and personnel constraints. Further, they lack the internal expertise needed to effectively apply transfer pricing rules, including the PSM as contemplated by this final guidance, to the multiple industries within which multinational groups operate.

A PSM approach is sorely needed that avoids uncertainty for tax authorities and taxpayers alike while avoiding subjective analyses of each and every group situation that involves

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[38] E. Baistrocchi (2006), 'The Transfer Pricing Problem: a Global Proposal for Simplification', *Tax Lawyer* 59: 941-979.

[39] OECD (2018), *Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Paris. www.oecd.org/tax/beps/revised-guidance-on-the-application-of-the-transactional-profit- split-method-beps-action-10.pdf.

evident transfer pricing risk. The approach must be predictable and reduce taxpayer/tax authority disputes.

To achieve these goals, we recommend significantly expanding PSM use by making it truly easy for both taxpayers and tax authorities to apply by eliminating much of the subjectivity inherent in the OECD's final guidance. This can be accomplished through the use of standardised concrete allocation keys and weightings for common business models. Rather than focusing on subjective issues of relative risk and the relative values of varying economic functions, solely objective factors (e.g. personnel, assets, etc.) would be used as the standardised concrete allocation keys to apportion profits. This approach would ignore internal group-controlled and tax-motivated arrangements such as intercompany contractual terms. It would also dispense with the need for subjective value judgments, greatly reducing the potential for conflict and uncertainty.[40]

With this 'lowest common denominator' OECD final guidance requiring an ad hoc approach for each and every MNE product or line of business, it is time for individual countries, regional groups, or organizations such as the UN (perhaps within the Platform for Collaboration on Tax) to push forward toward real simplification that will benefit taxpayers and tax authorities alike. For example, an individual country or regional grouping could develop specific keys and weightings to be used for common business models relevant to their country or region. The UN could of course apply a broader worldwide approach in developing stardardised keys and weightings that individual countries could adopt into their domestic laws and transfer pricing rules. These could also be implemented through sectoral Advance Pricing Arrangements (discussed in the previous section), developed in consultation with relevant industry associations. These keys and weightings should of course be made public, a step that would increase transparency, eliminate the risk of sweetheart tax deals, and encourage other countries and regional groups to adopt the same keys and weightings for common business models relevant to them.

Where a country adopts this PSM approach for a common business model in a particular sector, it would be required for all taxpayer MNEs in that sector that use that model. The burden of proof would be on the taxpayer if it wishes to opt out and use any approach other than the PSM, or any keys and weightings other than those set out in the local transfer pricing rules. Under this approach, it would only be necessary for tax authorities to get involved in understanding and analyzing the accurately delineated controlled transactions when a taxpayer group makes a claim that another transfer pricing method or other keys and weightings should be used. Taxpayers would gain the predictability of being able to rely on the prescribed methodology and allocation keys and weightings. This would dispense with the need for taxpayers to employ a small army of specialists to devise transactional transfer pricing methodologies, and produce the detailed documentation needed to defend them in case of audit.

6. Simplified Methods within an Enforcement Strategy

A key element of developing a suitable transfer pricing enforcement strategy is to manage the scarce skilled resources available to any tax authority by selecting sectors for which simplified methods would be beneficial, as well as deciding on the appropriate method.

Two factors seem to be relevant here. Some consider applying a standardized simplified method to be appropriate to sectors which present a relatively low tax avoidance risk. This

[40] See J. Kadet (2015), 'Expansion of the Profit Shift Method: The Wave of the Future', *Tax Notes International*, 77: 1183, and J. Kadet, T. Faccio, and S. Picciotto (2018), 'Profit Split Method: Time for Countries to Apply Standardized Approach', *Tax Notes International*, 91: 359.

seems to be the case with the Mexican maquila sector. In such circumstances, the main advantage is that applying a standardized method will produce an acceptable level of revenue, while freeing resources to conduct more intensive scrutiny of more high-risk taxpayers. However, there is also evidence that tax authorities in less developed countries are concerned to find effective measures to apply to sectors which both pose the greatest challenges in the application of transactional transfer pricing approaches and are important for revenue generation. There is some evidence that African revenue authorities support the use of simplified methods for such sectors.[41] The Dominican Republic example also seems to be one where the sector was economically important.

The second factor is whether there is a large number of taxpayers with a similar business model, to which a standardized simplified method could be applied.

For many less developed countries it may be essential to apply simplified methods in a generalized way, which has been the strategy of Brazil.

Each country needs to formulate an enforcement strategy which is tailored to its own circumstances. These include both the characteristics of foreign investment in the country, and the level of resources it could reasonably devote to transfer pricing enforcement. We recommend that the Subcommittee consider these issues and formulate guidance that will assist developing countries in their development of practical and effective enforcement strategies.

[41] Alain Charlet, Caroline Silberztein and Gerard Pointe, *Étude sur la faisabilité de l'introduction de régimes de protection unilatéraux ou bilatéraux en matière de prix de transfert dans les pays membres de la CEDEAO/Transfer Pricing: Study on the Feasibility of Introducing Safe Harbour Provisions in ECOWAS Countries* (2016), European Commission.