

An overview of international Safe Harbor provisions and the need for Safe Harbor in India



Deloitte is pleased to announce the release of its latest white paper - "An overview of International safe harbor provisions and the need for safe harbor in India". The Government of India introduced the Finance (No 2) Act 2009 containing significant proposals with respect to the Indian transfer pricing provisions, one of which is safe harbors. In view of the same, this white paper has been prepared to outline the safe harbor rules prevalent internationally and draw upon our existing international experience and best practices while contemplating rules for India. This document also discusses some general recommendations, based on our international experience, for Central Board of Direct Taxes (CBDT) to consider while drafting safe harbor rules for India.

This is part of the research initiative that Deloitte has undertaken for the industry at large including all the companies and Indian tax authorities. We encourage you to share this white paper with your colleagues at your company. It has been our endeavour to ensure that this paper includes all key aspects and issues relevant for this theme.

Deloitte remains committed to being a knowledge-driven organization. We aim to develop cogent thought papers which look at issues and provide useful insights in to the same. If you want to dig deeper into any or all of the topics we have presented, please do not hesitate to contact us with questions and comments.

We do hope that you find this document useful as a guide towards developing better transfer pricing practices in the light of the new legislation in this regard.

Executive summary



Objective

Finance (No 2) Act 2009 contains significant proposals with respect to the Indian transfer pricing provisions, one of which is safe harbors. In view of the same, this white paper has been prepared to outline the safe harbor rules prevalent internationally and draw upon the existing international experience and best practices could be drawn upon while contemplating rules for India. This document also consists of general recommendations based on international experience.

Introduction

India's transfer pricing legislation dates back to 2001 and is in line with OECD guidelines barring a few aberrations. Transfer pricing audits in the country have generated significant controversies and concerns, due to an exponential increase in audit activity & transfer pricing adjustments. The need of the hour is clarity on a number of issues revealed through the transfer pricing audits, in order that those investing in the country are not put to undue hardship. Ensuring the country gets its fair share of global tax revenues is imperative, too. Initial positions by a tax authority tend to evolve towards 'globally accepted best practices' over a time frame and India is no exception to this rule. Accordingly, the Government of India vide the Finance (No 2) Act 2009 made significant proposals with respect to the Indian transfer pricing provisions, one of which is safe harbors.

A safe harbor has been defined to mean 'circumstances' in which, the Indian Revenue Authorities shall accept the transfer pricing declared by the taxpayer. While the rules in India will be notified in due course by the Central Board of Direct Taxes, these regulations would be effective April 1, 2009. To alleviate uncertainty faced by captive units and at the same time ensure an acceptable level of taxable profit, introduction of safe harbor provisions is a step in the right direction. Apart from India, the compliance and administrative burden of having to go through a fact-intensive application of the arm's-length principle with due application of judgment has led some jurisdictions to consider safe harbors as an effective way of dealing with transfer pricing issues. Safe harbor (referred to as a comfort mechanism in the OECD guidelines) has been defined to mean circumstances in which tax authorities shall accept the transfer prices declared by the taxpayers.

Generally, safe harbors provide for circumstances in which a certain category of taxpayers can follow a simple set of rules under which transfer prices are automatically accepted by the revenue authorities. Safe harbor provisions offer essentially benefits to taxpayers and tax administrators with benefits of compliance relief, administrative simplicity and certainty.

Safe harbors can take two forms, exclusion of certain classes of transactions from transfer pricing regulations; and stipulation of margins or thresholds for prescribed classes of transactions.

The introduction of safe harbors is common practice in some advanced countries (for example, United States, Australia for non-core services) as well as in developing nations (like Brazil and Mexico) and has been known to ease compliance pains to a large extent. Worldwide, safe harbor rules have mostly been in the domain of intra-group services wherein threshold mark-ups have been prescribed like in Australia, Singapore and New Zealand to certain developed countries that have introduced more advanced rules of thin capitalization as in Australia, New Zealand and Switzerland.

For the tax authorities, the safe harbor provisions substantially reduce the administrative burden involved in terms of minimal examination (or limited number of companies being picked up for detailed scrutiny) of the transfer pricing compliance by the taxpayers. They can choose to concentrate their time and resources on larger taxpayers, transactions or issues.

Generically, the adoption of safe harbor rules provides many perceived benefits both for taxpayers and the revenue authorities in terms of predictability as well as continuity for all the participating organizations, elimination of the possibility of litigation between the taxpayers and the revenue authorities through the process of automatic approvals and self assessment procedures, easing compliance by exempting taxpayers from collection and analysis of data that may be difficult to obtain and evaluate for application of the arm's length principle, advance information or knowledge about the range of profits or prices to qualify for the safe harbor helps in better planning of intra-group transactions.

Safe harbor results in a degree of administrative simplicity for the revenue authorities and the revenue authorities could then allocate more resources to the examination of other material transactions and taxpayers. Introduction of the safe harbor rules is expected to boost the foreign investment climate in the sectors of information technology and information technology enabled services.

Along with the benefits, certain challenges will also be faced by the taxpayers as well the revenue authorities while actually implementing safe harbor rules in India, as it will be difficult to establish satisfactory criteria for defining safe harbors, and accordingly could potentially produce prices or results that may not be consistent with the arm's length principle. Further, obtaining relevant information for establishing and monitoring safe harbor parameters may therefore impose administrative burdens on the revenue authorities. The foreign tax administration might challenge prices derived from the application of a safe harbor, with the result that the taxpayers could face the prospect of double taxation. Safe harbors raise equity and uniformity issues.

In a country like India, where there are a multitude of organizations which are involved in the execution of routine, repetitive tasks such as transaction processing, or claims processing and so on, the provision of a safe harbor rule would definitely be perceived as a breather to such industries and save them a substantial proportion of compliance costs. The software development and back office sectors that have witnessed numerous transfer pricing adjustments in the past years, whereby revenue authorities have determined the arm's length margin to be earned by such companies anywhere between 15-30%, are amongst the top aspirants anticipating relief. In India safe harbor rules are potentially expected in these domains that have been one of the most litigative domains in transfer pricing audits. However, at the same time, it is also expected that the Central Board of Direct Taxes would give due consideration to all aspects associated with the safe harbor rules before releasing the rules and ensure that safe harbors are not viewed as a departure from the arm's length principle.

In this document, we have presented an economic model that provides support for the safe harbor rate in India. This model estimates a revenue neutral safe harbor rate that, if adopted, would result in saving of significant amount of time and costs for the tax authorities by avoidance of long drawn litigation process as well as ensuring an assured level of revenue immediately occurring to them. This alternative approach is based on a set of plausible economic assumptions that are spelled out in more detail when this methodology is discussed later in this report.

Model results: Revenue neutral safe harbor rates

Our model provides estimates of revenue neutral safe harbors assuming that post introduction of safe harbors, some categories of taxpayers will opt for this safe harbor resulting in assured revenue for the department with no cost of audit/litigation.

Taxpayers adopting safe harbor	Cost of audit	
	Low	High
Taxpayers with markups within 5 percentage points of the safe harbor	13.89%	13.61%
Taxpayers with markups within 10 percentage points of the safe harbor	15.84%	15.17%

In the end, a more pragmatic approach by the CBDT while formulating safe harbor rules is anticipated, keeping in mind the interests of both the taxpayers and tax authorities, to come out with 'safe harbor' parameters with clear cut guidelines to its applicability for taxpayers, to avoid any new set of complications in its implementation.

Safe Harbor concept

The term safe harbor refers to any provision contained within an agreement or within any law or regulation. The safe harbor provisions afford protection from penalty or liability subject to the satisfaction of the conditions as prescribed in the safe harbor regulations. The safe harbor concept in effect strives to relieve taxpayers of avoidable compliance costs and administrative burdens.

With reference to the subject of transfer pricing, a safe harbor refers to a provision wherein, upon the tax payers adhering to a simple set of prescribed rules/provisions, the transfer prices would be automatically accepted as being at arm's length by the income-tax authorities or the income-tax administration.

Evolution of concepts of safe harbor

OECD Committee on the Fiscal Affairs Report on the Inter-company Transfer Pricing Regulations under US Section 482 Temporary and Proposed Regulations, 1993

The concept underlying a safe harbor mechanism was debated by the OECD as part of a report prepared by its committee on Fiscal Affairs as early as in the year 1993. The fundamental tenet underlying the preparation of this report was to evolve a multilateral approach to solve the problems which were being encountered in the transfer pricing domain by the United States. As per the report such problems were similar to those encountered by the member nations of the OECD and the Task Force emphasized that as the problems were inherently global in nature, a unilateral approach would defeat the endeavours to settle the problems. Hence the aforementioned report drafted by a Special Task Force established by the committee of Fiscal Affairs of the OECD, was to provide the United States administration with the collective views of the other OECD member countries on the new Regulations under Section 482 of the United States Internal Revenue Code.

Task force recommendations on safe harbor

The task force recommended that the USA provide a safe harbor for small businesses. Such a measure was recommended with a view to avoid the compliance burden associated with the use of the comparable profits method. The task force however also acknowledged the fact that the concept relating to the safe harbor provisions required further work on the part of the OECD.

The task force citing limited availability of time desisted from making any specific recommendations on the safe harbor provisions.¹ The recommendation which was generally given on the concept of safe harbors by the special task force is reproduced herein below:

“It is recommended that the Profit Level Indicators be chosen with a view to providing the taxpayer with a result that is more likely to be favorable than that which would be achieved under a strict application of the arm's length standard and that the safe harbor be applied in a non-discriminatory manner”²

Draft Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995 (“1995 OECD Report”)

Safe harbors are defined in the OECD Regulations in Paragraphs 4.95 as follows : “ [...] Formally, in the context of taxation, a safe harbor is a statutory provision that applies to a given category of taxpayers and that relieves eligible taxpayers from certain obligations otherwise imposed by the tax code by substituting exceptional, usually simpler obligations. In the specific instance of transfer pricing, the administrative requirements of a safe harbor may vary from a total relief of targeted taxpayers from the obligation to conform with a country's transfer pricing legislation and regulations to the obligation to comply with various procedural rules as a condition for qualifying for the safe harbor. [...]”.

Paragraph 4.96 further add: “A safe harbor may have two variants regarding the taxpayer's conditions of controlled transactions: certain transactions are excluded from the scope of application of transfer pricing provisions (in particular by setting thresholds) [emphasis added], or the rules applying to them are simplified (for example by designating ranges within which prices or profits must fall) [...]”.

¹Paragraph 3.30 of Chapter H of the Task Force Report

²Paragraph 3.35 of Chapter H of the Task Force Report

The provision of safe harbors raises significant questions about the degree of arbitrariness that would be created in determining transfer prices by eligible taxpayers, tax planning opportunities, and the potential for double taxation resulting from the possible incompatibility of the safe harbors with the arm's length principle.

Evolution of safe harbor rules in United States³

Section 482 of the Internal Revenue Code provides that the Internal Revenue Service (IRS) may, in reviewing transactions between entities under common control, allocate income in such a manner as to ensure an appropriate reflection of income between the entities. While the legislative history of Section 482 is long, the fiscal objective underlying the provision has always been to ensure that the substance of related-party transactions satisfies an arm's length test. Historically, the United States has maintained this focus on the application of the elusive arm's length principle in dealing with transfer pricing issues. In fact, the arm's length standard is the primary basis in most developed nations for assessing reasonableness in related-party dealings. The standard has surfaced in most bilateral income tax conventions, and the concept is firmly entrenched in the OECD model income tax treaty. The dilemma, particularly observable in US history, lies in the formulation of pragmatic rules for applying the arm's length standard in respect of specific related-party transactions.

a) The early years

Congress expressed interest in and concern about transfer pricing as early as 1917. The commissioner of internal revenue was authorized to force worldwide consolidation of affiliated groups if he believed it necessary in order to "equitably determine the invested capital or taxable earnings" of a related corporate group. Related party transactions and opportunities for abuse remained a congressional concern into the 1920s.

b) The 1960s

It was in the 1960s that Congress and the IRS began particularly to intensify their efforts to facilitate and enforce transfer pricing law in respect of international transactions. Treasury formulated regulations that were issued in final form in 1968.⁴ These regulations were the first comprehensive legislative pricing guidelines developed by any country, and they essentially governed US transfer pricing practices until the early 1990s.⁵ The initiative marked the first serious attempt to establish detailed rules for defined intercompany transactions. The regulations confirmed the arm's length standard as the principal basis for monitoring and reviewing related-party transfer pricing and adjustments, and they established ground rules for specific intercompany transactions, including the performance of services, the licensing and sale of intangible property, and the sale of tangible property. Relatively detailed rules were presented for determining the appropriateness of related-party transfer prices of tangible property and particularly the application of the arm's length standard. Three specific pricing methods were given priority: the comparable uncontrolled price method, the resale price method, and the cost plus method. All three methods relied on comparables for determining arm's length price, either directly or by reference to appropriate markups and markdowns from unrelated transactions. The regulations also authorized the use of other "unspecified methods".⁶

During the rather difficult birth of these regulations, many taxpayers argued for "calculated safe harbors" based upon profit margins, percentage markups or markdowns, etc. safe harbors were rejected. The drafters suggested that the likelihood of widely divergent ranges of returns earned in arm's-length transactions, even within a single industry or company, simply meant that no acceptable and equitable basis for safe harbors could be devised. Further, safe harbor approaches would likely, if not inevitably, evolve into an effective "floor" that would invariably apply to taxpayers not otherwise able to document a more advantageous fact pattern.⁷

³Canadian Tax Journal, 1995 Edition, Resolution of International Transfer Pricing Disputes

⁴IRC reg. section 1.482.

⁵In fact, proposed regulations were actually issued in 1965, withdrawn, repropoed in 1966, and ultimately enacted in 1968. These regulations were the first such changes of any substance to section 482, or its predecessor section 45, since 1935.

⁶IRC reg. section 1.482-2(e)(1)(iii)

⁷See, for example, comments of Stanley S. Surrey, "Treasury's Need To Curb Tax Avoidance in Foreign Business Through Use of Section 482" (February 1968), 28 The Journal of Taxation 75-79.



Final Section 482 Regulations and OECD Guidelines

The OECD's criticisms of the commensurate-with-income approach were acknowledged in the final US regulations by the provision of safe harbor rules that will apply under certain conditions.⁸ For example, periodic adjustments will not apply if actual profits generated by intangibles fall within a range of 80 to 120 percent of projected profits.⁹ Further, where the test is met for each of the first five years, the taxpayer is insulated from the threat of a subsequent adjustment.¹⁰

The 1968 Regulations contained a cost-only safe harbor, which taxpayers historically relied upon when performing their transfer pricing analyses for intercompany services. A cost-only safe harbor permits a renderer of services to charge the recipient of those services, in satisfaction or in substitution of the arm's length standard, an amount equal only to the direct and indirect costs incurred in rendering those services. The overarching purpose of a cost-only safe harbor is to allow taxpayers and revenue authorities to focus their resources on compliance with larger, more contentious, transfer pricing issues. Consistent with that overarching purpose, the 2006 Temporary Regulations replaced the nearly 40-year old cost-only safe harbor with what is now known as the Services Cost Method (SCM), which may be used to price at cost only the low-margin controlled services transactions that meet certain quantitative and qualitative conditions and requirements. We will discuss this in greater detail when we talk about the various international safe harbor regimes.

Overall, the final section 482 regulations and the OECD 1995 guidelines reflect compromise on both sides, and the two documents are similar in structure and broadly compatible in approach. While differences remain, they are essentially differences of emphasis. The approaches are sufficiently similar as to suggest that the United States and its major trading partners may be able to resolve what might otherwise have been potentially irreconcilable differences in transfer pricing approaches to, and resolution of, bilateral issues. In concluding this overview of the US scene, it is appropriate to emphasize again that it has been developments in the United States, particularly in recent years, that have primarily and significantly influenced attitudes and approaches of other governments in respect of international related-party transactions.

The influence will inevitably continue, particularly as MNEs—whether US or foreign-based—experience the application of the US law by the IRS and as, in the longer term, the interpretation of that law and its application evolves in US courts, as well as among other nations with vested interests.

Factors supporting use of safe harbors¹¹

The basic objectives of safe harbors are as follows: simplifying compliance for eligible taxpayers in determining arm's length conditions for controlled transactions; providing assurance to a category of taxpayers that the price charged or received on controlled transactions will be accepted by the tax administration without further review; and relieving the tax administration from the task of conducting further examination and audits of such taxpayers with respect to their transfer pricing.

1) Compliance relief

Application of the arm's length principle may require collection and analysis of data that may be difficult to obtain and/or evaluate. In certain cases, such complexity may be disproportionate to the size of the corporation or its level of controlled transactions.

Safe harbors could significantly ease compliance by exempting taxpayers from such provisions. Designed as a comfort mechanism, they allow greater flexibility especially in the areas where there are no matching or comparable arm's length prices. Under a safe harbor, taxpayers would know in advance the range of prices or profit rates within which the corporation must fall in order to qualify for the safe harbor. Meeting such conditions would merely require the application of a simplified method, predominantly a measure of profitability, which would spare the taxpayer the search

⁸IRC reg. section 1.482-4 (f)(2)(ii).

⁹IRC reg. sections 1.482-4 (f)(2)(ii)(B) and (C).

¹⁰IRC reg. section 1.482-4 (f)(2)(ii)(E).

¹¹Paragraphs 4.98 through 4.102 of the 1995 OECD Report

for comparables, thus saving time and resources which would otherwise be devoted to determining transfer prices.

2) Certainty

Another advantage provided by a safe harbor would be the certainty that the taxpayer's transfer prices will be accepted by the tax administration. Qualifying taxpayers would have the assurance that they would not be subject to an audit or reassessment in connection with their transfer prices. The tax administration would accept without any further scrutiny any price or result exceeding a minimum threshold or falling within a predetermined range. For that purpose, taxpayers could be provided with relevant parameters which would provide a transfer price or a result deemed appropriate to the tax administration. This could be, for example, a series of sector-specific mark-ups or profit indicators.

3) Administrative simplicity

A safe harbor would result in a degree of administrative simplicity for the tax administration. Once the eligibility of certain taxpayers to the safe harbor has been established, those taxpayers would require minimal examination with respect to transfer prices or results of controlled transactions. Tax administrations could then allocate more resources to the examination of other transactions and taxpayers.

Problems presented by use of safe harbors ¹²

The availability of safe harbors for a given category of taxpayers would have a number of adverse consequences which must carefully be weighed by tax administrations against the expected benefits. These concerns stem from the facts that:

- 1) The implementation of a safe harbor in a given country would not only affect tax calculations within that jurisdiction, but would also impinge on the tax calculations of associated enterprises in other jurisdictions, and
- 2) It is difficult to establish satisfactory criteria for defining safe harbors, and accordingly they can potentially produce prices or results that may not be consistent with the arm's length principle.

The issue can be examined from several perspectives.

- i. Under a safe harbor, taxpayers may not be required to follow a specific pricing method, or even have a pricing method for tax purposes. Where a safe harbor imposes a simplified transfer pricing method, it would be unlikely to correspond in all cases to the most appropriate method applicable to the facts and circumstances of the taxpayer under the regular transfer pricing provisions. For example, a safe harbor may impose a minimum profit percentage under a profit method when the taxpayer could have used the comparable uncontrolled price method or other transaction-based methods.
- ii. Such an occurrence could be considered as inconsistent with the arm's length principle, which requires the use of a pricing method that is consistent with the conditions that independent parties engaged in comparable transactions under comparable conditions would have agreed upon in the open market. Some sectors where goods, commodities or services are standard and market prices are widely publicised such as, for example, the



¹²Paragraphs 4.103 through 4.107 in the 1995 OECD Report

oil and mining industries and the financial services sector could conceivably apply a safe harbor with a higher degree of precision and, thus, a lesser departure from the arm's length principle. But even these industry segments produce a wide range of results which a safe harbor would be unlikely to be able to accommodate to the satisfaction of the tax administrations. And the existence of published market prices would presumably also facilitate the use of transaction-based methods, in which case there may be no need for a safe harbor.

iii. Even assuming that the pricing method imposed under a specific safe harbor is appropriate to the facts and circumstances of particular cases, the application of the safe harbor would nonetheless sacrifice accuracy in the reporting of transfer prices. This is inherent in safe harbors, under which transfer prices are predominantly established by reference to a standard target as opposed to the individual facts and circumstances of the transaction, as under the arm's length principle. It follows that the prices or results that produce compliance with the standard target may not be arm's length prices or results.

iv. Safe harbors are likely to be arbitrary since they rarely fit exactly the varying facts and circumstances even of enterprises in the same trade or business. This arbitrariness could be minimized only with great difficulty by devoting a considerable amount of skilled labor to collecting, collating, and continuously revising a pool of information about prices and pricing developments. Obtaining relevant information for establishing and monitoring safe harbor parameters may therefore impose administrative burdens on tax administrations, because such information may not be readily available and may be accessible only through in-depth transfer pricing inquiries. Therefore, the extensive research necessary to set the safe harbor parameters accurately enough to satisfy the arm's length principle would jeopardize one of the purposes of a safe harbor, that of administrative simplicity.

3) Risk of double taxation and mutual agreement procedure difficulties

From a practical point of view, the most important concern raised by a safe harbor is its international impact. Safe harbors could affect the pricing strategy of corporations.

The existence of safe harbor "targets" may induce taxpayers to modify the prices that they would otherwise have charged to controlled parties, in order to increase profits to meet the targets and thereby avoid transfer pricing scrutiny on audit. The concern of possible overstatement of taxable income in the country providing the safe harbor is greater where that country imposes significant penalties for understatement of tax or failure to meet documentation requirements, with the result that there may be added incentive to ensure that the transfer pricing is accepted without further review.

Taxpayers may value the certainty provided by the safe harbor to the point where they would raise the prices charged to associated enterprises for the purpose of qualifying for the safe harbor, notwithstanding the fact that those transfer prices would be above the relevant taxpayer's arm's length prices taking into account its specific circumstances. In that case, the safe harbor would work to the benefit of the tax administration providing the safe harbor, as more taxable income would be reported by such domestic taxpayers. On the other hand, the safe harbor would penalize both the foreign associated enterprises and their tax administrations, since less profits and taxable income would be reported in their respective jurisdictions. This would create an issue with respect to the proper sharing of tax revenue between tax jurisdictions. Indeed, in such cases, the tax administration of the jurisdiction adversely affected may not be in a position to accept the prices charged to their taxpayers in connection with transactions with associated enterprises in the safe harbor country. The prices may differ from those obtained in these jurisdictions by the application of transfer pricing methods consistent with the arm's length principle. It would be expected that foreign tax administrations would challenge prices derived from the application of a safe harbor, with the result that the taxpayer would face the prospect of double taxation.

At the outset, one would argue that the possibility of double taxation would nullify the objectives of certainty and simplicity originally pursued by the taxpayer in electing the safe harbor. However, taxpayers may consider that a moderate level of double taxation is an acceptable price to be paid in



order to obtain relief from the necessity of complying with complex transfer pricing rules. It follows that double taxation may not, in itself, be a disqualifying factor against safe harbors. One may argue that the taxpayer alone should be required to make its own decision if the possibility of double taxation is acceptable in electing the safe harbor or not. However, in order to ensure that taxpayers make such a decision clearly on the basis of this trade-off, the country offering the safe harbor would need to make it explicit whether or not it would attempt to alleviate any eventual double taxation resulting from the use of the safe harbor. Since the safe harbor provides taxpayers with the privilege of avoiding any subsequent review or audit of their transfer prices resulting from the application of a safe harbor and given the nature of safe harbors, whose prices or results are, by design, only a proxy for those obtained under the arm's length principle, it is only appropriate that the taxpayer should equally be prepared, in electing the safe harbor, to bear any ensuing international double taxation resulting from the non-acceptance by a foreign tax administration of the transfer prices reported under the safe harbor. This would logically imply that taxpayers electing the safe harbor should generally be prohibited from bringing double taxation issues before the competent authorities should the use of the safe harbor result in international double taxation. Tax relief from double taxation attributable to a taxpayer's election of a safe harbor should be granted in the foreign country only if the taxpayer can prove that the results of meeting the safe harbor are consistent with the arm's length principle.

However, transfer pricing adjustments of foreign tax administrations will be complicated when the MNE has chosen a safe harbor in another country, because the taxpayer is likely to dispute the adjustment to prevent double taxation. The prospect that mutual agreement procedures are generally not available to adjust prices or results downwards that have been set under a safe harbor regime may therefore have a detrimental effect on the tax administration in the foreign countries.

The adoption of safe harbor regimes in one country may require that the other countries' tax administrations examine the transfer pricing policy of all companies associated with enterprises that have elected a safe harbor in order to identify all cases of potential inconsistency with the arm's length principle. Failure to do so could amount to a transfer of tax revenue from those countries to the country providing the safe harbor. Consequently, any administrative simplicity gained by the tax administration of the safe harbor country would be obtained at the expense of other countries, which, in order to protect their own tax base, would have to determine systematically whether the prices or results permitted under the safe harbor are consistent with what would be obtained by the application of their own transfer pricing rules. The administrative burden saved by the country offering the safe harbor would therefore be shifted to the foreign jurisdictions.

Double taxation possibilities would exist not only where a single country adopts a safe harbor. Adoption of a safe harbor by more than one country would not avoid double taxation if each taxing jurisdiction were to adopt conflicting approaches and methods. The parameters of two countries' safe harbors for specific industry segments are likely to deviate since both countries would want to safeguard their revenues. In theory, international coordination could achieve the degree of harmonization among national systems that would be required to prevent double taxation. However, in practice, it is most unlikely that two jurisdictions could harmonize conflicting safe harbors that would eliminate double taxation.



Advance pricing arrangements and safe harbors

Internationally, safe harbor and Advance Pricing Arrangement (APA) are emerging as the two most efficient ways of reducing litigation in the area of transfer pricing, which is developing as the most important taxation subject among the chief executives and tax authorities. As discussed in the earlier sections, though the safe harbor provisions provide a degree of simplicity for tax administrations and taxpayers, these suffer from certain drawbacks.

APA is the alternative approach, which is gradually gaining greater acceptability. The basic difference between the two is that while safe harbor is general in nature, APAs are taxpayer-specific.

An APA is as an arrangement between a tax authority and a taxpayer that determines, in advance of intra-group transactions, an appropriate transfer pricing methodology for a fixed period of time. An APA is unilateral if one tax jurisdiction is involved, and bilateral when two tax jurisdictions are involved. The latter provides the certainty of the arrangement being accepted by both the tax jurisdictions, thereby removing any chance of double taxation.

In spite of certain shortcomings, APAs are becoming popular due to the certainty these provides. Many countries, such as the US, the UK, Australia, China, South Korea and Singapore, have put APA mechanism in place. India is also moving in the directions of proposing to implement APAs with the release of new draft Direct Tax Code, along with Discussion Paper, to be effective from April 1, 2011. The Code envisages certain far-reaching changes within the transfer pricing regime. Some of the significant ones include the introduction of advance pricing agreement, anti-avoidance/thin capitalization measures, application of risk management strategy for selection of cases for scrutiny, etc.

Presumptive taxation and safe harbor

Safe harbor rules indicate a sort of presumptive taxation. Such practices are already prevalent the world over and now India is following the trend. These rules help to certain extent in reducing the judgemental errors in determining transfer price in international transactions.

Using presumptions and safe harbors improves the admissibility of a tax while lowering its accuracy. The key question that arises: to what extent the former benefit justifies the latter cost. On a related issue, some in the field believe that presumptive taxation and safe harbors should be considered a permanent supplement or even a replacement for the more traditional tax system. Others see it as a merely transitional phase until the tax administration is capable of collecting the normal tax without the widespread use of presumptions.

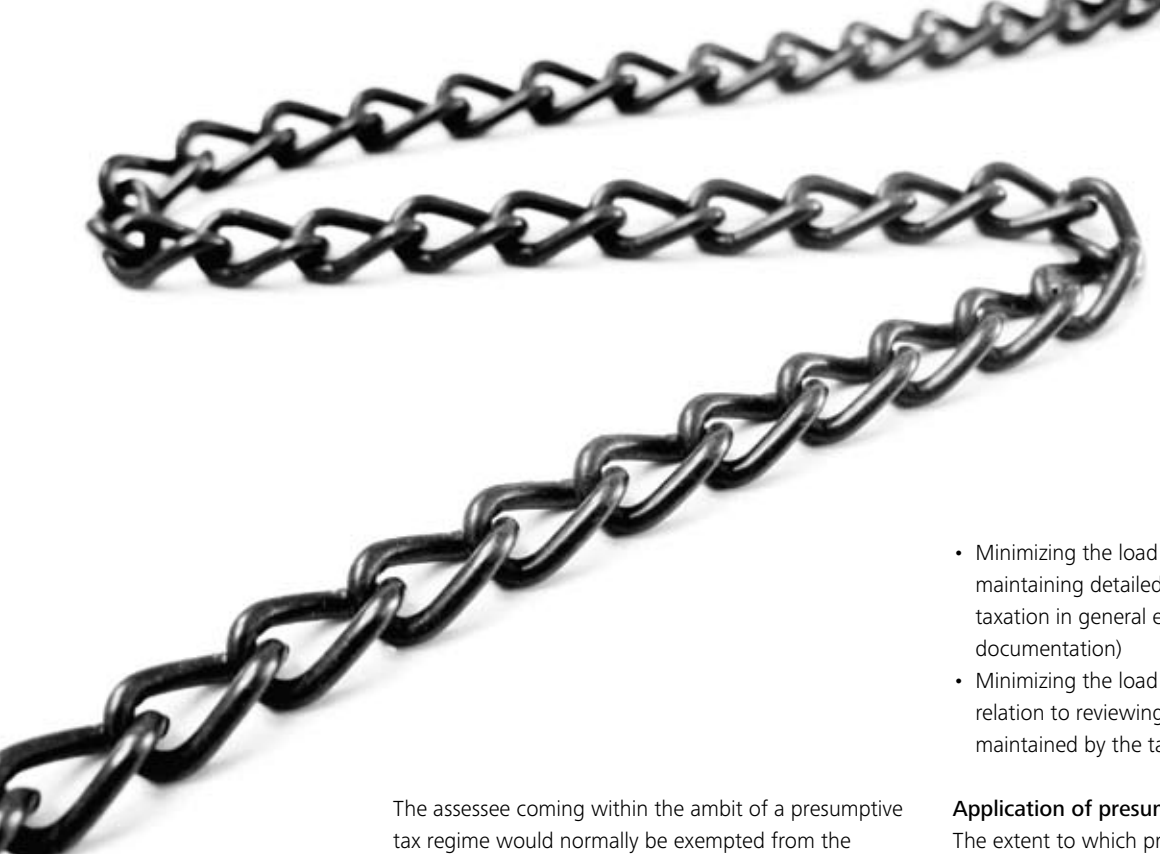
Presumptive taxation raises both theoretical and practical issues of great importance. From a policy perspective, the extent to which presumptions can operate to simplify the task of administration without fundamentally changing the tax base is a key issue. From a practical perspective, the fundamental issue in presumptive taxation is the trade-off between accuracy and administrability. The same issues arise in the case of implementation of safe harbor rules also.

Concept of presumptive tax

Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts. The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method. As discussed below, this presumption may or may not be rebuttable. The concept covers a wide variety of alternative means of determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation.

Under the Income-tax law, a provision for presumptive tax purports to bind the assessee to a presumptive income, which would be construed to be the minimum on which the tax liability of the assessee would be fixed.

Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts.



The assessee coming within the ambit of a presumptive tax regime would normally be exempted from the rigors of a tax audit and also from the maintenance of stipulated books of account. The assessee, in case happens to generate a larger income than the aforementioned presumptive income, he would be obliged to file a return of income declaring such larger income and also backing the same by maintaining the prescribed books of accounts.

Objective

The general premises underlying the introduction of a presumptive tax regime are as broadly summarized herein below:

- A simplified procedure for the computation of income with a view to bringing more prospective tax payers within the tax net (in such a manner that the exchequer is not at a monetary loss while offering presumptive taxation as opposed to normal taxation)
- Providing for equitable distribution of tax burden, especially in situations where certain tax payers are under taxed when applying normal tax provisions (for e.g. in case of tax payers where the business modalities are such that what is depicted as income in the books of account is much lesser than the actual income of such tax payers)
- Effectively combating tax evasion/tax avoidance;
- Relaxing unwanted compliance procedures in the case of certain assesseees
- Providing optimum tax certainty (conventional taxation often does not ensure tax certainty in many cases)
- Attracting foreign investments into the country (especially in certain key sectors) by providing for simplistic presumptive taxation of non-residents investing in those designated sectors
- Simplifying the procedure for computing income in the case of certain non residents whose business is spread across several countries

- Minimizing the load on the tax payer in relation to maintaining detailed documentation (presumptive taxation in general entails maintenance of minimal documentation)
- Minimizing the load on the Revenue Authorities in relation to reviewing the detailed documentation maintained by the tax payers etc.

Application of presumptive taxation in general

The extent to which presumptive taxes are used varies greatly from country to country. Some countries (e.g., the United States) employ almost no presumptive taxation, while others (e.g., France) use presumptive taxes extensively. Possible legal constraints on the adoption of presumptive methods should be considered in drafting legislation for their application, including constitutional constraints, such as equality before the law and a prohibition on confiscation of property. They might also include obligations under international agreements. For example, some double tax treaties may prohibit taxing a non-resident on a presumptive basis without allowing the taxpayer to prove its actual income and be taxed accordingly.¹³

The use of withholding taxes is sometimes discussed together with presumptive techniques. Withholding taxes can also achieve the effect of taxation based on an alternative simplified base. Withholding is commonly used for the income tax and is usually based on the gross amount of a payment. Withholding can also be imposed on other bases, for example, on the amount of imported goods, with a credit allowed against income tax. The legal nature of withholding taxes is normally not the same as that of presumptions, because taxpayers normally have the right to file a return and receive a refund of excess amounts withheld. If taxpayers are not given the right to claim a refund, then the withholding tax is in effect a minimum tax collected by withholding, which does not differ conceptually from other minimum taxes.

Another factor to consider is the international tax priorities for developing and transition countries. Taxation can have important effects on many parts of the economy, including impacts on firm creation and on the development of Small and Medium-Sized Enterprises (SMEs).

¹³See OECD Model Convention art. 7(1), reprinted in Klaus Vogel, Double Taxation Conventions 308 (1991); U.N. Model Convention art. 7(1), reprinted in id., at 309; U.S. Model Convention 7(1), reprinted in id. These provisions allow taxation of only the profits that are attributable to a permanent establishment. Imposition of a presumptive tax might result in a tax even where there are no such profits, and might therefore violate the treaty, if the presumptive tax is a tax covered by the treaty.



Developing an environment conducive to SME growth whilst ensuring tax compliance is a challenge developing and transition countries face.

Typical areas where presumptive taxation is applied

An illustrative list (though not exhaustive) of some typical areas where presumptive taxation may be a preferred alternative are as under:

- Taxation of certain key identified sectors which are instrumental in economic growth and development of the country (for e.g. IT Industry, oil and gas industry, etc.)
- Taxation of certain non resident entities whose business is spread across several countries (for e.g. shipping companies, airlines, channel broadcasting companies, transponder companies, etc.)
- Taxation of small time assesseees (for e.g. assesseees having a very small turnover)
- Taxation of retailers having limited turnover
- Taxation of foreign sportsmen, athletes, stage performers, artists, musicians who globe trot and earn income from several countries
- Taxation of old assesseees who have crossed a particular age (i.e. senior citizens)
- Taxation of a particular sect of tax payers where it may be practically difficult to apply the normal tax provisions
- Taxation of a particular sect of tax payers where there is high quantum of tax evasion/tax avoidance etc.

Global experience

In the international scenario, conventionally, presumptive taxation has been used as a mechanism to levy tax in areas where it is rather difficult to measure, verify or monitor taxability. As a substitute for the desired tax base is the "presumed" tax base, which is derived from a formula, which itself may be simple or complex, based on more readily monitored items. Further, it is generally observed that presumptive taxation is more frequently used in developing economies when compared with the developed economies.

Further internationally, presumptive tax is also perceived as an effective tool to tax what is commonly known as the "hard-to-tax" ("HTT"). HTTs' can be broadly divided into three distinct categories:

- Small firms and individuals who do not keep good books and records but are potentially taxable
- Firms and individuals whose activities are clearly large enough to fall within the scope of the tax system but who are tax evaders
- Large and medium entities that are fully capable of complying with the normal tax system but simply fail to do so

Use of presumptive taxation methods (country wise analysis)

USA - Being a highly developed nation, it has very limited presumptive taxation within its tax code.

France - Presumptive taxation is significantly used in France. The methods commonly adopted are contractual method and "Outward Signs of Lifestyle" method.

Israel - Presumptive taxation is followed in Israel to some extent. "The Standard Assessment Guides" method (popularly known as "tachshivim" in the local language) is used in Israel.

Argentina, Columbia, Mexico and Venezuela - The percentage of assets method is commonly followed in these countries.

Austria - Presumptive taxation has been adopted in Austria in the context of unincorporated businesses, restaurants, hotels and food retailers with turnover below specified limits, drug stores with turnover below specified limits, sales representatives, artists, writers etc.

Belgium - In Belgium, the tax administration can decide, upon agreement with the interested professional bodies, of the presumptive bases of taxation. The tax administration can apply the presumptive tax regime to taxpayers that are not members of the concerned professional associations and which do not agree on the basis of taxation for the related presumptive tax. Taxation under the presumptive bases constitutes a particular application of taxation by comparison, and the assent of the taxpayer relative to a legal mode of taxation is not legally required.

Mexico - Small taxpayers (Repecos) are taxed on a presumptive bases (annual turnover). In order to be taxed as Repecos, the income that arises from the activities of these taxpayers, plus the interests from the previous year must not exceed prescribed limits. Repecos are subject to a single 2% rate on their gross income. In the case of incorporated businesses, the fiscal authority is entitled to determine, presumptively, the taxpayers' fiscal profit based on a percentage which differs between sectors.

Spain - Unincorporated businesses performing certain qualified economic activities are eligible for the presumptive taxation system in Spain.

Nepal - Nepal is also an active exponent of presumptive taxation and has been practicing the same from the early 1960s'. Presumptive taxation has been adopted in Nepal for foreign airlines, small contractors having revenues within the prescribed limits, small entrepreneurs, importers, etc.

Indian experience

The Income Tax Act, 1961 (IT Act) currently provides for presumptive taxation in the context of certain tax payers/incomes. Some of the examples are Sections 44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 115JB among others. Whatever little presumptive taxation India has seen so far, the experience in this regard has been fairly good and encouraging. Given the complex nature of the IT Act, taxability as per normal provisions of the IT Act has always been a complicated procedure. The presumptive taxation regime has provided the much desired simplification and tax certainty to tax payers falling within the net of presumptive taxation.

There have been some minor issues while interpreting the presumptive tax provisions such as:

- Quite a few of the above presumptive tax provisions do not encompass all the incomes earned by the tax payer. Hence, in such a scenario, the tax payer has to decide how he would offer such income (which is not covered within the presumptive taxation regime) to tax

- The definitions of key terms within the presumptive tax provisions are at times loosely/arbitrarily worded. Accordingly, interpretation of such terms in the context of the presumptive tax provision becomes a difficult task
- Presumptive taxation does not suit tax payers who work on wafer thin profit margins and whose tax computation applying normal provisions of the IT Act is much lesser than the presumptive tax on such income
- Presumptive taxation, being a beneficial piece of legislation, should be liberally interpreted. However, quite a few judicial precedents on the existing presumptive tax provisions have provided a rather narrow and restrictive interpretation of the concerned presumptive tax provision, etc.

However, it is pertinent to note that the above issues are miniscule and insignificant if one were to compare then with the plethora of issues that typically arise while computing the income as per normal provisions of the IT Act. Having regard to the above, it is rather obvious that presumptive taxation has always been more than welcome in India and given the complex nature of tax laws in India, it is one of the best ways to simplify the same and make life somewhat simpler for the tax payers.

Presumptive taxation has always been more than welcome in India and given the complex nature of tax laws in India, it is one of the best ways to simplify the same and make life somewhat simpler for the tax payers.

Recommendation for Safe Harbors

While recognizing the various advantages, the OECD report did not recommend replacing the arm's length standard with a set of safe harbor rules. The report identified several drawbacks that outweigh the advantages.¹⁴ Both the advantages and the problems, as laid out by the OECD, have been discussed in detail in the paragraphs as above. Even the United States, over the years, has moved away from safe harbor regime.

Nevertheless, just like presumptive taxation, the adoption and acceptance of safe harbors should be seriously considered. Tax administrations of smaller countries or less developed economies cannot afford the allocation of resources needed in the transfer pricing area, and even the most powerful country, the United States, constantly suffers from underpayment of taxes by MNEs under the current transfer pricing regime.

Despite the clear drawbacks of safe harbors, they should not be ruled out by domestic legislatures. Such rules should be coupled with bilateral or multilateral accords in order to avoid international tax conflicts. Agreement on some limited safe harbors within the arm's length norm is desirable. It would ease compliance, afford flexibility, and provide certainty without the drawback of creating potential areas for double taxation when such rules are not uniform in the two countries. Safe harbor rules should play only a limited role in the transfer pricing area because of their disadvantages, such as clear deviation from the arm's length standard and unjustified national tax losses. Following it up, many international countries have set up safe harbor regimes that will be discussed comprehensively in the following sections.



¹⁴Para 4.118 of the 1995 OECD Report

International Safe Harbor regimes

Australia

The only sphere of the Australian tax regime containing a reference to safe harbor provisions is the one relating to certain categories of inter-company services. The Australian Taxation Office (hereinafter referred to as "ATO") has issued a specific taxation ruling in relation to inter-company services (TR1999/1). The ruling includes specific categories of inter-company services where an Australian taxpayer may elect to apply the so-called 'administrative practices' (i.e. safe harbor) guidelines. As set out in the TR1999/1, the rationale for the safe harbor in this instance is to reduce compliance costs for taxpayers in circumstances where the amounts involved may not be significant.

The following sections contain a detailed discussion of the ruling.

Legislation: Taxation Ruling 1999/1

Year of implementation:

1997-98 and subsequent years

Scope of the rules:

Taxation Ruling TR1999/1 adopts a safe harbor arrangement with respect to specific types (or value) of services provided between international related parties. Such an arrangement is possible under Division 13 because the commissioner has the discretion not to make a transfer pricing adjustment in certain, specified, circumstances. The ruling adopts defined administrative arrangements (or safe harbors) for: non-core (i.e. not integral to the profit earning activities of the multinational group) intra-group services for which the total amount charged for the services is not more than 15 per cent of the total expenses of the Australian group of companies; and the total intra-group services supplied or received are relatively small in dollar value (the total direct and indirect costs of providing the services is not more than AUD 500,000 in any one year). The following discussion of TR 1999/1 deals with the ruling in more general terms:

Benefit test

TR1999/1 indicates that the central test in determining whether an intra-group service must be charged for is the "benefit test."

This requires consideration of whether the relevant activity gives rise to a benefit to the party being provided with the services. A benefit is considered to be something of economic or commercial value that an independent entity might reasonably expect to pay for, or to obtain consideration for supplying. This is the case even if the benefit is not realized in practice.

Administrative practices and safe harbor arrangements

Having determined that a benefit is provided or derived, there are two possible ways whereby a taxpayer can gain greater certainty in certain circumstances. These are through the application of the administrative practice for non-core services, and the administrative practice for de minimis cases.

- *Non-core services*

The first means of obtaining certainty is referred to as the administrative practice for non-core services. It refers to services supplied or acquired which are not integral to the profit earning activities or economically significant activities of the multinational group (hereinafter: the MNE). In order for transactions to fall within the safe harbor prescribed by TR1999/1, the total amount charged for the services must be no more than 15 per cent of the total revenues of the Australian company group. Taxpayers must still prepare documentation that demonstrates that the services to which the administrative practices are intended to apply are non-core.

- *De minimis cases*

The second situation arises where the total direct and indirect costs of all intra-group services supplied or acquired are relatively small and the compliance effort required to establish precisely arm's length prices would not be justified relative to the adjustments which may be foregone. The safe harbor will apply in this situation where the total direct and indirect costs of providing the services is equal to or less than AUD 500,000 in the relevant year. The practice will apply to all intra-group services supplied or acquired where the relevant cost limit is not exceeded.

The following table highlights the important aspects of each of the administrative practices and the rules regarding their application:

Particulars	Services acquired from foreign associated enterprises		Services supplied to foreign associated enterprises	
	Administrative practice for non-core services	Administrative practice in de minimis cases	Administrative practice for non-core services	Administrative practice in de minimis cases
Principal restrictions of the application of the administrative practices	The total amount charged for the services is not more than 15% of the total expenses of the Australian Group companies	The total direct and indirect costs of providing the services is not more than \$500,000 in the year	The total amount charged for the services is not more than 15% of the total revenues of the Australian Group companies	The total direct and indirect costs of providing the services is not more than \$500,000 in the year
Acceptable Arm's Length Price	Not more than the lesser of: (a) Actual charge; and (b) The cost of providing the services plus a mark-up of 7.5%	Not more than the lesser of : (a) The actual charge; and (b) The cost of providing the services plus a mark-up of 7.5%	Not less than the greater of: (a) Actual charge; and (b) The cost of providing the services plus a mark-up of 7.5%	Not less than the greater of: (a) Actual charge; and (b) The cost of providing the services plus a mark-up of 7.5%
Alternative mark-ups in transfer prices for particular countries	Increased to 10% with additional documentation	Increased to 10% with additional documentation	Reduced to 5% with additional documentation	Reduced to 5% with additional documentation

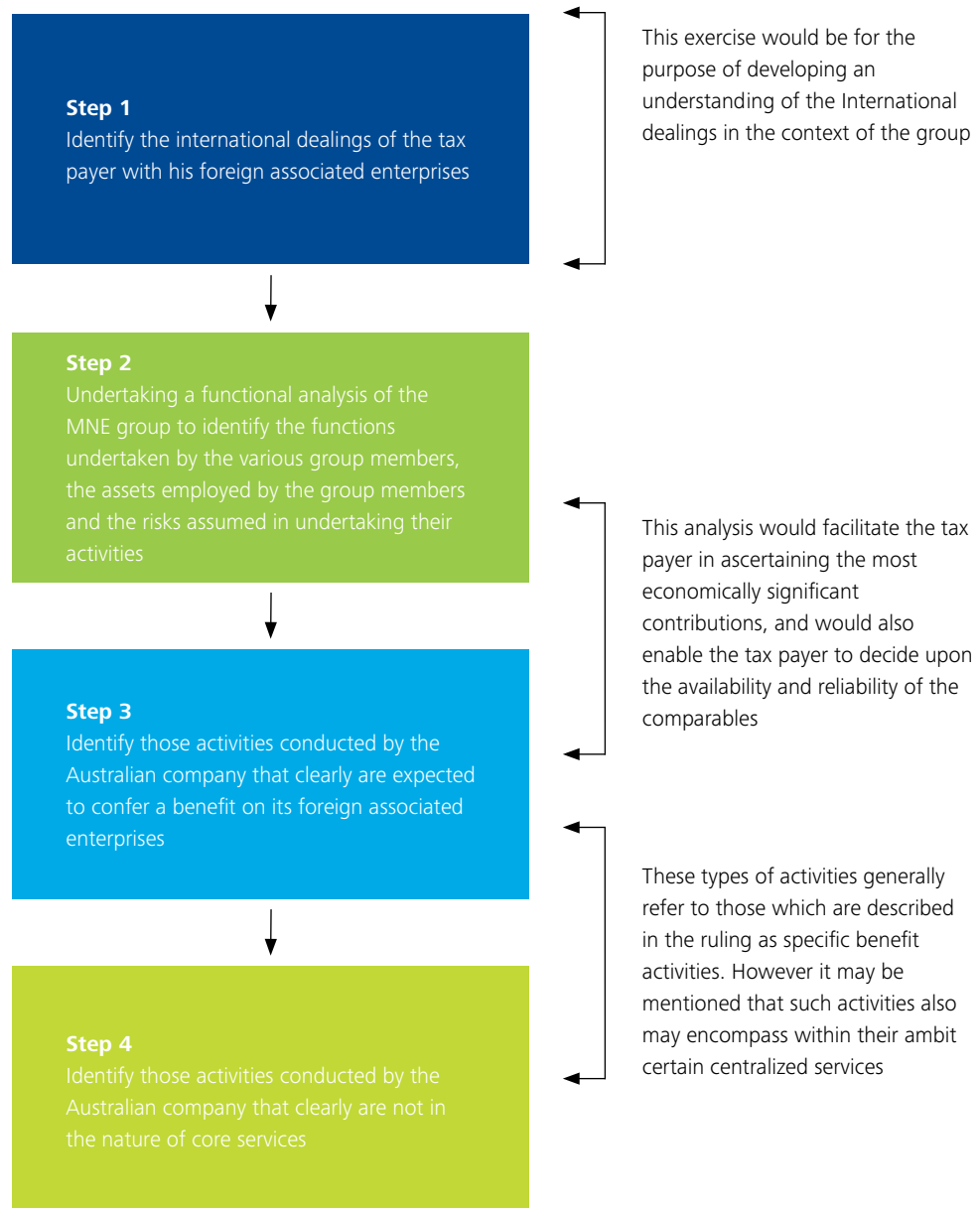
Acceptable transfer prices

The parameters of the safe harbor (i.e. the acceptable markup) are the same for both non-core services and de minimis cases where services are supplied to foreign associated entities. For outgoing services, the transfer prices charged will be within the acceptable range if the prices are not less than the cost to the Australian entity of providing the services plus a mark up of 7.5 per cent. The mark-up may be reduced to no lower than 5 per cent with additional documentation. For incoming services, the transfer prices will be within the acceptable range if the prices are not less than the cost to providing the services plus a mark up of 7.5 per cent. The markup may be increased to not more than 10 per cent with additional documentation. Clearly, these arrangements depend upon the acceptance of the proposed mark-up by any other tax jurisdictions involved in the transactions.

Nevertheless, in recognizing the practical difficulties associated with determining the arm's length price for intra-group services, the ATO arrangements give more certainty to taxpayers with international related party services that are either non-core or of a small value while concentrating the application of the arm's length principle on the more significant related party dealings.

Since the applicability of the safe harbor provisions as contained in the ruling is restricted to the non-core and de-minimis categories of services, it becomes absolutely quintessential for the tax payer to determine what constitutes chargeable activities and what falls within the ambit of non-chargeable activities from amongst the whole gamut of services rendered to an associated enterprise.

Determination of whether a particular activity constitutes a core activity or a non-core activity begins with the conduct of a detailed functional analysis. The steps involved in such a functional analysis are as illustrated herein below:





Documentation

The ruling also provides guidelines on the aspects of documentation relating to the provision or receipt of services. The following types of documentation have been stated in the ruling as being of assistance in the case of supply or acquisition of services between associated enterprises:¹⁵

1. Contracts or agreements for the provision of services between related parties;
2. Documents supporting the categorization of activities and in particular the consideration and recognition of any non-chargeable activities;
3. Documents supporting the selection of a charging method;
4. Documents supporting the calculation of cost-based charges;
5. Documents supporting the mechanism used to determine the amounts to be apportioned amongst Associated Enterprises;
6. Documents supporting the selection of keys for apportionment among several associated enterprises;
7. Documents supporting the selection of a pricing methodology or methodologies and any documentation supporting the consideration and rejection of other methodologies;
8. Where a cost-plus methodology has been selected, documents outlining reasons for selection of a particular mark-up;
9. Documentation created in the undertaking of a functional analysis of the various group members providing and receiving services.

International experiences/challenges

- a. The alternative mark-ups for other countries are only available where it is established that it is the practice of that country to require that mark-up for such services and that the country will accept such mark-ups for similar services provided by an Australian company to an associated enterprise resident in that country
- b. All companies in the group must use the same markup on costs for services supplied to or acquired from associated enterprises in the same country
- c. The taxpayer must maintain documentation that establishes the benefit provided and the cost of providing the services
- d. Where a transfer pricing method has been applied to the aggregate level of the group, neither of the administrative practices may apply
- e. Where an arm's length methodology has been used in respect of some core services provided by the group, the de minimis administrative practice may not be utilized in respect of any other core services provided.

¹⁵Paragraph 104 of the Australian Tax Ruling TR 1999/1, Page 34

Thin capitalization rules¹⁶

Year of implementation

The thin capitalization rules apply from the entity's first income year beginning on or after 1 July 2001.

Thinly capitalized entities

A thinly capitalized entity is one whose assets are funded by a high level of debt and relatively little equity. The new thin capitalization legislation can apply to both foreign controlled Australian investments and to Australian entities investing overseas.

Purpose of the rules

- a) The rules seek to limit the amount of debt used to fund those Australian operations or investments mentioned above. They do so by disallowing the debt deductions that an entity can claim against Australian assessable income when the entity's debt to equity ratio exceeds certain limits.
- b) The previous thin capitalization rules were not fully effective at preventing an excessive allocation of debt to the Australian operations of multinationals because

they only related to foreign related-party debt owed by an Australian entity; and applied to inward-bound investment, meaning Australian entities or operations controlled by non-resident entities.

Entities affected

The thin capitalization rules affect entities with operations or investments both in Australia and overseas, and apply to both inward investing entities and outward investing entities, as well as to associate entities of outward investing entities. Affected entities are companies, trusts, partnerships and individuals.

Entities not affected

- a) The rules do not apply to an entity whose debt deductions, together with those of its associate entities, are \$250, 000 or less for an income year. They also do not apply where the foreign assets of an entity and its associates represent 10 per cent or less of their combined Australian and foreign assets.
- b) Further, the regulations provide for special rules for financial and grouped entities.

¹⁶www.ato.gov.au/print.asp?doc=/content/19566.htm

New Zealand

New Zealand has a transfer pricing regime which is broadly based on OECD guidelines. In respect of intragroup non-core services, a safe harbor rate of cost plus a mark up of 7.5% is applied.

The following sections contain a detailed discussion of the ruling.

Legislation: Transfer pricing guidelines

Year of implementation: January 2000

Scope of the rules:

a) Services: The Inland Revenue Department (IRD) does not support safe harbors for transfer pricing. This is because such safe harbors can sanction a transfer price that is inconsistent with the underlying arm's length principle. Safe harbors also provide incentives for taxpayers to set terms and conditions of transactions just up to the safe harbor limit and may result in more tax avoidance than if the safe harbor had not been offered.

The IRD is concerned with minimizing compliance costs, especially if that can be done without compromising the arm's length principle. To this end the IRD proposes to follow (subject to a de minimis threshold) the administrative practice of the Australian Tax Office for services.

The administrative practice would apply to:

- Non-core services - These are activities that are not integral to profit-earning or economically significant activities of the group (they include activities that are supportive of the group's main business and could be routine, but are similar to activities by which the group derives its income); and
- Services below a de minimis threshold - This applies when the total direct and indirect costs of supplying services to New Zealand or foreign associated enterprises are not more than NZD 100,000 per annum. (This applies to all intra-group services supplied or acquired where the cost limit is not exceeded.)

To accommodate the varying requirements of other jurisdictions (and to avoid the possibility of double taxation arising), taxpayers may use alternative prices for non-core services if they use the administrative practice. A markup of up to 10% will be acceptable for non-core services between associated enterprises, where it is established by the taxpayer that it is the practice of the revenue authorities in a country to accept those prices for its own purposes and to accept such prices for similar services supplied by New Zealand companies to associated enterprises resident in that country. To obtain a higher markup there must be symmetry in the markups.

On the other side, a transfer price of not less than cost plus a markup of 5% but less than cost plus 7.5% would also be acceptable where there was also symmetry of treatment, as outlined above.

In addition, all companies in the MNE group must use the same markup for services supplied or acquired from associated enterprises in the same country if they wish to reply upon the administrative practice.

The IRD emphasizes that the determination of appropriate arm's length prices for intra-group services must remain a practical issue. While the arm's length principle is paramount, there may be good practical reasons why a revenue authority may want to forgo accuracy in favor of practicability.

There are no judicial precedents which have led to the implementation of safe harbors in New Zealand.

Documentation rules

The administrative practice, also, does not remove the need for taxpayers to establish that a service has actually been supplied. If a taxpayer wishes to reply upon the administrative practice, the taxpayer must maintain documentation to establish the nature and extent of the services acquired or supplied and to cover the relevant issues in calculating the relevant.



International experiences/challenges

One of the main challenges with the adoption of safe harbor rules has been the interpretation of core & non-core services by taxpayers. This often leads to some contention among the taxpayers and tax authorities.

b) Thin capitalization: New Zealand's thin capitalization regime is directed primarily at New Zealand taxpayers who are controlled (as to a 50% or greater interest) by a single non-resident. The purpose of the regime is to ensure, in the case of a New Zealand taxpayer controlled by a single non-resident, and which has a disproportionately high level of New Zealand group debt funding, an appropriate apportionment to the New Zealand taxpayer of the worldwide interest expenditure of the group of entities of which the New Zealand taxpayer is a part. Anti-avoidance provisions ensure taxpayers do not artificially manipulate their level of assets or debt to vary their debt ratio temporarily, with the purpose of defeating the intent and application of the thin capitalization regime.

Brazil

The safe harbor provisions in Brazil are attracted only in respect of transactions in the nature of exports. There are three levels at which the principle of safe harbor apply in the Brazilian transfer pricing regime. The safe harbor rules not mandatory. These are rules set forth by the Brazilian tax authorities that may release the taxpayer from the obligation of justifying prices carried out on export operations with related parties. The taxpayer may choose to apply them or not and in case it does not, he will have to calculate the parameter prices based on one of the methods mentioned above, on a product by product basis. The Brazilian transfer pricing legislation does not accept benchmark studies.

The following sections contain a detailed discussion of the ruling.

Legislation: Normative Ruling no. 243/02

Brazilian transfer pricing law differs to that applicable in most countries, as well as from the practices recommended by OECD, namely because the restrictions there under are based on methods that must be strictly followed. Additionally, even if the taxpayer has evidence that its transactions are priced on an arm's length basis, tax may nevertheless be imposed if the agreed pricing is in excess of the amount determined based on the prescribed methods. Actually, although Brazilian law is influenced by the international experience in stating the applicable methods, there is no general provision allowing taxpayers to avoid increased tax assessment by proving that an import or export was carried out in line with the price and conditions that would have been agreed by independent parties under free market conditions.

Scope of the rules:

The safe harbor provisions in Brazil are attracted in respect of following transactions:

1. 90% Pre-requisite: Article 14

According to this article, there are three levels at which the principle of safe harbor apply in the Brazilian transfer pricing regime:

Level 1: At this level the safe harbor test is undertaken by comparing the local market prices with the transfer prices charged in the export transactions.

On a comparison with the local market prices, any export price which is higher than 90% of such local market prices, would be termed to be compliant with the safe harbor rules at this level. The sales price in the domestic market must be net of unconditional discounts, sales taxes, freight and insurance provided by the seller.

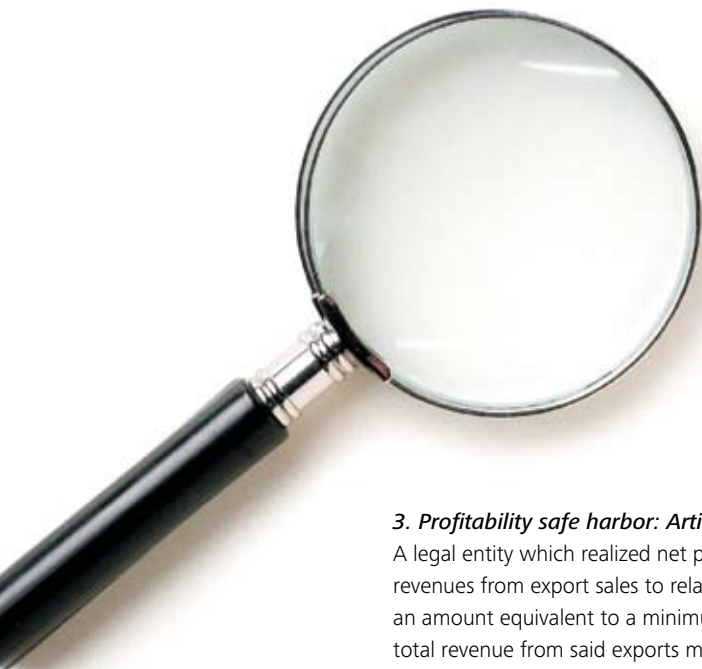
Level 2: At this level, the safe harbor test seeks to compare the profitability levels on export transactions. Where the profit before tax on export transaction is higher than 5% of net revenue, the safe harbor provisions/guidelines are said to have been complied with.

Level 3: This level provides for materiality thresholds whilst checking whether the safe harbor provisions have been complied with by the tax payer. As per the test envisaged at this level, if the total net revenue accrued on exports is below 5% of the total net revenue of the company, compliance is deemed to be ensured with the safe harbor provisions. In other words this level ignores all those export revenues which are immaterial when weighed against the total revenues generated by a company.

2. Conquer of new markets: Article 30

Exports to a related party carried out for purposes of capturing a market in a country for the goods, services or rights produced in Brazil may be transacted at average prices lower than 90% of the average prices used in Brazil, irrespective of any adjustment to the underlying revenues, provided that:

- I- The goods, services or rights exported have not been traded in the country of destination by the exporting company or by a related party located elsewhere;
- II- The goods, services or rights are resold to consumers at a price which is lower than other equivalent or similar goods, services or rights traded within the country of destination;
- III- The exports are made in compliance with the conditions established in a specific export plan previously approved by the SRF's General Taxation Coordination (Cosit);
- IV- The export plan demonstrates that the related party resident in the country of destination shall not earn a profit from the transaction and, if a loss is anticipated for the Brazilian company due to the lower price charged, it should disclose the period of time within which profitability is expected to be achieved.



3. Profitability safe harbor: Article 35

A legal entity which realized net profits deriving from revenues from export sales to related companies, in an amount equivalent to a minimum of 5% of the total revenue from said exports may demonstrate the adequacy of prices charged in referred exports, during the same period, exclusively with the documents relating to the operation itself.

4. Revenue representativeness safe harbor: Article 36

A legal entity whose net revenue originating from exports during the calendar year does not exceed 5% of the total net revenue realized in the same period may demonstrate the adequacy of prices charged in referred exports exclusively with the documents related to the operation itself. Herein, the net revenue originating from exports shall include revenues from sales made to individuals or legal entities resident or domiciled in countries imposing low taxation.

International experience/challenges

- a) The Brazilian tax authorities created the safe harbor rules in order to stimulate and encourage export operations. The tax rates of several federal and state taxes were lowered for export transactions and the Brazilian transfer pricing legislation is much more focused on imports from related parties domiciled abroad. Therefore, the majority of the taxpayers which export to related parties domiciled abroad are able to apply the safe harbor rules and in most cases, lowering or even eliminating its transfer pricing adjustments arising from export operations.
- b) The calculation of the profitability percentages considered for the test of 90%, safe harbors and cost plus method is based on data comprised from the taxpayer's income statement and, in reference to that, its adequate utilization was rendered impossible in the last tax years as a result of the appreciation of the Brazilian Real vis-à-vis the US Dollar and to a lesser extent, other currencies. Thus, by December, 2005 the Minister of Finance, taking into consideration the variation in the exchange rate accumulated in the previous years, issued Administrative Ruling no. 436/05, authorizing taxpayers, on an exceptional basis, to multiply revenues arising from related-

party exports by the 1.35 factor, for purpose of calculating the profitability safe harbor and the cost plus method. Based on the said Administrative Ruling, the Secretary of the Federal Revenue Services issued the Normative Ruling 602/05, authorizing taxpayers to utilize the 1.35 factor also for purposes of determining whether they would have fulfilled profitability safe harbor requirements. The same mechanism of adjustment was offered to the Brazilian taxpayers in 2006, through the Ordinance no. 425/06 and Normative Ruling no. 703/06, where the revenue arising from exports can be multiplied by 1.29. Considering the continuous valorization of the Brazilian national currency in 2007, as experienced in the previous years, another normative ruling was issued establishing the factor the taxpayers can utilize in order to mitigate the foreign exchange impact in their transfer pricing calculation. According to Administrative Ruling no. 329/07, issued by the Minister of Finance, and Normative Ruling no. 801/07, issued by the Secretary of the Federal Revenue Services, for purpose of calculating the profitability safe harbor and the cost plus method, prices of exports performed during the 2007 calendar year can be adjusted upward by 28 percent. In 2008, according to Normative Ruling no. 898/08 issued by the Secretary of the Federal Revenue Services and Administrative Ruling no. 310/08, issued by the Minister of Finance for purpose of calculating the profitability safe harbor and the cost plus method, prices of exports performed during the 2008 calendar year can be adjusted upward by 20 percent. The above mentioned normative rulings, allowing the upward adjustments on export revenue to related parties also authorized taxpayers to disregard provisions from Normative Ruling no. 382/03, which set forth the calculation based on the computation of the triennial average. However, in case it is still beneficial, the taxpayer may choose to calculate a weighted average of the profit arising from export to related parties using data from the two precedent years and the year under study. Should the company fail to fulfill the requirements of the above-mentioned safe harbors, it shall provide evidence of its export prices' adequacy based on any of the methods set forth by Brazilian transfer pricing legislation, which are summarized below:

- *Acquisition or Production Cost Plus Taxes and Profit Method (CAP)*

Under this method, the basis for comparison is the arithmetic mean of the acquisition or production cost of exported goods, increased by taxes and contributions paid in Brazil and by a 15% profit margin computed on the aggregate of cost plus taxes and contributions.

- *Export Sales Price Method (PVEx)*

Under this method, the basis for comparison is the arithmetic mean of the price charged for each product at unrelated-party exports made by the company itself, or by another Brazilian exporter of equivalent or similar products, during the same tax-computation period and under similar payment conditions.

- *Wholesale Price in the Country of Destination Less Profit Method (PVA)*

Under this method, the basis for comparison is the arithmetic mean of the price of equivalent or similar goods in sales made between unrelated parties in the wholesale market of the country of destination, under similar payment and negotiation conditions, reduced by the taxes included in the price and charged by the respective country, and by a profit margin of 15 percent of total wholesale price.

- *Retail Price in the Country of Destination Less Profit Method (PVV)*

Under this method, the basis for comparison is the arithmetic mean of the price of equivalent or similar goods in sales made in the retail market of the country of destination, under similar payment and negotiation conditions, reduced by the taxes included in the price and charged by the respective country, and by a profit margin of 30 percent of total retail price.

c) One of the challenges faced by the application of safe harbor that its calculation may be disregarded

by the tax authorities in case any inadequacies are encountered in an eventual audit process:

d) Also, when calculating the profitability safe harbor, the apportionment criteria for costs and expenses

“do not entail definitive acceptance of the revenue amount recognized on the basis of the price adopted, which may be adjusted, if deemed inadequate, via *ex officio* procedures on the part of the SRF” (NR RFB n° 243, 2002, art. 37, item II)”

are sometimes questioned by the tax authorities, as most of the companies cannot separate and identify the costs and expenses correspondent only to export operations to related parties. Therefore, all taxpayers are advised, even when meeting the criteria for any one of the safe harbors, to perform calculation of parameter prices using any of the above mentioned method, set forth by the Brazilian transfer pricing legislation.

e) Lastly, most of the disputes between the revenue and taxpayers involve imports and exports, and due to the continuing lack of experience with the methods described in the 1996 legislation, jurisprudence still needs to resolve several pending issues.¹⁷

In a nutshell, safe harbor provisions are set forth by the Brazilian transfer pricing legislation and their application is not questioned in any way by tax authorities. The criteria and manner in which they are applied might be subject to questioning and investigation by authorities.

¹⁷Explanation reproduced from IBFD, International Transfer Pricing Journal-January/February 2002

Switzerland

The existing laws governing taxation in Switzerland does not contain explicit regulations on transfer pricing between associated enterprises or contain any domestic documentation provisions.

However, there exist legal grounds for Swiss tax authorities to adjust the net profits of any Swiss taxpayer on an arm's length basis for all non-commercially justified expenses (Article 58 of the Federal Taxes Act and Article 24 of the Harmonisation of the Cantonal Tax Laws Act). Such expenses include, in particular, hidden distributions of profit and financial contributions, as well as gains and liquidation surpluses, which the taxpayer failed to report in its profit and loss account. In this regard Switzerland has agreed to apply the key aspects of the OECD transfer pricing guidelines and hence, recognizes the arm's length principle based on interpretation of current legislation. In confirmation of this approach, the Swiss Federal Tax Administration (SFTA) instructed the Cantonal Tax Administrations in a Circular Letter issued in 1997 to adhere to the OECD transfer pricing guidelines.

In general, the Swiss tax authorities are becoming increasingly aware of transfer pricing issues and have, in recent years, become concerned that in certain situations Multinational Corporations (MNCs) may actually be over-compensating the foreign end of their related party transactions to mitigate audit risk in countries with aggressive TP regimes and/or onerous TP documentation requirements.

The following sections contain a detailed discussion of the ruling.

From a Swiss perspective, particular attention should be paid on "Debt/Equity Ratio exposures" (i.e. thin capitalization risks), and "Interest Rates on Inter-Company Loans" given additional domestic tax regulations in these areas.

1. Debt/Equity ratio

The SFTA Circular Letter issued in June 1997 determines the Swiss Thin Capitalization Rules. In this Circular it is stated that all liabilities which economically have

the function of equity are re-qualified as equity for tax purposes, if they meet the following conditions:

Only debts from shareholders or affiliated parties may qualify as hidden capitalization. If capital is made available from an independent third party, it will not be qualified as hidden capital, unless the relation between the lender and the borrower qualifies as tax evasion.

The capital placed at the disposal of the company by a shareholder or affiliated party is compared to the assets of the company. All the asset-positions have a respective percentage of maximum allowable underlying debts as determined by the federal tax authorities (see table below), and any surplus will usually be qualified as hidden equity.

If the debt-equity ratio foreseen by the tax authorities is not observed, the last chance to avoid the application of the thin capitalization rules is to prove that the financing conditions between the associated borrower and lender do not differ from conditions that would be agreed between independent parties.

The maximal amount of interest bearing debts accepted for tax purposes based on the assets of the corporation are (non-exhaustive):

Assets	Max. underlying debts
Cash	100%
Bonds denominated in CHF	90%
Bond denominated in foreign currency	85%
Receivables	85%
Stock	85%
Investments in subsidiaries	70%
Plant and equipment	50%
Intangibles	70%
Loans	15%
Real estate	30%

From an income tax perspective, the tax consequences of thin capitalization may, if the debts are interest bearing-debts, result in the interest paid being classified as hidden equity qualifying as a deemed dividend distribution and, therefore, subject to income taxation and withholding tax.

2. Interest on inter-company loans

The Swiss Federal Tax Authority (SFTA) publishes yearly Circulars in respect of interest on inter-company loans. Given that this Circular is in German, we provide a translation of some of the key points contained in the current Circular (issued 3 February, 2009) below.

For CHF denominated loans made to related parties, the minimum interest rate, which a Swiss resident must receive (rates valid for 2009):

- On loans financed through equity is 2 ½ %
- On loans financed through debt it is the actual cost plus ¼ - ½ % on amounts up to CHF 10 million, or plus ¼ % on all amounts exceeding CHF 10 million, but in all cases at least 2 ½ %

For CHF denominated loans received from related parties, the maximum interest rate payable ranges between 2 ½ % - 4 ¾ % depending on the status of the payer and the underlying assets. Please note that these safe harbor interest rates are also provided for a number of other currencies (e.g. USD, GBP).

Where taxpayers can prove that the arm's length interest rate for example, varies from the safe harbor interest rate, this will be accepted. While interest rates which fall into the safe harbor range are unlikely to be questioned by the SFTA, if questions are raised they still need to be supportable as being at arm's length.

In practice, it is noted that certain companies ignore the safe harbors (particularly for inter-company interest rates), do not perform supporting economic analysis, and accept that there is a risk of enquiry from the

tax authorities. This risk is increasing due to the ever growing focus of the SFTA on transfer pricing.

Documentation rules:

While there are no formal documentation rules therein, it is recommended to maintain documentation to substantiate the arm's length nature of the international transactions.

International experiences/challenges

Use of safe harbor rules still lead to litigation in cases where all pre-conditions are not met. However, there are no published rulings or court cases on safe harbor related litigations in the past.



Singapore

In Singapore there are no presumptive taxation rules or provisions in existence till date. safe harbor provisions do exist in Singapore but not in form of any legislation. It is a tax circular, referred above, which has introduced the concept of safe harbor in Singapore.

The following sections contain a detailed discussion of the ruling.

Legislation: IRAS Supplementary e-Tax Guide on Transfer Pricing Guidelines for related party loans and related party services

Year of implementation:
Published on 23 February 2009

Scope of the rules:

a) Related party loans

Loans extended between related parties both of which are Singapore based entities are exempt from the need to apply an arm's length interest rate. Loans between a Singapore based entity and a related entity based outside Singapore (related cross border loans) are required to comply with arm's length principle from January 1, 2011.

The circular provides a brief guidance on determining the arm's length nature of related cross border loans. Taxpayers could rely on the following approach when analysing and determining the arm's length interest for related party loans.

When conducting a comparability analysis, all the relevant facts and circumstances relating to the loan must be considered. These factors include:

- i. The nature and purpose of the loan;
- ii. The market conditions at the time the loan is granted;
- iii. The principal amount, duration and terms of the loan;
- iv. The currency in which the loan is denominated;
- v. The exchange risks borne by the lender or borrower;
- vi. The security offered by the borrower;
- vii. The guarantees involved in the loan;
- viii. The credit standing of the borrower;
- ix. The interest rate prevailing at the situs of the lender or borrower for comparable loans between unrelated parties.

The Comparable Uncontrolled Price (CUP) method is the preferred method for determining the arm's length pricing for related party loans, not only because of its conceptual superiority compared to the other methods, but also because it is often found to be the most suitable method for loan transactions. However, if circumstances render another method to be more appropriate, taxpayers could rely on that method, and maintain documentation to justify why that method is more suitable.

As practical guidance for the arm's length analysis, IRAS suggests that taxpayers rely on a suitable reference rate, such as the Singapore Inter Bank Offered Rate (SIBOR), the London Inter Bank Offered Rate (LIBOR), prime rates offered by banks or specific rates quoted by banks for similar loans. Adjustments could then be made to the reference rate, based on the outcome of the comparability analysis undertaken, to arrive at the appropriate arm's length rate or range of rates.

b) Related party services

Since 2006, when TP rules were first introduced in Singapore, 5% has been unofficially used as a safe harbor in Singapore for services rendered between related parties and was not officially endorsed by IRAS until February 2009.

Firstly, taxpayers should assess whether a service has been provided. In doing so, taxpayers should assess whether the service is expected to confer a benefit on the related party recipient. Furthermore, an assessment should be made on whether this benefit is identifiable and one that an independent party in comparable circumstances would be willing to pay for or carry out itself in house. IRAS suggests the application of this "test" to situations where one party extends a service to one or more parties (e.g. group companies). Where such activities rendered are those which an independent party would be willing to pay for or perform for itself, they constitute related party services.

Where a related party service has indeed been provided, it is then necessary to determine the appropriate arm's length charge for the service. This requires the identification of chargeable costs. The IRAS describes two methods for doing so:



- i. Direct charge method - Where the beneficiary and costs incurred are clearly identifiable
- ii. Indirect charge method - Where the direct charge method cannot be used, allocation keys are used instead to allocate costs amongst recipients commensurate with benefits received

After the allocation of costs, the remuneration to the service provider (i.e. the arm's length fee) should then be determined in accordance with the arm's length principle and documented in accordance with the 2006 Guidelines.

It is a common practice among parent companies or group service companies to charge a 5% mark-up on costs incurred for providing certain routine support services which, for business convenience and efficiency reasons, are centralized within the parent company or a group service company. Examples of such services include accounting, payroll and certain other management or administrative functions. In practice, related companies may also, based on their own business considerations, provide intra-group services to one another where the nature of services is beyond routine services.

The issue of whether a 5% cost mark-up conforms to the arm's length principle will depend on the exact nature of service provided, actual or reasonably expected benefits to the recipient of the service, and a detailed analysis of what an independent party would have been willing to pay for a similar service under similar circumstances. Performing a proper

transfer pricing comparability analysis for every type of service would greatly increase the administrative and compliance burdens for the taxpayer and increase the administrative costs of IRAS to evaluate them. To facilitate taxpayers' compliance with the arm's length standard while maintaining a high level of adherence to the arm's length principle, and based on industry norms, IRAS accepts the 5% mark-up adopted for certain routine support activities¹⁸ as a reasonable arm's length charge for such services, provided that these routine support activities that the service provider offers to its related party are not also provided to an unrelated party.

Pass through costs

When examining the nature of a cost item and the roles of the service provider, to determine if it is indeed pass through in nature (i.e. can be passed on to a related party without a further mark-up), the IRAS requires that there should be evidence to the effect that the related party service recipient is "legally or contractually liable" for the payment of such costs. Only then would the service provider be considered to be merely a paying agent in the arrangement, and hence able to pass through the cost without a mark-up.

Cost-pooling arrangement

Payments charged to a related party for its proportionate share of the cost of services may be allowed on a prospective basis with no element of mark-up, provided that the following conditions are fulfilled:

- i. The service that the service provider offers to its related parties is not also provided to an unrelated party;

¹⁸The list of services is as follows: Accounting and Auditing, Accounts Receivable and Accounts Payable, Budgeting, Computer Support, Database Administration, Employee Benefits, General Administrative, Legal Services, Payroll, Corporate Communications, Staffing and Recruiting, Tax, and Training and Employee Development.

- ii. The provision of the service to the related parties is not the principal activity for which the service provider is set up to undertake. Whether the provision of a particular service constitutes, for the service provider, the principal activity that it undertakes in a financial year will depend on the specific facts and circumstances of each case. For this purpose, if the cost of provision of the service does not exceed 15% of the total expenses of the service provider as reflected in its accounts for the financial year concerned, such service will not be treated as the principal activity of the service provider for the particular financial year. All costs associated with services provided under the various cost pooling arrangements of each service provider will be aggregated for purposes of applying the 15% threshold set out above;
- iii. The service being provided is a routine support service as mentioned above; and
- iv. There is sufficient documentation showing that the parties intended to pool resources together to share costs prior to the provision of the service. For example, a cost pooling arrangement should be supported by a written agreement which, among other things, is duly signed by all related parties involved in the arrangement.

Taxpayers should maintain adequate documentation to support the basis of the allocation of costs as being at arm's length, and reflective of the sharing of expected benefits arising from the provision of services. In order to minimize the risk of double taxation, such documentation should include a description of the type of services provided, why a specific method of allocating costs was selected, what was contributed by the related party, what benefit is anticipated and the details of the calculations used.

Documentation:

The TP regulations highlight the importance of documentation. This is also true for transactions pertaining to related party loans and services covered in the supplementary e-tax guide.

International experiences/challenges:

- a) The safe harbor provisions are not treated as a compulsory compliance. There have been no case

Taxpayers should maintain adequate documentation to support the basis of the allocation of costs as being at arm's length, and reflective of the sharing of expected benefits arising from the provision of services. In order to minimize the risk of double taxation, such documentation should include a description of the type of services provided, why a specific method of allocating costs was selected, what was contributed by the related party, what benefit is anticipated and the details of the calculations used.

laws in Singapore either in favor of or against the safe harbor provisions.

- b) In addition, the circular refers to the use of the 5% mark-up as an "alternative" to the use of a mark-up percentage that is supported by transfer pricing analysis. However it is to be noted that even prior to the formal adoption of safe harbor rules in Singapore, the 5% mark up was accepted commonly by IRAS. Hence it would be need to be seen if IRAS will readily accept the use of a mark-up of less than 5% by Singapore service providers, where such percentage has been properly determined by proper transfer pricing/benchmarking analysis.
- c) On pass through costs, with the strict position, most if not all of the costs incurred by a group service provider are now unlikely to be considered as being pass-through in nature, which means that a mark-up will have to be applied on these costs as well.

Japan

There are no safe harbor provision rules in Japan. However, the Japanese transfer pricing regulations contain certain administrative guidelines.

The following sections contain a detailed discussion of the regulations.

Legislation: Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines) National Tax Agency of Japan

Year of implementation: June 1, 2001 (Latest amendment: June 25, 2007)

Scope of the rules:

There are no safe harbor regulations or presumptive taxation rules per se in Japan. However, under the Japanese transfer pricing regulations there is a provision that in case of services which are incidental to the original business activities, the gross cost of providing such services may be treated as the arm's length price without marking up the amount of expenses required to provide the services (Administrative Guidelines 2-9). The gross cost for the provision of services includes, as a rule, not only direct expenses related to the services but also indirect expenses, such as the general and administrative expenses of the department in charge or any assisting department, calculated in accordance with reasonable distribution standards.

It may be noted, that the gross cost incurred for the provision of services shall not be treated as an arm's length price if:

- (a) The cost incurred for the provision of the services accounts for a considerable portion of the amount of costs or expenses of the corporation or the foreign related person for the taxable year during which such services are rendered; or
- (b) It is deemed inappropriate to treat the gross cost for the provision of the services as a consideration of the service; this is because the intangible properties are used for the provision of such services, or for other similar reasons.

International experiences/challenges:

Based on practical experience in applying this guideline, it is understood that there is not much clarification as to the determination of whether a particular service is "incidental" or not. It is actually treated as a grey area in the Japanese transfer pricing regulations.



Mexico¹⁹

The Mexican Transfer Pricing Guidelines contain safe harbor provisions relating to maquiladora operations.

The following sections contain a detailed discussion of the regulations.

Legislation

Articles 216-Bis and 2 of the Income Tax Law of Mexico

The transfer pricing regulations in Mexico which broadly follows the OECD arm's length principle were enacted in the year 1996. Mexico has developed a special regime for "maquiladora" way back in 1960's with intentions to generate economic activities in the manufacturing industry and generate employment in Mexico. Maquiladora is Mexican subsidiary of a foreign parent and engaged in providing toll manufacturing or assembling services. Typically, foreign parent company owns technologies, equipment, inventories, etc. and provides maquiladora with all inputs to carry out manufacturing activities. Subsequently, the programme was adapted to also provide tax benefits and incentives to maquiladora with an intention of more meaningful economic development of manufacturing industry. The tax benefits mainly includes, favorable changes to the relevant income tax law, flexible indirect tax regulations and exemption from Permanent Establishment (PE) implications subject to fulfilment of specific transfer pricing requirements.

From a transfer pricing perspective, the Mexican transfer pricing regulations provide specific transfer pricing requirements for maquiladora. The object of introducing such requirements for maquiladora is to create simplified transfer pricing compliance mechanism for maquiladora and also to provide exemption to maquiladora from creating PE of foreign parent in Mexico.

Exemption from PE is available to maquiladora if the foreign parent is resident of a country with which Mexico has entered into a tax treaty and maquiladora complies with specific transfer pricing rules established by the Mexico tax authorities.

Maquiladora is Mexican subsidiary of a foreign parent and engaged in providing toll manufacturing or assembling services. Typically, foreign parent company owns technologies, equipment, inventories, etc. and provides maquiladora with all inputs to carry out manufacturing activities. Subsequently, the programme was adapted to also provide tax benefits and incentives to maquiladora with an intention of more meaningful economic development of manufacturing industry.

¹⁹Source: OECD Peer Review of Mexican Transfer Pricing Legislation and Practices, 2005 and IBFD Transfer Pricing Database

Scope of the rules:

Article 216-Bis of the Income Tax Law provides following transfer pricing options only to maquiladora which also provides exemption from creating Permanent Establishment (PE) in Mexico.

Cost plus mark-up with additional mark-up of 1 percent:

Under this option, arm's length price is based on arm's length cost plus mark-up determined by undertaking based on adequate transfer pricing study and increased by 1 percent of the net book value of foreign owned machinery and equipment permitted to be used by maquiladora. A maquiladora may either (a) adopt the "safe harbor" rules or prepare compare transfer pricing documentation, or (b) elect to obtain an Advance Pricing Arrangement (APA) via a private letter ruling.

Safe harbor:

Safe harbor requires maquiladora to report taxable income that represents higher of the following: (a) 6.9 percent of its assets employed in maquiladora operations including foreign owned assets. The assets include fixed assets and inventories; or (b) 6.5 percent of its cost and expenses incurred in maquiladora operations. The cost base consists of operating costs and expenses as computed under Mexican accounting standards. The cost base does not include depreciation on foreign owned assets, interest costs, foreign exchange losses and inflationary adjustments.

Return on foreign owned assets:

Return on foreign owned assets requires maquiladoras to maintain adequate transfer pricing study which uses Transactional Profit Margin Method (TPMM) as the transfer pricing method and Return on Asset (ROA) as the profit level indicator in determining the arm's length price. The asset base consists of foreign owned assets used for maquiladora operations but excludes inventory.

In earlier years (1995 to 2002), maquiladora was required to follow either safe harbor rule or obtain Advanced Pricing Agreement (APA) also known as Private Resolution.²⁰

However, post 2002, maquiladora may elect to obtain APA at its option and is not mandatory unlike earlier years.

A Presidential Decree was issued in 2003 whereby maquiladora can reduce its effective tax to the extent of difference between tax liability calculated by using safe harbor rule, and tax liability calculated by using higher of 3 percent of ROA or 3 percent on operating cost. The difference can be used as a tax credit which will reduce effective tax rate of maquiladora.

Further, in 2007, another Presidential Decree was issued whereby certain maquila companies can determine their tax base in accordance with Article 216-Bis and earn tax credit under the flat rate business tax (IETU) regime in Mexico. Effectively, maquiladora's maximum tax liability would be equal to IETU rate i.e. 17 percent for 2009 and 17.5 percent for 2010 and subsequent years.

Documentation rules

Application of cost plus mark-up method or return on foreign owned asset method requires maquiladora to determine arm's length price based on the transfer pricing study and maintenance of transfer pricing documentation.

International experiences/challenges

- a) From a legislative perspective, the Mexican safe harbor rules have been criticised as not being in accordance with OECD Guidelines²¹ - on one side it reduces the tax burden for maquiladora companies but raising question about arm's length price on the other hand.
- b) The rules also lack clear definition and adequate guidelines in following safe harbor such as inclusion or exclusion to cost base and asset base. This has resulted in contention between tax payers and tax authorities.
- c) Further, frequent changes to the rules and interpretations have resulted into increase in the administrative burden for maquiladoras.

²⁰Article 34-A of the Fiscal Code

²¹Para 4.121 to 4.123 of the OECD Guidelines



USA

The United States of America (USA) have established safe harbor provisions with respect to Intra Group services. Such provisions are contained under Section 482 of the Internal Revenue Code. This Section inter alia deals with the treatment of intra-group services, allocation of income and deductions from intangibles and Stewardship expenses. The Internal Revenue Service (IRS) has issued final and temporary regulations providing guidance regarding the treatment of controlled services transactions under Section 482.

The following sections contain a detailed discussion of the regulations.

Legislation:

Section 482 of Internal Revenue Code

Temporary Services Regulations under section 482 issued on 31 July 2006 (Temporary Regulations)

Final Services Regulations under section 482 issued on 4 August 2009 (Final Regulations)²²

Year of implementation

Temporary Regulations - Effective for taxable years beginning after December 31, 2006

Final Regulations - Effective for taxable years beginning after July 31, 2009

Section 482 of the Internal Revenue Code provides that the tax authority may allocate gross income, deductions and credits between controlled entities in order to prevent evasion of taxes and ensure an appropriate reflection of income between controlled entities. On April 16, 1968, regulations under section 482 were published to provide guidance on transactions between controlled entities including transactions pertaining to transfers of tangible and intangible property and the provision of controlled services. The said regulations were updated and revised from time to time. With a view to provide more clarity and treatment on controlled service transactions, proposed regulations were published on September 10, 2003. The proposed regulations also included allocation of income from intangible property in case of contributions to the value of intangibles between controlled parties.

On July 31, 2006, temporary regulations relating to the treatment of controlled service transactions were published which replaced the proposed regulations issued in 2003. The temporary regulations also included other aspects such as allocation of income from intangible assets and stewardship expenses. The temporary regulations, inter-alia, introduced new cost safe harbor by way of Services Cost Method (SCM) for certain controlled services. Apart from introduction of SCM, the temporary regulations also dealt with safe harbor rules and contemporaneous documentation, changes in the residual profit split method rules, intangible ownership rules, contingent payments, stock option costs and methods for determining arm's length charge.

The Treasury Department and IRS issued the regulations in temporary form in order to provide opportunity to taxpayers to submit their comments prior to issuance of final regulations.

After considering public comments, IRS issued final regulations under section 482 on August 4, 2009 replacing the temporary regulations of 2006. While these final regulations reflect some modifications in response to comments received on temporary regulations, the format and substance of the final regulations are consistent with the temporary regulations. The changes in the final regulations are more in the nature of clarification without fundamentally altering the policies reflected in the temporary regulations.

Apart from the safe harbor for controlled services, US transfer pricing regulations also provide safe haven interest rates in respect of loans and advances between controlled group entities.

Scope of the rules:

Charge for inter-company services

The safe harbor in the form of SCM is contained in Treas. Reg. § 1.482-9 of the final regulations. As mentioned earlier, the SCM was originally introduced in temporary regulations in 2006. The final regulations on SCM contain changes in the nature of clarifications only.

The arm's length amount charged in controlled services transactions must be determined under one of the

²² § 1.482-9

specified methods²³ and each method must be applied in accordance with the best method rule²⁴, comparability analysis²⁵ and arm's length range²⁶. The methods that are specified are SCM, comparable uncontrolled services price method, gross services margin method, cost of services plus method, comparable profits method, profit split method and unspecified methods.

A. Services Cost Method (SCM)

The SCM evaluates whether the amount charged for certain services is at arm's length by reference to the total services costs without markup. Under the SCM, taxpayer may determine the arm's length charge for "covered services" as defined below, based on total service costs without markup.

In order to qualify for the SCM, the regulations prescribed the conditions necessary for a service to be eligible for application of SCM. It is clarified in the final regulations that all the conditions must be satisfied²⁷. The conditions are as under:

Covered service: The services must be covered services which consist of controlled service transactions that are either "specified covered services" or "low margin covered services".

"Specified covered services" are controlled services transactions that the tax authorities specifies by revenue procedure²⁸. At the time of publication of temporary regulations in 2006, the IRS specified around 48 categories of services in its draft revenue procedure. The specified covered services broadly include payroll administration, accounts payable and receivable, general administration, public relations and coordination, accounting, auditing, tax, treasury, staffing, recruiting and training related services, legal services, etc.

"Low margin covered services" are controlled service transactions for which the median comparable markup on total services costs is less than or equal to 7 percent. The median comparable markup in this context means the excess of the arm's length price of the controlled services transaction over total services costs, expressed as a percentage of total services costs.

(a) Not an excluded service: Certain service categories have been specifically excluded for the applicability of SCM. Accordingly, if the controlled service falls within the list of excluded service, SCM cannot be applied. Excluded services broadly include manufacturing, production, extraction and exploration of natural resources, construction, reselling, distribution, commission agent, research and development, engineering or scientific services, financial transactions including guarantees and insurance.

(b) Business judgment rule: The business judgment rule requires that a service to be eligible for application of SCM should not be a service that contributes significantly to fundamental risks of business success or failure. The taxpayer is required to reasonably conclude in its business judgement that the service does not contribute significantly to key competitive advantage, core capabilities or fundamental risks of the business of the entire controlled group.

(c) Documentation: The taxpayer is required to maintain adequate books and records in respect of the services to which SCM is to be applied. Maintenance of documentation with regard to SCM is discussed elsewhere in this report.

In order to apply SCM, the taxpayer has to determine "total services cost". Total services costs include all costs in cash or in kind, including stock-based compensation, that directly identified with or reasonably allocated to the services and excludes interest expenses, domestic and foreign income taxes.

The regulations provide that if taxpayer applies SCM in accordance with the rules then it will be considered to be the best method under the best method rule of § 1.482-1(c). Consequently, the tax authority's power of allocation will be limited to determining amount of total service costs and amount charged for services²⁹.

²³ § 1.482-9(a)

²⁴ § 1.482-1(c)

²⁵ § 1.482-1(d)

²⁶ § 1.482-1(e)

²⁷ 1.482-9(b)(2)

²⁸ 2006-34, IRB 321

²⁹ 1.482-9(b)



*B. Shared services arrangement*³⁰

Specific regulations are provided for cases where the SCM is used to evaluate the amount of charge for covered services which are in nature of shared services arrangement. The taxpayer can enter into shared service arrangement if it meets specified eligibility criteria such as inclusion of two or more parties to the arrangement, inclusion of parties which will be benefited from the covered services and structured in a way so that each covered service confers a benefit on at least one participant.

The taxpayers are required to allocate cost of such covered services based on the "reasonably anticipated benefits" to the party without regard to whether the anticipated benefits are in fact realized. Such allocation must be on a consistent basis for all parties using allocation method that provides the "most reliable measure" of the benefit to the parties. If the taxpayer reasonably concludes that it has selected the allocation method that most reliably reflects the participants' anticipated benefit shares, the IRS may not adjust the allocation basis.

With regard to shared services arrangement, the taxpayer is also required to maintain sufficient documentation in order to substantiate its compliance with the requirements prescribed by the IRS. Maintenance of documentation with regard to shared services arrangement is discussed elsewhere in this report.

Interest on inter-company loans

Treas. Reg. § 1.482-2(a) deals with loans and advances between controlled entities and determination of arm's length interest rate in controlled transaction. The arm's length interest rate has been defined as a rate that would have been charged at the time the indebtedness arose in independent transactions with unrelated parties under similar circumstances³¹. The regulations require taxpayers to consider various factors such as principal amount of the loan, duration of the loan, security involved, credit rating of the borrower and interest rate of comparable loans.

Safe haven interest rates have been prescribed which applies to loan transactions entered into between controlled group entities post May 1986³². The interest rate in respect of controlled transaction is considered to be at arm's length if it falls within the prescribed range of 100% to 130% of the applicable federal rate. The applicable federal rate for loans having term of 3 years or less is federal short-term rate, loans having term of more than 3 years but less than 9 years is Federal midterm rate and loans having term of more than 9 years is federal long-term rate.³³ The federal rates are revised and published monthly by IRS.

The safe haven interest rates do not apply in the cases of (a) lender who is regularly engaged in the business of making loans and (b) loan and advances, the principal or interest of which is expressed in a currency other than US Dollars.

Apart from the above, the US transfer pricing regulations also provide "situs of borrower" rule³⁴. This rule was introduced in 1965. According to this rule, if a lender makes loan to a controlled entity and fund for making such loan is obtained at the situs of the borrower (typically from the same country of the borrower), the arm's length interest rate shall be equal to the rate actually paid by the lender for obtaining such fund from the country of the borrower plus costs incurred by the lender in borrowing such amount and making such loan. The taxpayer may also choose to establish more appropriate rate in line with the arm's length principle.

Commensurate with Income Rules with respect to transfers of intangible property under Section 1.482(f)

Special rules for transfers of intangible property - (1) Form of consideration. If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty, unless a different form is demonstrably more appropriate.

³⁰1.482-9(b)(7)

³¹1.482-2(a)(2)

³²1.482-2(a)(2)(iii)

³³1.482-2(a)(2)(iii)(B)/(C)

³⁴1.482-2(a)(2)(ii)

(2) Periodic adjustments - (i) General rule. If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Adjustments made pursuant to this paragraph (f) (2) shall be consistent with the arm's length standard and the provisions of § 1.482-1. In determining whether to make such adjustments in the taxable year under examination, the district director may consider all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was an arm's length amount will not preclude the district director in a subsequent taxable year from making an adjustment to the amount charged for the intangible in the subsequent year. A periodic adjustment under the commensurate with income requirement of section 482 [26 USCS § 482] may be made in a subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute of limitation purposes. For exceptions to this rule see paragraph (f) (2)(ii) of this section.

(ii) Exceptions - (A) Transactions involving the same intangible. If the same intangible was transferred to an uncontrolled taxpayer under substantially the same circumstances as those of the controlled transaction; this transaction serves as the basis for the application of the comparable uncontrolled transaction method in the first taxable year in which substantial periodic consideration was required to be paid; and the amount paid in that year was an arm's length amount, then no allocation in a subsequent year will be made under paragraph (f)(2)(i) of this paragraph for a controlled transfer of intangible property.

(B) Transactions involving comparable intangible. If the arm's length result is derived from the application of the comparable uncontrolled transaction method based on the transfer of a comparable intangible under comparable circumstances to those of the controlled transaction, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established -

(1) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable

year subject to such agreement, such consideration was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid under the agreement, and such agreement remained in effect for the taxable year under review; (2) There is a written agreement setting forth the terms of the comparable uncontrolled transaction relied upon to establish the arm's length consideration (uncontrolled agreement), which contains no provisions that would permit any change to the amount of consideration, a renegotiation, or a termination of the agreement, in circumstances comparable to those of the controlled transaction in the taxable year under review (or that contains provisions permitting only specified, non-contingent, periodic changes to the amount of consideration); (3) The controlled agreement is substantially similar to the uncontrolled agreement, with respect to the time period for which it is effective and the provisions described in paragraph (f)(2)(ii)(B)(2) of this section; (4) The controlled agreement limits use of the intangible to a specified field or purpose in a manner that is consistent with industry practice and any such limitation in the uncontrolled agreement; (5) There were no substantial changes in the functions performed by the controlled transferee after the controlled agreement was executed, except changes required by events that were not foreseeable; and (6) The aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the comparability of the uncontrolled agreement was established under paragraph (c)(2) of this section.

(C) Methods other than comparable uncontrolled transaction. If the arm's length amount was determined under any method other than the comparable uncontrolled transaction method, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established - (1) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, and such agreement remained in effect for the taxable year under review;

(2) The consideration called for in the controlled agreement was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid, and relevant supporting documentation was prepared contemporaneously with the execution of the controlled agreement; (3) There have been no substantial changes in the functions performed by the transferee since the controlled agreement was executed, except changes required by events that were not foreseeable; and (4) The total profits actually earned or the total cost savings realized by the controlled transferee from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the controlled agreement was entered into.

(D) Extraordinary events. No allocation will be made under paragraph (f)(2)(i) of this section if the following requirements are met - (1) Due to extraordinary events that were beyond the control of the controlled taxpayers and that could not reasonably have been anticipated at the time the controlled agreement was entered into, the aggregate actual profits or aggregate cost savings realized by the taxpayer are less than 80% or more than 120% of the prospective profits or cost savings; and (2) All of the requirements of paragraph (f)(2)(ii) (B) or (C) of this section are otherwise satisfied.

(E) Five-year period. If the requirements of § 1.482-4 (f)(2)(ii)(B) or (f)(2)(ii)(C) are met for each year of the five-year period beginning with the first year in which substantial periodic consideration was required to be paid, then no periodic adjustment will be made under paragraph (f)(2)(i) of this section in any subsequent year.

Documentation rules:

One of the conditions to qualify for applicability of safe harbor is maintenance of adequate books and records in respect of the services to which SCM is to be applied. Such books and records must include statement evidencing taxpayer's intention to apply SCM, description of the services in question, identification of parties to the services and methodology of allocation of total service cost. Thus, the condition requires taxpayer to maintain permanent documents which also forms part of the taxpayer's contemporaneous documentation requirement.

Regulations pertaining to shared services arrangement prescribe maintenance of sufficient documentation which, inter-alia, include statement evidencing taxpayer's intention to apply SCM to shared services arrangement, list of parties rendering covered services, description of the bases of allocation which is consistent with the reasonably anticipated benefits and description of aggregation of covered services under shared services arrangement³⁵.

International experiences/challenges:

- a) In general, the experience of application of safe harbor in US and acceptability by IRS has been favorable. However, the scope of eligible services to which safe harbor applies is narrow and requires comprehensive analysis for applicability of SCM to the eligible services. This would create additional administrative burden on the taxpayers.
- b) One of the major concerns for taxpayer is business judgement rules, its documentation and administration. Business judgement rule requires taxpayers to apply reasonable conclusion in its business judgement that whether the service contributes significantly to fundamental risks of business success or failure. Taxpayers have raised concerns about who in the organization should decide whether the service contributes to the success or failure of business. The business judgement rule is required to be applied on a case-by-case basis taking into consideration the fact and circumstances of each case. Guidance is also sought by taxpayers on how to evidence the business judgement. As clarified by IRS, conclusion by taxpayer under business judgement rule may be subject to examination by the IRS. The power of IRS raises question as to the extent of acceptability of taxpayer's business judgement by the IRS, though it says that IRS must satisfy a high threshold to override a taxpayer's business judgment.
- c) With regard to safe haven interest rates in US, most of the countries do not provide for such regime. Interest rate which is within the safe haven range and acceptable from IRS perspective may not be acceptable by the foreign tax authorities.

³⁵1.482-9(b)(7)(D)

Taiwan

The basic premise governing the introduction of the safe harbor rule was with an objective to alleviate the burden faced by the tax payer in complying with the transfer pricing regulations. The safe harbor provisions seek to provide a breather to the tax payer by accepting the transfer prices as declared by them without subjecting such tax payers to further audits.

The following sections contain a detailed discussion of the regulations.

Legislation

The Taiwan Transfer Pricing Examination Guidelines effective from 30 December 2004.

Scope of the rules:

- Taiwan transfer pricing regulations provide safe harbor rule in respect of maintenance of transfer pricing documentation on taxpayer meeting certain criteria. On November 6, 2008, the Ministry of Finance issued Ruling No. 09704555160 amending the erstwhile safe harbor rules for maintenance of transfer pricing documentation. The amended guidelines ease the threshold for preparing transfer

pricing study reports. As per the ruling, the taxpayer can maintain alternative documents to substitute transfer pricing study report if following criteria are met:

- The annual turnover, including non-operating revenue, does not exceed NTD 300 Million
- The annual turnover, including non-operating revenue, exceed NTD 300 Million but does not exceed NTD 500 Million; and
 - Does not utilize tax credit for more than NTD 2 Million in a particular year or offsets net operating loss carry-forward of NTD 8 million or below for the prior five years
 - A financial holding company or any corporation or its subsidiary stipulated in the Enterprises Merger and Acquisition Law and has no foreign related party or other profit-seeking enterprise
- Not qualified for the aforementioned two items but the total annual amount of controlled transactions is below NTD 200 million

It has been clarified that the foregoing amended safe harbor rules are applicable when enterprises file their financial year 2008 income tax returns.





The alternative documentation which can be maintained to substitute transfer pricing study reports are as under:

- Related open-bidding information or documents of the comparable uncontrolled transactions
- Information of current market price regulated by the rules governing the assessment of Income Tax for the enterprises
- Appraisal reports issued by appraisers or unjustified authorities
- Foreign transfer pricing study report for the foreign related party participating in a controlled transaction (contents shall be modified accordingly to meet requirements of related Taiwan transfer pricing rules and regulations)
- Other documentation that could be applied to the comparability principle of the Taiwan transfer pricing

guidelines and could substantiate related pricing to be in conformity with arm's length result.

International experiences/challenges

Since the safe harbor provisions were enacted only with effect from November 6, 2008, Taiwan is still in the process of implementing these rules. It is too early to comment on the experiences on the maintenance of alternative documentation.

International countries that have abolished safe harbor regime

Russia

Under the earlier transfer pricing rules, 20% deviation to the transfer price was allowed to comply with the arm's length principle. Now, with the new transfer pricing legislation to be adopted by the autumn this year, the safe harbor provision has been abolished and is replaced with compliance with arm's length pricing.

Kazakhstan

Kazakhstan's transfer pricing policy is incompatible with the guiding principles for World Trade Organization (WTO) members. Hence in its quest to make it to the WTO, the 10% safe harbor threshold is proposed to be abolished in the revised transfer pricing law.

Other international countries

China

There are no safe harbor rules under Chinese corporate income tax ("CIT") regime. The Chinese tax authorities prefer a case by case analysis.

Cyprus

The new transfer pricing code is expected to provide for certain safe harbor margins to determine an appropriate contribution to the taxable profit in Cyprus, taking into account specific functions performed and risks assumed.

Safe Harbor regime for India

General recommendations based on our international experience

- **Potential double taxation risks:** Availing of safe harbor provisions in one country with certain specified transfer price could lead to different transfer prices, following the arm's length principles, reported by the associated enterprise in another country. This may trigger potential double taxation risks, i.e. the risk of paying taxes twice in two different countries. The CBDT should provide for circumstances as a result of which an Indian taxpayer availing of the safe harbor provisions can get the necessary relief from double taxation in another country, if the results of Indian safe harbor meet with the arm's length principle.
- **Risks of potential transfer pricing adjustments:** The taxpayer may be more likely to dispute a transfer pricing adjustment in the country where he has availed safe harbor provisions to prevent potential double taxation. Recognizing this, the CBDT should clarify when the safe harbor provisions, when adopted, will prevail over the provisions arising from the implementation of the tax treaty with other countries.
- **Resolving conflicting provisions:** Different countries may have their own safe harbor provisions, among other things, to safeguard their share of taxes and also for administrative convenience. The possibility of conflicting approaches and methods with respect to the same industry segment or transactions in such a case cannot be ruled out. Hence it is emphasized that CBDT should review and peruse the safe harbor laws of various countries, more particularly the major countries with whom Indian industry has majority of international transactions and should come out with a mutually satisfying safe harbor parameters that minimizes conflicts.
- **Specification of scope:** It is very essential that the parameters/conditions for availment of safe harbor are clearly specified e.g. the nature of the services which are covered should be clearly defined to avoid any debate. This will also encourage tax payers to determine whether it can opt for safe harbor or not.
- **Determination of cost base:** Where safe harbor provisions are adopted based on a cost-plus methodology, it is very important that the CBDT clearly defines the types of costs to be included in the cost base for the purpose of determining the arm's length price. Based on our international experience, definition of cost base has been a grey area and source of contention between the tax payers and tax authorities.
- **Determination of mark-up on cost base:** International experience (particularly US) suggests that routine support services and low margin services can be charged with or without mark-up. Also, OECD Guidelines suggest that a mark-up might not always make sense as accumulating the support evidence for establishing the appropriate profit mark-up might be a costly and cumbersome process. Currently Indian transfer pricing regulations do not shed any light on the issue that there could be situations where no mark-up is charged for transfer pricing purposes. Hence CBDT should take this opportunity and should give a safe harbor for mark up for low margin services whereby the tax payers will have a choice to charge these services with or without mark-up. Like IRS in US, CBDT should also recognize the overarching purpose of a cost-only safe harbor which is to allow taxpayers and revenue authorities to focus their resources on compliance with larger, more contentious, transfer pricing issues and that safe harbor is not a revenue generating measure.
- **Documentation to be maintained:** The safe harbor rules have internationally been adapted to simplify the compliance burden for the taxpayers. Hence, the CBDT along with the safe harbor rules should clearly specify the documents to be maintained by the taxpayer opting for the safe harbor rule. The documentation requirements should necessarily be less stringent than currently provided under rule 10D of the Income-tax Rules, 1962. Hence, the documentation requirements may mostly be restricted to the functional analysis and establishing the cost of services.
- **Option for the taxpayer to opt out of safe harbor:** Internationally, safe harbor provisions are not treated as a compulsory compliance. The taxpayer has an option to adopt a price which is less than the arm's



length price established by the safe harbor rules. In such cases, the burden of proof shifts to the taxpayer. The CBDT should also allow this option of taxpayers, wherein the taxpayers may not opt for safe harbor rules and establish arm's length price based on standard transfer pricing regulations in India.

- **Safe harbor not to become "deemed arm's length price":** Safe harbor is for reducing administrative and compliance burden. Care is to be taken to ensure that mark-up specified under safe harbor does not become a deemed arm's length price and adjustments are made during the course of audit of the tax payers which can justifiably document a lower mark-up.
- **Entry and exit from safe harbor regulations:** Opting for safe harbor should not carry exposure to the tax payer for the earlier tax years e.g. a taxpayer opting for safe harbor with may be higher mark-up than what was previously offered cannot be precluded from arguing the case for the earlier tax years. Similarly a tax payer opting out of the safe harbor regime cannot be subjected to safe harbor mark-up for the subsequent years.

Specific recommendations to Indian IT/ITES

Industry India has been a favored destination for many multinational companies for the outsourcing of Information Technology (IT) services and Information Technology Enabled Services (ITES) such as Business Process Outsourcing (BPO) services. A combination of cost advantages, availability of a qualified english speaking workforce, and reduced turnaround time have been critical factors in drawing companies to India. Most Indian service providers have been set up as captive entities of MNC groups, and have no external customers. Given the relatively routine nature of these services and the low-risk profile of the activities, these entities were compensated on a total cost-plus mark-up (in the range of 7 percent to 12 percent).

- **IT industry and the transfer pricing conundrum** Transfer pricing audits in India are conducted based on an objective criterion. Cases are selected for transfer pricing audit scrutiny when the total value of cross border related party transactions exceeds INR

150 Million (approximately USD 3.8 million). Currently, the tax authorities are in the process of auditing the transfer pricing policies of companies for the fiscal year ended March 31, 2007. Companies operating in the IT/ITES sectors faced aggressive audits for their transfer pricing policies during the year ended March 31, 2006, with TP authorities determining arm's length markups in the range of 25 percent to 40 percent on total operating cost, resulting in revenue adjustments of approximately INR 10 Billion. The current year audits appear to be no different, with proposed markups of 27 percent for the IT sector and 30 percent for the ITES sector.

While the high cost plus mark-ups being proposed by the tax authorities in India have received much publicity not much has been written about the basis adopted by the tax authorities to arrive at these mark-ups. Transfer pricing analyses for Indian captive service entities adopted the Transactional Net Margin Method (TNMM) and benchmarked the net margin earned by such entities against the net margin earned by independent comparable entities. The difference in the results arrived at by the taxpayers and the tax authorities lies in the variance in the approach to the methodology and criteria for choosing the comparables. The fundamental differences between the taxpayers and the tax authorities in this regard are summarized as follows.

Selection of comparables

- Several purported comparables proposed by the tax authorities have [OWN?] significant intangibles (research & development intangibles and/or marketing intangibles) unlike the captive offshore entities;
- The tax authorities have not considered differences in the scale of operations in arriving at the final proposed comparables. Some proposed companies in the tax authorities' set are huge, diversified organizations with significant economies of scale, unlike the offshore entities;

- All the independent companies bear entrepreneurial risk, whereas the offshore entities are risk-free entities that are compensated on a cost plus basis;
- Some purported comparables have been justified based on data obtained by the tax authorities through separate enquiries performed by the TP officer, a method unavailable to the taxpayer.

Rejection of the taxpayers' comparables

The reasons cited to reject the comparables proposed by the various taxpayers often lacked sound economic reasoning and were applied in an arbitrary and inconsistent manner.

It is noteworthy that the tax authorities have granted working capital adjustments to the comparables financials to better align the comparables results after adjusting for the differences in the working capital policies between them and the Indian tax payer.

The location savings impact³⁶

To a layperson, location savings refers to the benefits generated by shifting operations: (either a part of the core activity or some ancillary activity) from a high cost location to a low-cost-location. The sources of these benefits are the lower cost of labor, capital, rent, and raw material costs. But often an MNC's decision to relocate to a low-cost jurisdiction is a matter of business necessity to contain costs and maintain profit margins to remain competitive. In such cases, there is no location saving retained within the MNC group, because all such savings get passed on to the end customer in the form of lower prices. Customers gain the entire benefits from cost savings and the MNC continues to earn only a "normal" profit. Thus, even before one starts arguing for taxing location savings, it is important to identify the actual existence of such savings.

Application in the Indian context of IT/ITES

In the Indian context, given the relatively unrestricted availability of a qualified labor pool for IT/ITES services, it can be reasonably concluded that cost savings are generally available to any entity that chooses to set up a captive entity in India to provide outsourced services. Therefore, the factors determining whether location savings accrue to the MNC group is the degree of competition faced by the parent entity and the availability of the next-best low-cost location.

Financial analysis

Objective

The objective of the financial analysis exercise is to arrive at an appropriate arm's length markup for the purpose of proposing a Transfer Pricing (TP) safe harbor in respect of captive entities in India providing technology services to their related parties abroad. The arm's length markup will be determined by identifying comparable companies engaged in providing similar services.

Scope

For the purpose of this exercise, technology services have been segregated into:

- Information Technology (IT)/Software support services
- Information Technology Enabled Services (ITES)/ Business Process Outsourcing (BPO) services

A further refinement based on the sub-domains under each of these broad domains of IT & ITES has not been considered currently for the following reasons:

- Norms required to ensure suitability for comparability purposes are very stringent, resulting in a small number of comparables, even given the broad domain segregation
- Relevance to a large number of captive entities
- Simplicity in justification of transfer price & administration
- Wide variation in business models

Approach

The following publicly available databases have been used:

- Prowess containing information on over 7800
- Companies
- Capitaline Plus containing information on over 7000 companies

Also, annual reports of companies and web-based information were relied upon for the identification. The financial data and results are based on most current available information as of May 2008.

³⁶Source: "Outsourcing to India - Location Savings in Transfer Pricing Audits" dated May 2008 by Chandrima Bhattacharya, Manish Matta, and Vivek Dharma Sanakaran of Deloitte India

Process

Criterion	Rationale
Financial data available for the year 2007 or later	The TP regulations require the use of contemporaneous data
Sales turnover > Rs. 1 Crore	Ideally, the size criterion [upper and lower limits] should be set with reference to each company; however, for a generic selection, the lower limit of Rs.1 Crore has been selected to exclude very small companies
R&D expenditure < 3% of sales	In order to avoid selection of companies which are engaged in significant R&D activity and hence could have intangibles
Functional similarity	Companies engaged in activities other than BPO/ITES activities would not be functionally comparable
Related party transactions < 25% of sales	Companies with high related party transactions (affecting profits) cannot be considered as reliable benchmarks
Not consistently loss making	Companies which are consistently loss making cannot be considered representative of the industry
Absence of significant brand intangibles as per their financials	Companies with significant brand value would not be comparable to captive service providers who provide services only to related entities

Conclusion

Based on the financial analysis, the following observations are useful:

- Average margins for both software services as well as BPO services sectors are robust over the past three years
- BPO services, on average, tend to warrant a higher margin than software services

This is consistent given the higher cost base for software service companies, mostly due to more skilled labor warranting higher salaries.

Proposed safe harbors:

Software services: Cost plus 11% to 13%

BPO services: cost plus 11% to 13%

Apart from the analysis as discussed in the earlier paragraphs, we have also presented an economic model for determining revenue neutral safe harbor rate. This model has been created based on our past experience in the IT/ITES sector and the Indian transfer pricing audit scenario and is based on certain assumptions that are relevant for the Indian industry. We have explained the model in the paragraphs that follow.

Economic model for determining safe harbor

1. General assumptions for the model

- Safe harbor applicable to IT/ITES Captive service providers (N) operating on a cost plus model
- Existing audit environment in India results in 50% of cases audited of which transfer pricing adjustments are made on 25% of the cases
- Average cost plus mark-up proposed by tax authorities subsequent to audit is cost plus 22%
- Audit process is lengthy and takes 3 years to resolve; this results in an economic cost of delay

2. Model parameters

	Group I	Group II	Group III	Group IV	Group V
Adopted cost plus mark-up in the range of	0%-5%	5%-10%	10%-15%	15%-20%	20% +
Average mark-up for each group	2.5%	7.5%	12.5%	17.5%	-
Probability of TP adjustments for each group	50%	25%	25%	None	None
Tax revenue from TP adjustments for each group of tax payers	$[N*(50%*25%*50%)*(22\%-\text{average mark-up for each group})*\text{average cost base}*\text{corporate tax rate}]$ $(1+\text{discount rate})^{\text{period of audit}}$				

3. Model results: Revenue neutral safe harbour rates

Our model provides estimates of revenue neutral safe harbors assuming that post introduction of safe harbors, some categories of taxpayers will opt for this safe harbor resulting in assured revenue for the department with no cost of audit.

Taxpayers adopting safe harbor	Cost of audit	
	Low	High
Group III only	13.89%	13.61%
Group II and Group III only	15.84%	15.17%

As can be seen from the analyses presented in the above paragraphs, introduction of safe harbor provisions in India would alleviate to a substantial extent the administrative and compliance hurdles currently faced by the tax payer and the tax administration alike. The introduction of safe harbor mechanism would have the potential to mitigate protracted litigation, thus paving the way for a more amicable and cordial relationship between the tax payer and the tax authorities.

Specific documentation requirements for management charges

In the Indian transfer pricing context, one of the most nebulous and controversial areas is management charges. The Indian tax authorities are on a learning curve and at present there is no consistency in assessment proceedings of management charges among various tax jurisdictions. In order to mitigate the tax adjustments on account of management charges tax payers need to maintain extensive documentation to evidence the charges. At present, there is a lack of clarity among tax payers with respect to what could be treated as sufficient documentation by tax authorities. CBDT should consider this issue and attempt to bring clarity in the documentation requirements.

These types of minimum documentation requirements have been introduced in the past in many countries. For instance, the Pacific Association of Tax Administrator's (PATA) Transfer Pricing Documentation Package was released on March 12, 2003. The aim of this documentation package (the Package) was to allow taxpayers in PATA member countries (Australia, Canada, Japan and the United States) to create one set of transfer pricing documentation for a MNE that

would satisfy the documentary requirements of each respective jurisdiction thus avoiding the imposition of penalties on the taxpayer for having insufficient transfer pricing documentation. The compulsory nature of these requirements implied a safe harbor for taxpayers, that is, through compliance taxpayers will avoid the imposition of documentation penalties on any transfer pricing adjustment made by the relevant authority. The sheer volume of these requirements produced a situation where the Package had more rigorous documentary requirements than any of the respective PATA group members and conflicted with principles expressed in the OECD Guidelines. It became almost inevitable that the list of points to comply with would be longer than the list for any one country. Thus, producing a compliant documentation set involved greater effort than that involved in preparing documentation for any one jurisdiction.

Accordingly CBDT should be careful that any such documentation package should not create onerous burden on tax payers but should be comparatively easy to maintain such documentation. CBDT should also clarify that taxpayers should be aware that compliance with the Package does not mean that they can avoid transfer pricing adjustments. Rather, compliance should be intended to allow the taxpayer to avoid or reduce the imposition of transfer pricing penalties if the relevant authority has decided to make a transfer pricing adjustment.



Conclusion

Safe harbor provisions truly represent double edged sword entrusted to CBDT. CBDT, while formulating the safe harbor policies should always remember that while these provisions provide the needed relief of certainty, simplified method and administrative ease to tax authorities, the same provisions could lead to adverse effects, if not formulated or applied in an appropriate manner in the various cases of taxpayers/transactions.

The CBDT should take abundant caution while exercising the powers entrusted by the law, be more pragmatic in its approach while formulating safe harbor rules keeping in mind the interests of both the taxpayers and tax authorities, and come out with 'safe harbor' parameters with clear cut guidelines as to its applicability for taxpayers, to avoid any new set of complications in its implementation.



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