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TRANSFER PRICING

Study on the feasibility of introducing safe harbour provisions in ECOWAS countries

(Foreword, Abstract and Executive Summary – the main report itself is only available in French)

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Study on the feasibility of introducing safe harbour provisions in ECOWAS countries

Results and analysis of the questionnaires sent to governments, businesses and the civil society

By Alain Charlet, Caroline Silberztein and Gérard Pointe[1]

DISCLAIMER:

The information and views presented in this study are those of the authors and do not necessarily reflect the official opinion of the European Union.

The institutions and bodies of the European Union, or any other person acting on their behalf, cannot be held responsible for the use that may be made of the information contained in this study.

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FOREWORD:

The European Commission mandated a team of independent experts to proceed to a study on the feasibility of introducing transfer pricing unilateral or bilateral safe harbour provisions in ECOWAS countries (Economic Community of West African States). The fifteen ECOWAS states are : Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone and Togo.

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This team is composed of – by alphabetical order – Alain Charlet, Gérard Pointe and Caroline Silberztein. These experts are international tax lawyers with an experience in international organisations (OECD, IMF and World Bank), French and African tax Administrations and in the private practice. Amongst other things, Caroline Silberztein was the former head of the OECD transfer pricing unit and is nowadays leading the transfer pricing practice at Baker & McKenzie. Gérard Pointe was a former French tax Administration official detached in African tax Administrations. Alain Charlet is an independent expert for the IMF, the World Bank and the OECD. He is also teaching at the Paris mining school (Mines ParisTech) and at SciencesPo Paris.

This study consists in examining from a tax policy and tax administration point of view the pros and cons in relation with the implementation of safe harbour rules in ECOWAS countries. It also looks at making recommendations on how applying safe harbour rules in those countries.

In terms of methodology, a questionnaire was sent to each of the fifteen ECOWAS Member States, as well as to a selection of companies, international organizations and organisations of the civil society having a presence or activity in the sub-region. The purpose of this questionnaire was to gather information concerning the macroeconomic and administrative environment of each ECOWAS country but also regarding the transfer pricing and safe harbour legislation applicable in each of those countries.

This report presents a synthesis of the information and data collected. The **first section** explains the interest of the study; it describes in particular the tax revenues structure (tax "*mix*") of ECOWAS countries and the specific transfer pricing issues faced by developing countries. The **second section** defines what a transfer pricing safe harbour is and explains its main advantages and disadvantages. The **third section** presents the key findings emerging from the responses to the questionnaires. The **fourth section** presents the international experience concerning safe harbours; it describes the experience of some emerging countries which are pioneers in this field such as Mexico and India. The **fifth section** draws up proposals of safe harbours (defining the eligible activities and their level of added value and risk). The **sixth section** outlines the tax policy and tax administration considerations to be taken into account, namely – amongst other things – the search for a balance between revenue mobilization and tax management facilitation, the design of scalable safe harbours, including exiting opportunities, and the legal and administrative issues to be taken into account when considering the desirability or implementation features of a safe harbour.

ABSTRACT:

The purpose of this study is to investigate the desirability and feasibility of introducing transfer pricing unilateral or bilateral safe harbours in ECOWAS countries. A safe harbour in a transfer pricing regime is an administrative simplification. It is in principle optional. It uses for instance predetermined margin rates to assess arm's length prices, alleviates or removes the documentary obligation, or exempts a category of taxpayers or transactions from the application of ordinary transfer pricing rules.

This study presents a synthesis of the responses to a questionnaire. This questionnaire was sent to each of the fifteen ECOWAS member states, as well as to several companies, international organizations and organisations of the civil society having a presence or activity in the sub-region. Those responses allowed to gather information regarding the macroeconomic, legislative and administrative transfer pricing environment in eleven ECOWAS member states. Drawing from these elements, this study examines from a tax policy and tax administration point of view the pros and cons in relation with the implementation of safe harbour rules in ECOWAS countries. It also makes proposals as to how these safe harbour schemes might be applied taking into account the specificities of ECOWAS countries.

EXECUTIVE SUMMARY:

Although the tax structure of the ECOWAS (Economic Community of West African States) countries is marked by a preponderance of indirect taxes, the place of corporate income tax is generally proportionally higher in these countries than in developed countries. The risk of revenue losses related to corporate income taxes is thus an important issue. In addition, the fiscal transition that these countries will implement should logically be accompanied by a strengthening of the weight of direct taxes in the tax mix. Furthermore, with the expected development of international flows and increased attention to transfer pricing issues, these countries will face the need to develop administrative capacity, secure taxpayers and avoid double-taxation.

The implementation of safe harbours could help to secure corporate income tax revenues while facilitating the tax administration of States and the tax compliance of firms.

Definition of a safe harbour:

A safe harbour in a transfer pricing regime is an administrative simplification which is in principle optional (it consists for instance of a simplification when determining arm's length prices by using a pre-established transfer pricing method and margin rates and/or of an alleviation of the transfer pricing documentation requirement). A safe harbour may also exempt a category of taxpayers or transactions (for instance, small taxpayers or transactions of a low amount) from the application of all or part of the general transfer pricing rules.

Pros of safe harbours:

As far as businesses are concerned, a safe harbour increases tax certainty because the transfer prices set under this scheme must be accepted by tax authorities. Moreover, it reduces the cost of compliance with regulations.

Safe harbours may improve equity among taxpayers. Indeed, they help to ensure that all taxpayers placed in similar situations are subject to the same treatment, which is not always the case in the context of tax audits or negotiated agreements between businesses and tax Administrations (Advanced Pricing Agreement/APA).

Bilateral or multilateral safe harbours may reduce the risks of double taxation or double non-taxation by helping to establish an agreement between developing and developed countries on sensitive issues when the views of their respective tax

Administrations differ (for instance, in the case of the billing of intra-group services or of royalties).

Transfer pricing safe harbours might in some cases contribute to solving the issue of the valuation of supplies of services for the purposes of applying withholding taxes or VAT (which matters essentially – as far VAT is concerned – when the VAT is not deductible for the taxable person: i.e. in the case of some purchases for which there is no right to deduct or in the case of businesses having purchased a supply with VAT and carrying out a business partly or totally exempt from VAT). Safe harbours might also help to address exchange control issues in relation with transactions eligible to the safe harbour scheme. Thoughts about safe harbours covering both transfer pricing and customs duties issues might also be considered (see in this respect Mexico's experience that combines a safe harbour and an inward processing arrangement (*Section 4.1 below*); the case of ECOWAS countries exporting commodities or manufactured goods to a developed country might also be considered: a safe harbour might help to ensure that customs duties applicable at import in the developed countries and – as the case may be – at export in the ECOWAS country, would not be applied on a higher base than the one used to determine the taxable profit in the ECOWAS country under the safe harbour scheme).

As far as tax Administrations are concerned, a safe harbour enables tax authorities to secure tax revenues in low risk situations, with a limited commitment of administrative resources. This allows tax authorities to gradually develop their transfer pricing expertise and/or to redeploy their administrative resources to audit transactions/taxpayers which are more complex and/or are subject to higher risks.

Cons of safe harbours:

A safe harbour may lead to the determination of a transfer price and to a declaration of a taxable income not complying with the arm's length principle.

A unilateral safe harbour may create a risk of double taxation or double non-taxation.

Questionnaires results:

In order to assess the desirability and feasibility of introducing safe harbours in the ECOWAS, questionnaires were sent to governments of ECOWAS Member States, to multinational enterprises operating in the area, international organizations as well as to the civil society.

Responses of ECOWAS Member States:

Eleven Members States among the fifteen ECOWAS countries responded to the questionnaire. All respondents have at least a rudimentary transfer pricing scheme in their national legislation. A few countries – including Liberia and Nigeria but also Senegal, although more recently as from the 1st January 2013 – have introduced Advanced Pricing Agreement procedures (APA).

However, several countries shared their difficulty in applying the existing transfer pricing legislation, due to the lack of dedicated and trained staff, the complexity of the transfer pricing issues and the difficulties to find relevant comparables as well as to build a documentary database. In practice, very few adjustments seem to be made and there are almost no litigations.

Transfer pricing-safe harbour schemes seem inexistent in the ECOWAS zone, the only notable exception being Nigeria. However, the Nigerian safe harbour is quite specific: it exempts the taxpayer from complying with his documentary requirements, notably where the prices of his transactions were determined according to Nigerian rules or were approved by the authorities.

A majority of countries expresses an interest for the implementation of safe harbours. Among the countries who welcome the idea of implementing a safe harbour, a majority of them believes that this safe harbour should be multilateral.

Responses of businesses:

Among the businesses surveyed, many undertakings consider that improving transfer pricing tax certainty is important even when transfer pricing is not an obstacle per se to investment.

A majority of businesses would welcome the implementation of an optional and rebuttable safe harbour that would apply to low-risk or low value-added activities that do not involve the development or use of intangibles.

Businesses show a preference for defining a Community safe harbour scheme at the ECOWAS level. That is because they consider that a uniform treatment would ensure equal tax treatment which would make investment decision more neutral. The only business respondent benefiting from a safe harbour in West Africa (more precisely in Nigeria) underlined that the process for obtaining this safe harbour is slow and bureaucratic.

Responses of the civil society:

Civil society's views are divided. Some organizations consider that safe harbours might be mutually beneficial for businesses and governments. Thus, Christian Aid believes that safe harbours might increase tax certainty for businesses although Christian Aid also emphasizes that the very dynamic nature of developing countries' economies may soon render these safe harbours obsolete. According to Tax Justice Network, safe harbours allow reducing tax administration costs for governments and tax compliance costs for taxpayers, encourage voluntary compliance, offer some tax certainty, eliminate litigation risks and promote FDI.

Other organizations however have a critical look at these safe harbours. EURODAD believes that transfer pricing safe harbours might open new tax optimization opportunities for multinational companies. Espol indicates that implementing safe harbours is not a guarantee of revenue increase for governments.

The experience of emerging countries:

Several emerging countries already have a safe harbour experience. For example, Mexico in the nineties set up a specific transfer pricing safe harbour scheme for "*Maquiladoras*". The Mexican regime that has been tested over a relatively long period of time is particularly instructive for sub-Saharan Africa countries.

In Mexico, the implementation of specific tax and customs regimes seems to have favoured the establishment of manufacturing companies, especially at the border with the United States. These businesses called "*Maquiladoras*" are in principle held by foreign companies and are specialized in assembling, manufacturing, processing or repairing imported goods intended to be re-exported. The transfer pricing rules applicable to "*Maquiladoras*" are based on an optional system: the taxpayer must either elect for the safe harbour, or negotiate an APA with the tax authorities. This approach allows to validate the transfer pricing policy of the businesses who believe that the safe harbour scheme is unfavourable to them and, in doing so, allows to inform the tax authorities within the framework of the negotiation of the APAs.

Another interesting example is the one of India: it introduced in 2009 a new provision in its tax code allowing for transfer pricing safe harbours. Under the Indian safe harbour – which was eventually implemented in 2013, the Indian tax authorities must accept the transfer pricing policy of the taxpayer that opted for the safe harbour provided it complies with the minimum margins defined by the safe harbour rules. To be eligible for the safe harbour, the taxpayer must have an eligible activity and this must be a low risk activity. The taxpayer must also renounce recourse to the use of the mutual agreement procedure for the transactions covered by the safe harbour. In the Indian system, the minimum operating margin thresholds vary depending on the type of activity concerned.

What kind of safe harbour for the ECOWAS Member States?

According to the OECD report dated 16 May 2013 on the revised transfer pricing Guidelines, a safe harbour can only be relevant for "*low risk*" activities.

However, responses to the questionnaire sent to governments often indicate that transfer pricing related issues go beyond the sole manufacturing, distribution, or research and development low risk services. This raises the question of the relevance of the implementation in the sub-region of a safe harbour for high value-added activities, such as, for instance, extractive, telecommunications, banking and insurance activities.

The implementation of a safe harbour in developing countries should be the result of a trade-off between:

1) giving up some tax revenues (as compared to the amount of revenues that a systematic application of the arm's length principle would have raised in theory) in order to increase tax attractiveness and certainty, while minimizing the management and audit costs of the tax authorities and the compliance costs for businesses;

2) and the guarantee of a minimum of tax revenues as part of a transition of these economies towards a greater integration into international trade.

As regards the features of the safe harbour scheme, several solutions are possible. A safe harbour must be optional: otherwise it is a flat tax regime and not a simplification measure anymore. The originality of the Mexican model is to combine an optional scheme with an obligation to negotiate an APA if the taxpayer does not elect for the safe harbour. The development of an APA practice may facilitate the training of the tax Administration in transfer pricing issues.

Then, the definition of the applicable transfer pricing method (for instance the cost plus method) and of the margin thresholds must be done with the utmost vigilance. In India, the minimum operating margin thresholds vary depending on the type of activity concerned. Another option might be to make margin thresholds vary depending on the type of transaction and on its level of risk or value-added rather than on the type of activity.

With respect to transactions on raw materials (commodity transactions), implementing a safe harbour determining intragroup selling prices on the basis of existing relevant public quoted prices (adjusted, if necessary, to take into account possible differences between transactions) might be considered.

Finally, a safe harbour should go hand-in-hand with the economic development of businesses and of the country. Thus, a safe harbour should not discourage any investor to develop more value-added (which may happen if a safe harbour exclusively granted to low value-added activities is much more favourable than the general rules applicable to higher value-added activities). Second, a safe harbour might be designed as a temporary measure that should evolve according to the economic development of the country and the strengthening of the capacity of its tax Administration.

What legal and administrative scheme for safe harbours?

From a legal point of view, a safe harbour must be provided by national law: it must be a provision from the General Tax Code; it must not be embodied in a sectoral code. In order to avoid double taxation problems, bilateral or multilateral safe harbours should be preferred. Therefore, negotiations should be initiated within the sub-region but also with partner States at a national or at a regional level. A multilateral safe harbour scheme might be discussed within the framework of negotiation of bilateral or multilateral international treaties. Regional organizations such as the WAEMU (West African Economic and Monetary Union) or ECOWAS might define a legal standard that might be binding for their Member States (this might take the form of a regulation, directive or protocol) or propose a safe harbour model.

From an administrative point of view, it may be envisaged to strengthen and assign powers to an existing state or regional body (or to create a new body) so that this body can negotiate bilateral or multilateral safe harbours on behalf of its members. In addition to that, a technical unit dedicated to the administration of safe harbours should be created within the tax Administration. Finally, an impact study should assess periodically (especially during the years following the introduction of the safe harbour) the positive and negative effects of this scheme (on the tax revenues and on the economy as a whole) in order to plan the evolution of this safe harbour.

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