



Working Paper 100

Safe Harbour Regimes in Transfer Pricing: An African Perspective

Alexander Ezenagu

August 2019

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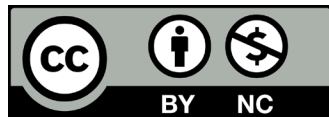
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Alexander Ezenagu

Summary

The transfer pricing methods established by the transfer pricing rules and practices of countries (generally modelled after the OECD Transfer Pricing Guidelines) are not only complex to implement, but also fraught with challenges – such as the availability of comparables for benchmarking purposes, accessibility of databases and the capacity of tax authorities to implement them. For tax authorities in African countries, these challenges are further amplified, for example, by lack of resources, especially human and capital, and little experience in applying transfer pricing rules. As a result of these challenges, achieving arm's length prices for transactions between related entities has posed a significant burden and cost to both taxpayers and tax authorities.

Tax authorities in some jurisdictions apply safe harbours and other simplified measures to mitigate the challenges of applying transfer pricing rules and practices. These reduce the need for taxpayers to prepare detailed transfer pricing documentation in justifying the arm's length price fixed for goods and services transferred among related entities. It also removes the need for tax authorities to audit the books of taxpayers where they act within approved margins. In some cases, they exempt taxpayers from applying transfer pricing rules to related-party transactions.

This paper analyses the adoption and application of safe harbour regimes by African countries, and how they should be designed. It recommends the cautious adoption and application of safe harbour regimes by tax authorities in African countries to achieve increased revenue collection, tax efficiency, certainty, simplicity and convenience, and to circumvent the complicated comparability analysis.

Keywords: allocation of profits; transfer pricing; simplified measures; multinational enterprises; safe harbours; international corporate taxation; Africa; transactional approach.

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Acronyms

AfCFTA	African Continental Free Trade Agreement
AMT	Alternative minimum tax
APA	Advance pricing arrangement
ECOWAS	Economic Community of West African States
FIRS	Federal Inland Revenue Service of Nigeria
MNE	Multinational enterprise
PCT	Platform for Collaboration on Tax
SME	Small- and medium-sized enterprises
SNMM	Shared net margin method
TNC	Transnational corporation
TPGs	Transfer Pricing Guidelines

Introduction

Overview

Applying transfer pricing rules in Africa poses great difficulties. There are few reliable comparables to benchmark prices and terms fixed by related entities in their transactions with each other. This means that jurisdictions struggle with applying the arm's length principle in intra-firm dealings, as prescribed by tax treaties and domestic laws. Furthermore, the requirement for an individual facts and circumstances analysis in transfer pricing promotes subjectivity in transfer pricing audit and administration. This subjectivity creates an environment of uncertainty for taxpayers and potential investors, who find it hard to predict tax outcomes. In addition, the requirement for individual facts and circumstances analysis in transfer pricing is resource-intensive, time-consuming and complex to implement for all – especially the tax authority, who is in competition with large accounting firms to arrive at an appropriate tax return for the taxpayer. This is where safe harbour regimes may be useful.

Safe harbour regimes are established to reduce the burden of tax compliance and ease administration of the tax system, while at the same time providing tax certainty. For taxpayers subject to transfer pricing rules of taxing jurisdictions, safe harbour regimes have the potential to reduce the compliance burden involved in establishing an arm's length price for transactions entered into with related entities. For tax authorities, safe harbour regimes can help to ensure effective management of limited resources needed for tax enforcement. Finally, they may be used to secure and increase corporate income tax of taxing jurisdictions.

Both the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD TPGs) and the *UN Practical Manual on Transfer Pricing for Developing Countries* (UN Practical Manual) recommend the application of safe harbour regimes to small- and medium-sized enterprises (SMEs) and small transactions, which are deemed to carry low tax risk, though creating significant compliance and enforcement burdens on taxpayers and tax authorities, respectively. The guiding reasons for introducing safe harbour regimes for rich countries are to reduce the compliance costs and burden for taxpayers, and enforcement burden for tax authorities. For African countries, increasing and guaranteeing corporate income tax collection is equally important. Appreciating this additional policy objective can help the effective introduction and design of appropriate safe harbour regime(s) for African countries.

This paper makes the case for the cautious introduction and use of safe harbours by tax authorities in African countries, to achieve increased revenue collection, tax efficiency, certainty, simplicity, convenience, and to circumvent complicated comparability analysis.

Reasons for considering simplified methods

The rules for allocating taxable income of multinational enterprises (MNEs) are important considerations for tax authorities and governments, as they determine the income and expenses of companies, which affect the taxable profits companies return to the tax authorities (Solilova 2013: 2757-2768).¹ This tax revenue is important for economic development and building basic infrastructure, and contributes to improving the quality of life of citizens (EuropeAid and PwC 2011).

¹ See also Cobham and Jansky (2017).

The internationally agreed principle for allocating income of MNEs is embodied in Article 9 of the model tax treaties; this gives power to national tax authorities to adjust the profits of entities that are part of an MNE group. The criterion for such adjustments is to allocate to the tax jurisdiction the income that the entity would have earned if it had been independent. Picciotto (2018) shows that almost all African countries have legislation that gives power of adjustment of taxable profits to tax authorities, akin to the provision of Article 9 of model tax treaties. To assist with the application of this provision, the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development (OECD) issued Transfer Pricing Guidelines in 1995, which have subsequently been revised (OECD 2017a). Picciotto (2018) further reveals that 17 of the African countries with provisions on adjustment of taxable profits have transfer pricing regulations based on the OECD's TPGs.

The legal status of these TPGs depends on the domestic laws of taxing jurisdictions. Though generally regarded as soft law (Christians 2007), they have been given some form of legal effect in some jurisdictions, even in countries that are not members of the OECD. For example, Nigeria² and Kenya³ have, through legislative and judicial pronouncements, given legal backing to their application within their jurisdictions. To other tax jurisdictions, the TPGs are merely persuasive instruments, at best. For example, in a recent judgement of the High Court of Malawi, the court held that, 'where local legislation provides for the law, it is always imperative to apply that law and use any international instruments in interpreting that local law'.⁴ However, tax authorities in most tax jurisdictions aim as far as possible to keep in line with the TPGs. Hence, the quasi-legal nature of the TPGs poses some limits to the ability of countries to choose the approach most suited to their conditions for attributing income to MNEs within their jurisdictions. Given the established flaws in the application of the OECD TPGs, countries search for alternatives or simplified measures (Durst 2016; Picciotto 2018). I discuss the flaws below.

A central difficulty of applying the TPGs is the requirement to conduct an individual analysis of each entity within an MNE corporate group, coupled with the search for comparables for the purpose of benchmarking transactions between related entities. The transactional approach requires an analysis of the relationships between entities in a corporate group according to the individual facts and circumstances of each entity (functional analysis). The purpose of this individual analysis is to ascertain that the transfer price set for transactions between related parties conforms to the price two independent parties would have fixed for similar transactions (Picciotto 2018). This comparability analysis aims to find the most reliable comparables (uncontrolled transactions) for the transaction between related entities (controlled transactions) (OECD 2017a: 150).

A controlled transaction is deemed comparable to an uncontrolled transaction where there are no material differences between them that could affect the price being determined – or, where there are differences, adequate adjustments can be made to eliminate the effects of those differences. In other words, 'the economically relevant characteristics of the two transactions and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length result' (United Nations 2017: 66). In considering whether transactions are comparable, the TPGs lay down the procedures for conducting what is usually termed a functional analysis (OECD 2017a: 46). Briefly, this entails consideration of:

² Regulation 18 of the Income Tax (Transfer Pricing) Regulations, 2018, pursuant to the Federal Inland Revenue Service (Establishment) Act, 2007, Laws of Federation of Nigeria.

³ Unilever Kenya Ltd v The Commissioner of Income Tax [2005] eKLR.

⁴ Eastern Produce (2018). The State and the Commissioner General Malawi Revenue Authority, ex parte Eastern Produce Malawi Ltd. [2018] MWHC 800, available at <https://malawilii.org/mw/judgment/high-court-general-division/2018/800>.

- the contractual terms of the transaction;
- the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices (the functional analysis);
- the characteristics of the property transferred, or services provided;
- the economic circumstances of the parties and of the market in which the parties operate; and
- the business strategies pursued by the parties.⁵

To effectively carry out this analysis, a tax authority must have sufficient technical knowledge of the economic sector of the taxpayer, its business model, the goods or services transferred and the terms of the transaction. The tax authority must then search for comparable transactions between unrelated entities to arrive at arm's length prices or terms.

The difficulty with this requirement to search for comparables is that, in a lot of cases, suitable comparable transactions do not exist. This is mainly due to the integrated nature of MNEs, the uniqueness of goods and services due to their technological superiority, peculiar industry practice and the business models adopted by MNEs when transacting with related entities. In more precise terms, the individual facts and circumstances analysis fails to recognise the economies of scale, scope, synergy and the interrelation of diverse activities created by integrated businesses, which are integral to the corporate group. It denies the fact that commercial activities of related entities are not decided on a stand-alone transactional basis. Business transactions between related entities are structured to promote the common enterprise and increase the total profit of the corporate group.⁶

The arm's length principle does not allocate value to the common enterprise that contributes to the total profit of the corporate group. The lack of appreciation of the integrated nature of MNEs, and the business model used by them, has led to unsuccessful searches for comparable transactions by both taxpayers and tax authorities, aiming to determine the arm's length price.⁷ The OECD is aware of these challenges. It admits that associated entities may engage in transactions that independent entities would not undertake. It further realises that where this is the case comparable transactions may not be found, and an arm's length price may be indeterminable.⁸

Furthermore, applying this transactional approach creates enormous administrative difficulties for taxpayers, and especially tax authorities: high cost of documentation, unpredictability of outcome, lengthy audit procedures, possible adjustment of taxable profits and potential liability to penalties. The OECD recognises these difficulties in its 2017 TPGs, where it admits that applying the arm's length principle could be a resource-intensive

⁵ See OECD Transfer Pricing Guidelines (2017a: ch. 1).

⁶ For a comprehensive discussion on the nature of MNEs and influences on FDI, see Hymer (1976); Letto-Gillies (2002); Dunning and Christos (2010).

⁷ The OECD: 'Both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm's length principle. Because the arm's length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data. The information that is accessible may be incomplete and difficult to interpret; other information, if it exists, may be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns. In other cases, information about an independent enterprise which could be relevant may simply not exist, or there may be no comparable independent enterprises, e.g. if that industry has reached a high level of vertical integration. It is important not to lose sight of the objective to find a reasonable estimate of an arm's length outcome based on reliable information' (OECD 2017a: para. 1.13, ch. 1, p. 37).

⁸ See OECD (2017a: para. 1.11, ch. 1, p. 37).

process, and could impose a heavy administrative burden on taxpayers and tax administrations, exacerbated by both complex rules and resulting compliance demands (OECD 2017a).

These problems are particularly acute for developing countries, such as those in Africa. The transfer pricing unit in Nigeria, a country that hosts many MNEs, consists of 32 officers; these carry out a transfer pricing audit of more than 2,900 taxpayers who are subject to transfer pricing rules.⁹ Compare this to the transfer pricing unit of KPMG Nigeria, which has more than 18 well-trained and incentivised staff advising clients on transfer pricing matters, while also enjoying support from other KPMG offices across the world. In Tanzania, the Tanzania Revenue Authority has 20 staff in its transfer pricing unit.¹⁰ The Large Taxpayers Office in Uganda has 9 officers in its international tax department auditing the accounts of over 820 taxpayers who are subject to transfer pricing.¹¹ In many African countries that have transfer pricing rules, transfer pricing units are understaffed compared to the multinational entities that they seek to audit.

Other limitations of applying the transactional approach to transfer pricing are: the financial cost of acquiring a licence to access a database of comparables, the relevance of the database to the taxing jurisdiction in question, and the requirement to adjust the information received from the database to reflect local circumstances, leading in some cases to reliance on imperfect data from foreign countries (PCT 2017: 12). In practice it is often extremely difficult, especially in African countries, to obtain adequate information to apply the arm's length principle. This is further complicated by the fact that most MNEs in Africa are headquartered outside the continent, and carry out business in other non-African countries that enjoy a better political climate and infrastructure. Many African countries are exposed to high political risks and dilapidated infrastructure, which make prices for transactions unpredictable and difficult to compare, in the absence of material adjustments.

Durst clearly summarises the limitations of applying transfer pricing rules discussed above:

Attempting, over the years, to perform 'from the ground up' factual and comparables analyses for each individual business operation, regardless of its uniqueness or complexity, has led to very large and in a great many cases prohibitive compliance costs. Despite the high costs incurred, however, the relative paucity of available comparables has caused comparable analyses to yield results that are too approximate and uncertain to be used by tax authorities in enforcement. As a result, transfer pricing enforcement efforts around the world, even in relatively straight-forward factual situations, have proven difficult and, in far too many instances, ineffectual. In many cases, transfer pricing rules are effectively unenforced because national tax administrations have no practical means of identifying clear benchmarks for acceptable arm's-length levels of income' (Durst 2012a: 65).¹²

As a result of the limitations of the arm's length principle and the OECD TPGs, countries seek simplified methods that address the absence of comparables, reduce the compliance

⁹ Information in 2018 provided by the Research and Development unit of the Federal Inland Revenue Service of Nigeria (FIRS), contained in responses to a questionnaire.

¹⁰ This information was provided in 2018 by a staff member of the Tanzania Revenue Authority, responding to a questionnaire in his personal capacity.

¹¹ This information was in 2018 provided by a staff member of the Uganda Revenue Authority, responding to a questionnaire in his personal capacity.

¹² Durst further argues that: '(1) reliance on searches for comparables cannot realistically be expected to generate data of sufficient quality to be useful in day-to-day tax administration; and (2) attempting to fashion transfer pricing methods on a case-by-case basis for all of the millions of transactions in which members of common groups engage around the world is an impossible, self-defeating, and damaging task' (Durst 2012a: 69).

cost and burden of administration, while guaranteeing and increasing revenue collection. Picciotto (2018) discusses some of the simplified methods available to tax authorities in the application of transfer pricing rules, examining the alternative minimum tax (AMT), the shared net margin method (SNMM), the fixed margin method adopted by Brazil and safe harbour regimes. According to Picciotto, the AMT and the SNMM 'essentially establish a benchmark effective tax rate, either as a minimum tax (based e.g. on turnover), or a profit margin set as a proportion of the TNC's global rate of profit (or loss)' (Picciotto 2018: 45). Brazil's fixed margin method 'specifies the profit margins to be applied to each type of transaction' (Picciotto 2018: 32). Without going into the merits and disadvantages of each simplified method, it is noteworthy that these methods seek to reduce the administrative burden of applying transfer pricing rules. The focus of this paper is on safe harbour regimes, which are discussed in the next section.¹³

1 Safe harbours

Countries use safe harbour regimes to achieve efficiency in tax administration and reduce the compliance cost and burden for taxpayers. Though safe harbours are not an exact science (similarly to the arm's length principle), and may not take into account the individual facts and circumstances of each individual taxpayer, they are recommended for African countries as they achieve a compromise between the need to protect the tax base (through strict adherence to transfer pricing rules), and to reduce the compliance and administration burden on taxpayers and tax authorities.

The OECD discusses the use of safe harbour regimes and their scope in chapter 4 of the OECD TPGs. In this section, I discuss the OECD's prescriptions on the adoption and application of safe harbour regimes and their limitations.

1.1 The OECD Transfer Pricing Guidelines on safe harbours

One area of recent positive development in the OECD TPGs is the acceptance of safe harbours as a transfer pricing simplification measure.¹⁴

The OECD's approach to safe harbours changed significantly in 2013. The 1995 Transfer Pricing Guidelines did not recommend that countries adopt safe harbours. These guidelines defined safe harbours as 'circumstances in which taxpayers could follow a simple set of rules under which transfer prices would be automatically accepted by the national tax administration' (OECD 1995: para. 205, section E, ch. VII). The Guidelines stated that 'whilst safe harbours could accomplish a number of objectives relating to the compliance and administration of transfer pricing provisions, they raise fundamental problems (OECD 1995: para. 231, section E, ch. VII). The view taken at that time was that safe harbour rules did not comply with the arm's length standard, and could lead to double taxation. The main reason for this was that where the safe harbour prescribed a transfer pricing methodology to be used by a specified group of taxpayers, it may fail to take into account the unique facts and circumstances of each of the taxpayers covered by the safe harbour regime. As such, the prescribed transfer pricing methodology may not be appropriate for all taxpayers.

¹³ The findings of this study are based on questionnaires and secondary sources. A questionnaire was sent to the Research and Development unit of the FIRS, Nigeria, requesting response to questions on the transfer pricing practice in Nigeria, limitations and the use of simplified methods. A similar questionnaire was sent to a staff member of the Tanzania Revenue Authority and the Uganda Revenue Authority, who both responded in their personal capacity. For a discussion on other simplified methods, see Picciotto (2018).

¹⁴ See OECD (2017a: section E, ch. 4).

On double taxation, the OECD held the view that unilateral safe harbours 'may have a negative impact on the tax revenues of the country implementing the safe harbour, as well as on the tax revenues of countries whose associated enterprises engage in controlled transactions with taxpayers electing a safe harbour' (OECD 1995: section E, ch. VII).¹⁵ Unilateral safe harbours are problematic because countries are not bound to accept tax returns made by a related entity to a different taxing jurisdiction or the transfer pricing adjustment made by another tax authority. However, where a double tax treaty exists between two countries, the other country may be persuaded to make a corresponding adjustment in line with the tax treaty.¹⁶ In the absence of the corresponding adjustment, there is potential for double taxation. The potential double taxation, attributed to the adoption of unilateral safe harbours, could negatively affect the relationships between countries where the mutual agreement procedures enshrined in treaties and bilateral agreements are insufficient to address the double taxation. This strain in the relationship between countries may affect investment and trade between them.

Other fundamental problems with safe harbours identified in the 1995 TPGs include the creation of avenues for tax planning, and equity and uniformity issues as a result of a distinct set of rules created by a safe harbour regime.

A less negative view emerged in a 2012 report by the Committee on Fiscal Affairs of the OECD, based on a survey of the transfer pricing simplification measures in practice in OECD-member and observer countries (hereinafter, OECD Report) (OECD 2012). This found that many countries had introduced such simplification measures, including:

- Exemptions from transfer pricing rules or from transfer pricing adjustment;
- Simplified transfer pricing methods, safe harbour arm's length ranges/rates and safe harbour interest rates;
- Exemptions from or simplified documentation requirements;
- Exemptions from or alleviated penalties; and
- Simplified advance pricing arrangement (APA) procedures or reduced APA charges.

The report revealed that, despite the views and fears expressed in the 1995 and 2010 OECD TPGs, in practice OECD member and observer countries who responded to the survey had found it necessary to introduce some safe harbour measures in their transfer pricing practices. Indeed, 33 out of the 41 respondent countries had transfer pricing simplification measures in place, with 69 measures in total. Almost three-quarters of these simplification measures were directed towards small- and medium-sized enterprises (21 countries); small transactions (15 countries); or low value-adding intra-group services (8 countries). A smaller number of countries (16) had 23 safe harbour rules between them, of which 35 per cent were exemptions from transfer pricing rules/adjustment; 26 per cent adopted simplified transfer pricing methods and a safe harbour arm's length range or rate; safe harbour interest rates accounted for 13 per cent. In relation to taxpayers or transactions, the report revealed that 30 per cent of safe harbour rules were directed at low value adding intra-group services; 26 per cent at loans; 22 per cent at SMEs; and 9 per cent at small transactions. South Africa, the only African country reported in the survey, was reported to have a safe harbour interest rate regime in place for inbound intra-group cross-border loans.

The OECD Report further showed that these respondent countries reported no case of double taxation from the application of safe harbour provisions. The simplification measures appeared to provide certainty and alleviate compliance costs, to the 'delight of the business

¹⁵ See also OECD (2017a): para. 4.96, section E, ch. IV).

¹⁶ See generally, Article 9 of most model tax conventions, e.g. Article 9 of OECD (2017b).

community (OECD Report 2012: 27).¹⁷ The findings in the 2012 OECD Report resulted in the revision of section E of chapter 4 of the TPGs, published in 2013, which has been retained in the 2017 version of the TPGs.

In the current version of chapter 4 of the TPGs, the OECD recommends that properly designed safe harbour provisions, applied in appropriate circumstances, can help to relieve some of the burdens associated with administering and complying with the transfer pricing rules, while providing taxpayers with greater certainty (OECD 2017a: para. 4.127, section E, ch. IV). This is because the 'benefits of safe harbours outweigh the related concerns when such rules are carefully targeted and prescribed and when efforts are made to avoid the problems that could arise from poorly considered safe harbour regimes' (OECD 2017a: para. 4.97, section E, ch. IV).

1.2 The OECD's prescriptions for safe harbour regimes and their limitations

The 2017 OECD TPGs recommend the use of safe harbour regimes to avoid the difficulties of applying the arm's length principle, by creating a regime where eligible taxpayers may elect to follow simplified transfer pricing rules or be exempted from the application of transfer pricing rules (OECD 2017a). The 2017 TPGs lists the benefits of safe harbours to include compliance relief, tax certainty and administrative simplicity. On tax certainty, safe harbours guarantee the acceptance of returns filed by taxpayers where the taxpayer has operated within the prescribed margins or applied the recommended transfer pricing methodologies. This guarantee of acceptance reduces the compliance burden on taxpayers, relieving them from potential further audits and reassessment of their tax returns. For the tax authority, the cost and burden of administration of the tax system are reduced, encouraging voluntary compliance by the taxpayer – this is less problematic and uncertain than compliance with the full transfer pricing process.

However, the 2017 TPGs list some major concerns over the adoption of safe harbour regimes. These include: divergence from the arm's length principle; risk of double taxation and double non-taxation mutual agreement; the possibility of opening avenues for tax planning; and equity and uniformity issues. These concerns result in two main conditions for safe harbours: they should not be mandatory but voluntary for taxpayers, and, if they may affect treaty partners, they should be agreed bilaterally, or be subject to mutual agreement proceedings. This is unsurprising, considering the OECD's insistence on an individual analysis of the facts and circumstances of each taxpayer, and determination of an arm's length price for transactions between related entities.

Consequently, the 2017 OECD TPGs offer the following recommendations to countries seeking to introduce safe harbour regimes: safe harbours should be (i) limited to small taxpayers and/or small transactions, and (ii) elective for taxpayers. Also, (iii) countries should be willing to modify safe harbour outcomes in mutual agreement proceedings to limit the potential risk of double taxation, (iv) safe harbours should be negotiated on a bilateral or multilateral basis, and (v) it should be clearly recognised that they do not bind or limit in any way any tax administration other than the tax administration that has expressly adopted the safe harbour. I shall further analyse these recommendations in the next section, in light of the types of safe harbours and their design.

Some observations may be made about the OECD's perspective on safe harbour regimes. First, it seems to consider them appropriate only for defined categories of low-risk and low-revenue-generating taxpayers or transactions. It would appear that its definition of 'category

¹⁷ The view of the South African tax authority on the use of safe harbours by the business community.

of taxpayers or transactions' is limited to small taxpayers and small transactions. Nothing in section E of chapter 4 of the TPGs indicates that the OECD contemplates the application of safe harbour regimes to high value-adding industries or large businesses. It also seems to exclude sectoral simplified regimes.

Second, the OECD's safe harbour prescriptions aim only at the use of safe harbours to reduce compliance and administration costs and burden. Nothing in the guidelines shows it considers safe harbours as relevant for improving and guaranteeing revenue collection, or addressing the issue of absence of comparables for benchmarking purposes. Hence, in terms of objectives, the OECD's concept of safe harbours is narrow.

Other reports have adopted wider objectives. For instance, the Platform for Collaboration on Tax (PCT)¹⁸ considers that 'carefully constructed safe harbours could be particularly useful for common types of transactions where comparable information is unavailable or unreliable' (PCT 2017: 13). It further argues that using safe harbours can relieve tax administrations from 'conducting the same comparability analysis and benchmarking analysis during an audit of a specific case' (PCT 2017: 57). This wider objective is important given the difficulty with accessing comparables for African countries. It is also significant, as it does not limit the application of safe harbours to small taxpayers or small transactions, but is focused on the limitations of the comparability analysis. This way, it extends the application of safe harbours to common types of transactions notwithstanding the size of the taxpayer.

A 2017 Report by Charlet, Siberztein and Pointe, commissioned by the European Union (EU Report), also recognises this wider objective. It states that, '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' (Charlet et al. 2017: 6). Consequently, it defines a safe harbour 'as 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 an alleviation of the transfer pricing documentation requirement)' (Charlet et al. 2017: 6). This broader objective of revenue collection informs suggestions for safe harbours to be applied to large taxpayers and/or large revenue-generating industries and transactions. This is particularly important for African countries grappling with base erosion and profit shifting activities of MNEs, which significantly affect the tax revenue coming to the countries.

In conclusion, the OECD's position on safe harbour regimes in the 2017 TPGs remains a cautionary one, albeit more positive than in the 1995 TPGs. However, as the OECD is currently undertaking a review of Chapter IV of the TPGs, it is hoped that it will provide clearer guidance on the suitability or otherwise of safe harbour regimes, especially for developing countries.¹⁹ In addition, an expansion of the application of safe harbour regimes to high revenue-generating taxpayers and the integral sectors of the economies of African countries could lead to increased revenue generation, while reducing the compliance and administrative burden. Furthermore, a broad appreciation of safe harbour regimes to mean simplified measures that reduce the compliance and administrative burden, would recommend the adoption of profit allocation methods outside the OECD's prescribed transfer pricing method, as long as they are deemed simple and efficient.

¹⁸ A joint effort launched in April 2016 by the International Monetary Fund (IMF), the OECD, the United Nations (UN) and the World Bank Group (WBG).

¹⁹ See the submission of The BEPS Monitoring Group on 'Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes', available online: <https://static1.squarespace.com/static/5a64c4f39f8dceb7a9159745/1/5b3242961ae6cf9812ba9e7c/1530020506821/Administrative+Approaches+to+TP+Disputes.pdf>.

2 Types of safe harbours

2.1 Exemption from transfer pricing rules and/or documentation

In OECD countries, exemptions from the application of transfer pricing rules, or from documentation requirements, are usually applied to small and medium enterprises (SMEs) and small transactions. These safe harbours aim to save SMEs from the disproportionately large cost of applying transfer pricing rules, as well as reducing the administrative burden for tax authorities from having to scrutinise low-risk taxpayers or transactions. I discuss the exemptions further below.

2.1.1 Exemption from transfer pricing rules

In certain cases, eligible taxpayers are exempt from applying transfer pricing rules to transactions with related entities. Such eligible taxpayers are either small taxpayers or taxpayers engaged in small transactions. For example, in Mexico small individual taxpayers (defined as taxpayers whose income from business activities and interest in a fiscal year does not exceed US\$161,500) are exempt from applying transfer pricing rules (OECD 2012). Similarly, the United Kingdom exempts SMEs from the requirement to apply transfer pricing rules.²⁰ The exceptions in the United Kingdom are where the SME transacts with an entity in a non-qualifying territory,²¹ HMRC notifies a medium-sized enterprise that it would be required to apply transfer pricing rules for a period, the SME elects to apply the transfer pricing rules, or the transaction of the SME is one relevant to a patent box claim.²²

Eligible taxpayers under this safe harbour regime are not required to show that they have complied with the arm's length principle, nor do they have to prepare transfer pricing documentation to that effect. The disadvantage of exempting taxpayers from compliance with the transfer pricing rules is that if the prices fixed for intra-firm transactions are not arm's length, they may be used to shift profits to more favourable jurisdictions. However, given the size of these taxpayers or transactions, the tax loss is minimal and the benefits of applying the safe harbour regime are likely to outweigh the relative loss of revenue from exemption from transfer pricing rules.

2.1.2 Exemption from transfer pricing documentation

This type of safe harbour exempts eligible taxpayers from preparing transfer pricing documentation unless the tax authority requests for documentation to be prepared. It must be observed here that the taxpayers are still required to comply with transfer pricing rules – the exemption applies to preparation of transfer pricing documentation. This safe harbour regime recognises the disproportionate cost of acquiring the services of tax lawyers and tax accountants skilled in the preparation of transfer pricing documentation. This cost is further increased by the requirement in some jurisdictions to prepare contemporaneous transfer pricing documentation, which entails preparation of comparability analysis for every related party transaction.

²⁰ Information obtained from the website of the HMRC, available online at: <https://www.gov.uk/guidance/transfer-pricing-transactions-between-connected-companies>.

²¹ Defined as a territory whose double tax agreement with the UK does not contain a non-discrimination article.

²² Information obtained from the website of the HMRC, available online at: <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm412070>.

This type of safe harbour is commonly applied to small corporate taxpayers and small transactions. For instance, Mexico exempts SMEs (corporations and individuals with revenue in the preceding fiscal year of not more than US\$1,040,000) from preparing transfer pricing documentation (OECD 2012). In some jurisdictions this is applied as a *de minimis* rule or a prioritisation practice of the jurisdiction, and not as safe harbour. A case in point is the provision of the transfer pricing rules of Nigeria. The *Guidelines on Transfer Pricing Documentation* issued by the Federal Inland Revenue Service, Nigeria, exempt the preparation of contemporaneous transfer pricing documentation by taxpayers where the total value of controlled transactions between the connected persons is less than ₦300,000,000 (less than US\$1,000,000) (FIRS 2018: para 8(a)).²³

This type of safe harbour regime has its setbacks. One setback is the determination of the monetary threshold to apply when determining taxpayers or transactions to be exempted from transfer pricing documentation. One way to address this may be to determine it in line with the average cost of preparing transfer pricing documentation by accounting firms. If the cost of preparing transfer pricing documentation is relatively significant to the value of the controlled transactions or revenue of the taxpayer for the fiscal year, exemption from transfer pricing documentation may be granted. For instance, an average fee for one of the big four accounting firms in Nigeria to carry out a comparability analysis and provide documentation for a client with three or four controlled transactions would be ₦6,000,000 (US\$20,000).²⁴ For a small enterprise, this could be up to 20 per cent of its total revenue in a fiscal year.

Similar to the discussion on exemption from compliance with the transfer pricing rules, exemption from transfer pricing documentation contributes to the sparsity of comparable data needed for benchmarking transactions. The tax authority has to decide whether to focus its resources on larger revenue-earning transactions or taxpayers, and exempt smaller taxpayers or transactions from transfer pricing documentation; or to insist on all taxpayers preparing the necessary transfer pricing documentation on time, which could be expensive for some taxpayers and burdensome for the tax authority.

2.2 Exemptions for SMEs in developing countries

As discussed above, exemptions from both documentation requirements and transfer pricing rules are most common for SMEs in OECD countries. The use of exemptions for SMEs is sanctioned by the OECD and other supranational bodies. According to the 2012 OECD Report, this recommendation 'is consistent with a pragmatic risk assessment strategy by governments and with the objective to keep compliance costs proportionate with the size and complexity of the transaction' (OECD 2012: para 9).

For richer countries with safe harbour regimes, reducing the cost and burden of enforcement largely informs the choice and design of safe harbour regimes. This justifies focusing the application of safe harbour regimes on SMEs. The rationale for this is that the category of taxpayers involved do not contribute significantly to revenue collection in these countries. They do, however, add to the enforcement burden of tax administrations, disproportionately with the tax revenue they bring in.²⁵ Also, SMEs are unlikely to use sophisticated tax planning schemes, and hence are considered low-risk for tax audit purposes. This is further

²³ Taxpayers should however be able to prepare transfer pricing documentation within 90 days of demand by the tax authority.

²⁴ This information was provided by a staff member of KPMG Nigeria in his personal capacity.

²⁵ See e.g. the safe harbour regimes in Australia and New Zealand. It makes sense for these countries to focus their enforcement resources on the big companies and significant revenue-generating transactions, while treating lesser transactions and taxpayers, in terms of revenue contribution, under a more resource-friendly regime.

explained by the cost of acquiring the services of lawyers and accountants who provide these tax planning services, compared to the revenue of the SMEs.

While the rationale behind providing exemptions for SMEs is commendable, a key issue to consider is what would constitute SMEs for African countries in relation to transfer pricing. This is particularly important considering that tax laws may fail to define an SME for tax purposes, leaving one to adopt broader definitions. For instance, the European Commission defines a small enterprise as an enterprise with fewer than 50 employees, which has an annual turnover not exceeding €10,000,000, and/or an annual balance sheet total not exceeding €10,000,000 (Bergner et al. 2017). A medium enterprise is an enterprise with fewer than 250 persons and which has an annual turnover not exceeding €50,000,000, and/or an annual balance sheet total not exceeding €43,000,000 (OECD 2007: 5). This definition of SMEs by the European Commission has been adopted by the UK's HMRC²⁶ and by Solilova and Nerudova in their book (Solilova and Nerudova 2017). However, this definition of SMEs may be inappropriate for African countries, and a revised approach may have to be adopted, taking account of the economies of African countries.

For instance, a small enterprise in Nigeria is one which employs 10 to 49 people and has an asset valuation (excluding land and building) of less than ₦50,000,000 (US\$150,000); a medium enterprise is one which employs 50 to 199 people and has an asset valuation (excluding land and building) valued at less than ₦500,000,000 (US\$1,500,000) but above ₦50,000,000.²⁷ A large taxpayer for purposes of taxation is one which has turnover in excess of ₦1 billion (US\$4,000,000). In Tanzania, a large taxpayer is one with annual turnover of TSh10 billion (US\$4,400,000). The amount in Uganda is USh15 billion (US\$4,000,000). Many large taxpayers in these African countries would be treated as SMEs in the EU. This implies that, going by the monetary thresholds, safe harbour rules would have to be adjusted to reflect the categorisation of taxpayers on the African continent.

As observed, SMEs do not come under the transfer pricing rules and practices of countries in Africa. Transfer pricing rules apply only to companies that are part of an MNE group and involved in cross-border transactions with affiliates. Most SMEs in Africa are not affiliates of multinational groups, nor engaged in cross-border intra-firm transactions, and as such are not subject to transfer pricing rules and practices of the tax jurisdictions. They are equally not catered to by the transfer pricing rules and practice of the tax jurisdiction. This explains why in some tax jurisdictions the transfer pricing unit or international tax department is located under a Large Taxpayers Office. For example, the international tax department in Uganda is located under the Large Taxpayers Office, and most large taxpayers are MNEs.

This observation that most SMEs are not subject to transfer pricing rules is not peculiar to the African continent. Solilova and Nerudova report that only 6 per cent of small and 16 per cent of medium enterprises in the EU invest abroad and that only 5 per cent of SMEs within the EU are affiliates of multinational groups, so that 'SMEs are less involved in cross-border activities' (Solilova and Nerudova 2017: 3).²⁸ Therefore, the discussion on the application of safe harbour regimes to SMEs as prescribed by the OECD may be academic for African countries, with little or no real practical implication. Few, if any, SMEs in Africa are affiliated

²⁶ See, the definition of small and medium enterprises by the HMRC, available on its website: <https://www.gov.uk/guidance/transfer-pricing-transactions-between-connected-companies>.

²⁷ See, Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) and National Bureau of Statistics Collaborative Survey' Selected Findings, 2013, available online: https://www.google.ca/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=2ahUKewij9ouB_JXfAhXARxUIHTm_BVYQFjAAegQIAxAC&url=http%3A%2F%2Fnigerianstat.gov.ng%2Fdownload%2F290&usg=AOvVaw2vMOGJi9rLe4-iUIM4npe1.

²⁸ The authors argue that SMEs are not involved in cross-border activities for the following reasons: lack of capital, lack of information, lack of public support, and unfriendly laws and regulations.

entities of a multinational group and engaged in cross-border activities with other related entities.

2.3 Exemptions for small transactions

As observed and further shown in the OECD 2012 Report, some countries limit the application of the safe harbour regime to small transactions or minor expenses. The UN Practical Manual gives the rationale for this as: ‘the cost of a tax authority making adjustments is not commensurate with the tax revenue at stake and therefore the taxpayer cannot be expected to incur compliance costs to determine more precise arm’s length prices’ (UN 2017: para B.4.5.2). Safe harbours for small transactions may entail exemption from transfer pricing documentation or from audit, as long as the value of the transaction falls within the defined limit (UN 2017: para B.4.5.2).

In some cases, such as Mexico and the UK, the eligible taxpayer is exempted from preparing transfer pricing documentation. In other cases, a transfer pricing methodology with fixed margins is specified by the tax authority – for example, a cost-plus method and a ‘margin of say 5 percent’ (PCT 2017: 70). The safe harbour regime may specify a fixed profit mark-up on the total value of the transaction between the related entities. However, to be eligible for the safe harbour regime, the value of the transaction must not be more than a prescribed percentage of the total deductions of the taxpayer or a stated amount.

Similar to the discussion on application of safe harbour regimes to small taxpayers, the key issue is what constitutes a small transaction. What will be the monetary threshold for a small transaction, and who determines the monetary threshold where a bilateral or multilateral safe harbour regime is negotiated? Only affected countries can decide what thresholds to adopt and apply. What may seem small to country A may be considered significant by country B. This is a potential conflict in a bilateral or multilateral safe harbour regime. Also, there is the potential for tax planning by taxpayers, who may break a transaction into small components to be exempt from applying transfer pricing rules.

3 Substantive safe harbours

Where substantive safe harbour regimes have been introduced, they have generally applied to specific types of enterprise or economic sectors. However, in some cases they have been described as sectoral Advance Pricing Arrangements (APAs) rather than safe harbours. We should therefore consider how the two concepts compare. An APA is a private agreement between a taxpayer and the tax authority. It entails negotiation of the terms and price of the transfer of goods and services between related parties with the tax authority of the jurisdiction in question. The agreement could be on the preferred transfer pricing methodology to be used by the taxpayer, acceptable margins, markups, interest rates or the process of arriving at the transfer price. APAs may be resource-efficient since an agreement covers a period of time – usually three to five years. While APAs are commonly individual agreements between a taxpayer and the tax authority of a jurisdiction, sectoral APAs have been observed. A sectoral APA implies some degree of consultation between taxpayers in the same sector or industry with the tax authority. For instance, taxpayers in the gold mining sector of a jurisdiction may be consulted by the tax authority in defining the scope and conditions of the arrangement.

A sectoral safe harbour regime implies prescription of safe harbours by the relevant tax authority that apply to taxpayers within a sector of the economy. This could take the form of a

prescription of transfer pricing methodology and price margins by the relevant tax authority for taxpayers within a sector or industry, such as the pharmaceutical or IT sector. An apparent distinction between a sectoral APA and a sectoral safe harbour regime is the method used to arrive at them. A sectoral APA presupposes an agreement between taxpayers and tax authority. The process of negotiation is voluntary, and taxpayers are involved in the negotiation and decision process. A sectoral safe harbour regime presupposes a prescription by the tax authority to the taxpayers, which the taxpayers may accept or reject. The process of arriving at a safe harbour regime may not be inclusive or voluntary, but it is recommended that compliance in a safe harbour regime is voluntary.

Other than the regime-making process, in practice a sectoral APA is akin to a sectoral safe harbour, and the issues discussed below are applicable to a sectoral APA.

3.1 Sectoral safe harbours

Countries which have adopted sectoral safe harbours include Mexico in its *maquiladora*²⁹ industry (Picciotto 2018: 37) and the Dominican Republic in its hospitality sector (Picciotto 2018: 39). The aims of the safe harbours adopted by both countries are to increase and guarantee tax revenue (especially in the Dominican Republic) (Picciotto 2018: 40), and to address the difficulties associated with individual scrutiny of arm's length standards applied by related entities. India's sectoral safe harbour regime is quite extensive, and covers, among others, software development services, IT services, and manufacture and export of core auto components.³⁰ For instance, India prescribes a safe harbour operating profit margin of 12 per cent or more on total operating costs for the manufacture and export of core auto services.³¹

Safe harbour regimes are generally not common in Africa. Where they do contemplate introducing them, the policy objectives must align with immediate interests – increasing and guaranteeing tax revenue. Applying safe harbours to large taxpayers and important sectors (high value-adding and revenue-generating sectors) of an economy has the potential to increase tax revenue, while granting predictability of revenue inflow. This will also encourage investment, as taxpayers are more inclined to invest in an environment where there is certainty in tax obligations or liabilities.

The first step towards designing a sectoral safe harbour is to determine the sector suited for the regime, coupled with the selection of eligible taxpayers for the regime. As regards the choice of sectors for safe harbour regimes, the EU Report reveals that the countries interviewed would like to see safe harbour regimes being established for large-revenue sectors such as mining, telecommunications, banking and insurance (Charlet et al. 2017: 10). For these African countries, the guarantee of a minimum tax revenue should not be limited to small transactions or small taxpayers, but should be extended to industries that provide the most revenue. It is also the case that in most African countries the main revenue-contributing industries are the ones with the most challenges in the application of transfer pricing rules. In Nigeria, the oil and gas sector, which remains the largest contributor to the nation's purse, is notorious for its vulnerability to tax avoidance, as a result of the challenges of applying the arm's length standard. A similar experience is observed in Tanzania, where

²⁹ Manufacturing company that imports duty-free components to be assembled and exported.

³⁰ See Ernst & Young (2017).

³¹ See India's Rules on Safe Harbours: <https://incometaxindia.gov.in/Rules/Income-Tax%20Rules/2008/10312000000009915.htm>.

the mining and exploration sectors pose most difficulties in the application of transfer pricing rules.³²

It is also likely the case that the determination of the suitable sector for a safe harbour regime would automatically mean incorporation of all taxpayers in the sector into the regime. The tax authority may elect to further prescribe eligible taxpayers within the sector. It is important that the tax authority is not seen as being discriminatory without cause. Decisions of the tax authority must be justifiable on exigency or relevance of the selected taxpayers to the revenue of the tax jurisdiction.

Furthermore, a sector-based safe harbour regime would require determination of the transfer pricing methodology and margins to be applied. These determinations are dependent on the priorities of the taxing jurisdictions, the industries and the revenue goals of the jurisdiction concerned. Safe harbours are more effective for transactions that are easy to benchmark, and where 'one-sided' transfer pricing methods can be applied 'with reference to financial data from a single member of a multinational group' (Durst 2012b: 68).

A sector-based safe harbour regime could address the issue of state capture by multinational entities, since it will be difficult for individual companies to influence tax decisions under a regime that applies to the entire sector. It could also address the issue of corruption by public officials, since taxpayers only have to concern themselves with complying with the safe harbour regime, expecting that their returns will be accepted when they have done so. A further step would be to provide for a presumption under the safe harbour regime – that eligible taxpayers will be presumed to have complied with the safe harbour regime and are not subjected to transfer pricing documentation (other than the requirement to present routine evidence of having adhered to the safe harbour rules) and audit, except where the tax authority can show evidence to the contrary. This will reduce administrative interference by tax authorities, apart from where they have compelling reason to intervene. This presumptive approach further improves the ease of doing business in African countries, whose average ease-of-doing-business ranking is not high at present.

In conclusion, given the unique economies of African countries, which can be dominated by large MNEs, with limited tax administration and strong reliance on corporate income tax (Cooper et al. 2017),³³ adoption of a safe harbour regime calls for a broader scope than the prescriptions of the OECD. Safe harbour regimes in African countries are best applied to large taxpayers and high value-adding transactions, which are the main revenue-generating streams for these countries.

³² For a discussion on introducing safe harbours to the mining sector see Gui et al. (2017), who support the application of safe harbours in the mining sector for routine low-risks functions.

³³ African countries rely strongly on corporate income tax due to the following reasons: the large informal sector makes it difficult to tax income of individuals who are mobile and/or not captured in the tax database; the main sectors of the economy are dominated by companies, in most cases MNEs, who make extraordinarily high profits from the exploration of the resources of these countries; the constitutions of most African countries adopt the ability-to-pay principle of taxation and as such deem it progressive to tax companies and regressive to tax individuals; finally, companies are now seen as the new forms of acquiring and keeping wealth.

4 Design of safe harbour regimes

4.1 Specification of the safe harbour transfer pricing methodology

A safe harbour on transfer pricing method prescribes the transfer pricing methodology to be used by taxpayers engaged in certain category of transactions. The PCT Toolkit states that safe harbours on methods are 'most suitable for transactions which, in principle, are able to be benchmarked – normally involving functions that do not use valuable intangibles or assuming significant risk' (PCT 2017: 68). It further states that such functions 'are typically the types of functions conducted by the "tested party" when a one-sided method is used' (PCT 2017: 68). For instance, Mexico prescribes the use of the transactional net margin method for its *maquiladora* sector, accompanied by an arm's length range (e.g. a taxable profit representing the greater of 6.5 per cent of total costs and expenses, or 6.9 per cent of *maquiladora* assets). In practice, a safe harbour on transfer pricing methodology must be accompanied with a margin provision. For example, the safe harbour provision may stipulate the use of the cost-plus method and a margin of 4 per cent as safe harbours for the category of transactions covered by the regime.

Adopting a safe harbour on method regime for a category of transactions could help resolve many of the transfer pricing disputes on the continent. Take, for instance, the Kenyan case of *Unilever v The Commissioner General, KRA (2005)*,³⁴ which concerned the determination of the arm's length price for goods sold by the Kenyan subsidiary of Unilever to its Ugandan related entity. The presence of a safe harbour on method regime, such as a cost-plus method, accompanied by acceptable margins, could have gone a long way in averting or resolving the dispute.

4.2 Safe harbour margins

The discussion here covers price range and interest rate margins.

4.2.1 Price range

As stated above, it is common practice for a safe harbour regime to prescribe first the transfer pricing method to be used, accompanied by a price range to be applied by the eligible taxpayers. However, it is observed that the safe harbour regimes of some countries (if not in practice, but in regulations) specify a price range without prescribing transfer pricing methods to be applied by the eligible taxpayers (Otufale and Olaniyi 2018). This can be found in the previous safe harbour regime of Nigeria, which may, arguably, be relevant today. Regulation 15 of the 2012 Transfer Pricing Regulations provided that a taxable person may be exempted from the provisions of Regulation 6³⁵ of the Transfer Pricing Rules where: (i) controlled transactions are priced in accordance with the requirement of Nigerian statutory provisions; or (ii) the prices of connected transactions have been approved by other government regulatory agencies or authorities established under Nigerian law. The intention of this provision was to promote reliance on prices specified by government agencies in accordance with the requirement of Nigerian statutes. This practice can be found in the regulation of prices for agricultural produce for export or provision of goods and services in the telecommunications and power sectors. Regulation 15 extended to acceptance of prices agreed with relevant government agencies, such as the National Office for Technology Acquisition and Promotion (NOTAP) by the revenue authority.

³⁴ *Unilever Kenya Ltd v Commissioner of Income Tax [2005] eKLR.*

³⁵ Regulation 6 of the Income Tax (Transfer Pricing) Regulations No. 1, 2012.

Though the 2012 Income Tax (Transfer Pricing) Regulations have been repealed and replaced by the 2018 Income Tax (Transfer Pricing) Regulations, these provisions have been retained (in the case of prices specified by government agencies), or, arguably, may still be applicable (in the case of prices agreed with government agencies). The Guidelines on Transfer Pricing Documentation issued by the Federal Inland Revenue Service (FIRS 2018) exempts a taxpayer from preparing contemporaneous transfer pricing documentation where related party transactions are priced in accordance with the stipulations of Nigerian statutory provisions.³⁶ It, arguably, retains price agreements with other government agencies in paragraph 8 (d) of the Guidelines, which exempts a taxpayer from contemporaneous transfer pricing documentation where the controlled transactions are priced in accordance with specific guidelines that may be published by the tax authority.³⁷ As at the time of writing, no further guideline on safe harbours has been released by the tax authority, and it is believed that the 2012 provisions may influence future guidelines (Adegite and Onyebezie 2019).

In conclusion, the practice for a price range safe harbour regime is to provide a range of prices that the tax authority would accept as having complied with the safe harbour regime. This price range may satisfy the arm's length principle, as eligible taxpayers are best suited to choose a price within the range that reflects their individual circumstances.

4.2.2 Interest rate

A strategy used by related entities to strip profits out of a high-tax jurisdiction is through loan transactions with high interest rates. This is distinct from thin capitalisation, which refers to the equity-to-debt ratio of the capital of an entity. Here, the focus is on the interest rate fixed when contributing debt capital to an entity.

For loan transactions between related entities, the concern is whether the price and terms of the loan are arm's length. Given that intra-firm loans are the norm, this is concerning for most tax authorities. A parent company may create a subsidiary located in a zero- or low-tax jurisdiction, which functions as a financing company to other subsidiaries in the MNE group. The financing company provides loans to other subsidiaries of the group, typically located in higher-tax jurisdictions. Given that interest paid is a deductible cost from the profit of the company before determining the taxable profit, this arrangement could significantly reduce the taxable profit of the company liable to tax in the higher-tax jurisdiction, thereby reducing the revenue to the government (Durst 2015).

The difficulty with determining an arm's length interest rate is that such a rate depends on the creditworthiness of the borrower. If the borrower is an independent entity in a developing country, the rate is likely to be significantly higher than the actual rate at which the multinational itself can borrow on international capital markets. This again demonstrates the unsuitability of the arm's length principle.³⁸

This is where a safe harbour regime becomes relevant. It recognises the nature of loan transactions between related entities, the absence of adequate comparables, and the difficulty of conducting comparability analysis where there are likely no similar uncontrolled transactions. It therefore prescribes an interest rate or range of rates. Taxpayers who come under the prescriptions are exempt from further audit (and transfer pricing documentation in some cases), while taxpayers who do not are required to prove through documentation and audit that their rates are arm's length.

³⁶ Paragraph 8 (c) of the Guidelines on Transfer Pricing Documentation.

³⁷ Paragraph 8 (d) of the Guidelines on Transfer Pricing Documentation.

³⁸ For a more comprehensive discussion on base erosion involving interest deductions, see OECD (2015).

Interest rate safe harbour regimes are in practice in some taxing jurisdictions. According to the 2012 OECD Report, 6 (including South Africa) of the 33 countries that had transfer pricing simplification measures had a safe harbour interest rate margin for eligible transactions.³⁹ South Africa applied safe harbour interest rate margins to inbound intra-group cross-border loans. An interest payment of prime plus 2 per cent for South African Rand (ZAR) denominated loans and LIBOR plus 2 per cent for foreign denominated loans is allowed. This was contained in Practice Note 2.⁴⁰ In 2017 Singapore introduced a safe harbour regime in the form of indicative margins⁴¹ (to be published on the website of the IRAS and updated at the beginning of each year) for related party loans not exceeding the equivalent of S\$15,000,000 (US\$11,000,000) (PwC 2017).

4.3 Opt-in or opt-out participation in safe harbours

The OECD recommends that safe harbours for taxpayers be voluntary to limit 'the divergence from arm's length pricing'.⁴² The intention is that taxpayers who choose not to come under the safe harbour regime may elect to apply the transfer pricing rules and present themselves for transfer pricing audit and possible adjustments.

Nevertheless, a taxing jurisdiction seeking to implement a safe harbour regime may choose between an opt-in or opt-out regime. Both can be considered to be voluntary for taxpayers. An opt-in safe harbour regime allows taxpayers to elect whether to come under the safe harbour regime. An opt-out safe harbour regime automatically covers eligible taxpayers, bringing them into the safe harbour regime except where they expressly elect to opt out of it. Provided that the regime can be considered non-mandatory, it would comply with the OECD's TPGs and their conditions for a safe harbour regime.

For African countries wanting to adopt a safe harbour regime, it is important to implement the right participation regime. With low tax compliance on the continent, an opt-in system is likely to be ineffective. Incentives, such as a low profit margin and discounted tax payments, would be needed to encourage opting-in; however, they would need to be significant to attract participation by eligible taxpayers. Giving significant tax incentives may end up being counterproductive for the government, as the potential benefits may not outweigh the losses.

Where the broader objective of increasing and guaranteeing tax revenue is adopted, an opt-out system is preferable. Though still an elective and voluntary approach, it puts the burden of showing cause for opting out of the safe harbour regime on taxpayers, which may be quite persuasive and effective. For example, India's 2013 safe harbour rules prescribed an opt-in regime, and the take-up by taxpayers was low because taxpayers viewed the safe harbour margins as very high compared to what taxpayers obtained under APAs. The opt-in regime meant that, in the absence of additional incentives, such as very low margins, taxpayers either elected to negotiate APAs or prepare transfer pricing documentation and be audited.

For an opt-out regime to succeed, the incentive to stay in must be attractive to taxpayers and the price of opting out must be expensive. Taking into account the capacity of the tax administration, the price of opting out may be a detailed and burdensome tax audit process. APAs, as alternatives to the safe harbour regime, should be discouraged, as taxpayers may

³⁹ Safe harbour margins accounted for 39% of transfer pricing simplification measures, with 26% applied to simplified transfer pricing method and safe arm's length range/rate, and the remaining 13% applied to safe harbour interest rate.

⁴⁰ South Africa presently has no safe harbour rules. See OECD (2018).

⁴¹ Suggestive of interest rate margins, the Inland Revenue Authority of Singapore (IRAS) will accept as arm's length price for loans.

⁴² Paragraph 4.129, Section E of Chapter 4 of the OECD TPGs.

opt for them – this could be burdensome on tax administrators, coupled with the potential for discrimination. There is also the suspicion of corporate capture and presence of corrupt practices by the parties involved.

In both instances, taxpayers who refuse to opt-in or decide to opt-out of the safe harbour regime may be required to prepare full transfer pricing documentation in line with the arm's length standard using the traditional transfer pricing methodologies. This approach does not solve the problem the safe harbour regime is created to address. It continues an ineffective system that drains limited resources – human and capital.⁴³

In conclusion, whether the taxing jurisdiction adopts the opt-in and opt-out approach, the tax authority must spell out in advance the acceptable alternative(s) for taxpayers. Doing this influences the decision of the taxpayer, as taxpayers are known to go for the less burdensome option in most cases.

4.4 Unilateral, bilateral or multilateral safe harbour regimes

A safe harbour regime may be established by a tax jurisdiction on its own, in agreement with a treaty partner, or as part of a regional agreement. I discuss below unilateral, bilateral and multilateral safe harbour regimes.

4.4.1 Unilateral safe harbours

Safe harbour regimes may be established at the national level, without entering into agreement with trading or treaty partners, or by negotiating a multilateral instrument. This is easier and quicker to establish, and to amend, adjust, repeal and re-enact. However, despite the relative ease of establishing a unilateral safe harbour, the OECD and other supranational bodies do not recommend it. As discussed above, a unilateral safe harbour regime has the potential to cause double taxation. This occurs because a unilateral safe harbour applies to only one taxpayer out of the two or multiple tax authorities involved in the controlled transaction. In the absence of a corresponding adjustment by the other tax authority or agreement with the adjustment of the tax authority of the unilateral safe harbour jurisdiction, double taxation may occur.

Notwithstanding the potential for double taxation or double non-taxation of unilateral safe harbour regimes, the experience of countries that have applied unilateral safe harbour regimes differs. As stated above, according to the 2012 OECD Report, no country reported double taxation caused by the application of its safe harbour regime or the safe harbour regime of another country. This may be attributed to the careful design of the safe harbour regime or failure of affected taxpayers to report to their relevant tax authorities. For whichever reason, the report reveals that the fear of double taxation may be overstated.

4.4.2 Bilateral safe harbours

A bilateral safe harbour is a regime agreed between two taxing jurisdictions to apply to taxable entities who are related and transact with each other. Unlike unilateral safe harbours, a bilateral safe harbour could relieve taxpayers from the compliance and administrative burdens of applying the arm's length principle, without creating problems of double taxation or double non-taxation. A successful bilateral safe harbour regime is the US-Mexico *maquiladora* arrangement, which covers eligible taxpayers engaged in manufacturing operations near the US-Mexico border (Durst 2012b).

⁴³ Refer to the discussion above on the limitations of the arm's length standard.

Negotiating a bilateral safe harbour regime is likely to be less burdensome than a multilateral one. However, such a recommendation supposes that a tax treaty or some form of tax agreement exists between the two entities exposed to transfer pricing disputes. This is not the case in Africa, where most African states have not entered into tax treaties with their trading partners. As such, countries in Africa may prefer to enact unilateral safe harbours. Even where tax treaties with their trading partners exist, negotiating a safe harbour regime could be expensive and demand a lot of resources. However, given the potential benefits of a safe harbour, it may be worth the cost and difficulty of negotiating one.

In addition, in the absence of existing tax treaty or bilateral tax agreements, countries may elect to negotiate a bilateral safe harbour regime with trading partners. This raises the fear of capture of the process by the superior country, putting the weaker African country in an unfavourable position. Take, for instance, the trade relationship between Nigeria and India. In 2017, 30 per cent of Nigeria's export value went to India, though Nigeria is yet to conclude a tax treaty with India.⁴⁴ Given India's advanced transfer pricing practice compared to Nigeria's nascent one, its larger economy compared to Nigeria's (India has a GDP of US\$2.597 trillion, while Nigeria has a GDP of US\$375.8 billion; 2017 data), there is potential for capture of the negotiation process. One way to address this is by appointing an unbiased mediator to oversee the negotiations, though the attitude of developing countries has been to protest the imposition of mediators in tax disputes. A second approach may be to have negotiators appointed for both parties by supranational or donor bodies such as the World Bank, IMF or OECD. Nigeria (as well as other African countries) could also enlist the service of the Africa Tax Administration Forum (ATAF) to represent it in negotiations. Recent activities in African countries show the willingness of tax authorities to accept the support of other organisations in designing their tax rules and resolving tax disputes.⁴⁵

4.4.3 Multilateral/regional safe harbours

Discussions on the adoption of multilateral safe harbour regimes in Africa may be considered at the continental level, or the level of regional blocs – such as the Economic Community of West African States (ECOWAS) or the East African Community (EAC). A study on the adoption of safe harbour regime in Africa at the regional level of the ECOWAS, was reported in the EU Report. Given the recent adoption of the African Continental Free Trade Agreement (AfCFTA) by African countries, akin to the European single market, it has become important to consider the application of transfer pricing simplified methods, such as safe harbour regimes, at a continental level. This is because the expected increase in intra-African trade will be largely informed by intra-firm transactions. Taking into account the adoption of transfer pricing rules and/or practice by African countries, modelled either after the OECD's transfer pricing rules or the UN's Practical Manual on Transfer Pricing, the problems of transfer pricing enumerated in the Introduction to this paper will be present.⁴⁶ Thus, it is important to seek alternatives to transfer pricing, such as formulary apportionment, or simplified methods, such as safe harbours, at a continental level. However, the administrative burden involved in arriving at such an agreement (especially a safe harbour regime), is daunting. It will be difficult to surmount the language and technical barriers, for example, on the continent. Many African states do not possess transfer pricing

⁴⁴ Data obtained from the database of the European Commission, available at: http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113427.pdf.

⁴⁵ ATAF has been particularly instrumental in the design of transfer pricing rules and establishment of transfer pricing units in African countries - see ATAF (2017; 2018). The Tax Inspector Without Borders (TIWB) programme (a joint programme of the OECD and the United Nations Development Programme) supports African countries in building tax audit capacity - see: <http://www.tiwb.org/resources/publications/tax-inspectors-without-borders-annual-report-2017-2018-web.pdf>; TIWB, Frequently Asked Questions, online: <http://www.tiwb.org/about/faq/>;

⁴⁶ See Ezenagu (2019).

rules in their tax laws.⁴⁷ The capacity required to establish a regional or continental safe harbour regime would have to be sought outside the continent.

These challenges are also present at a regional level, such as the ECOWAS. For countries like Nigeria, Liberia and Ghana, who already possess transfer pricing rules and have practical experience with applying them, establishing a regional safe harbour regime may cause delays if they have to wait for other ECOWAS countries to enact relevant transfer pricing regulations or establish transfer pricing units prior to establishing a multilateral safe harbour regime. These countries may be motivated to conclude unilateral or bilateral safe harbours that are easier to conclude and more practical. This is further informed by the exigency of increased revenue generation and the administrative efficiency that comes with establishing a safe harbour regime. There is the added consideration of regional economic powers in these negotiations. About 80 per cent of the GDP, FDI inflow, trade volumes taking place in the ECOWAS region are situated in Nigeria. Achieving a consensus multilateral safe harbour regime will be difficult in these circumstances given the unequal economic power.

Tax cooperation is essential in the fight against global corporate tax avoidance (Cooper et al. 2017; Alepin and Ezenagu 2017). However, achieving tax cooperation for a multilateral safe harbour at a continental or regional level presents a difficult task, which is only justified if negotiated on a sectoral level or for taxpayers or transactions that contribute significantly to the tax revenue of states concerned. Some of these sectors are mining, telecommunications, banking and insurance, and infrastructure, which are dominated by MNEs and contribute significantly to revenue. The political will required to negotiate regional or continental safe harbours cannot be guaranteed for small taxpayers or transactions that contribute little to the revenue purse.

Despite the challenges of arriving at a continental or regional agreement, cooperation on safe harbour regimes may go a long way to attract FDI, reduce tax competition and ensure administrative efficiency.

5 Conclusion

Corporate income taxation remains an important contribution to the revenue of most African countries. First, their natural resources are explored by large companies who are subsidiaries of entities headquartered abroad. Second, the effective taxation of individuals, especially those in the informal sector, continues to prove difficult due to absence of data, mobility of individuals and the inability of individuals to pay tax.

However, taxing companies, especially where they have related entities and transact with each other, is fraught with challenges – as highlighted above. The extant global tax architecture for taxing related entities has been adjudged to be impractical, inefficient, complex, costly and unfit for purpose. As such, countries seek simplified measures to tax related entities, with the hope of providing certainty and predictability to taxpayers, while guaranteeing ease of administration of the tax system and collection of revenue. This paper has focused on the establishment of safe harbour regimes by countries, as a simplified approach to the taxation of related entities. Safe harbours provide certainty, predictability, ease of compliance and administration, and guarantee collection of revenue, thereby aiding revenue forecast by the tax administration. They also reduce disputes between taxpayers and tax authorities, since in most cases taxpayers who comply voluntarily with the regime

⁴⁷ See Picciotto (2018: 47-51).

accept the terms stipulated in safe harbour rules. However, their establishment calls for caution and attention to adaptability.

First, the OECD's safe harbour prescriptions are limited in their scope and appear impractical for developing countries. A bolder, broader approach to safe harbours must be adopted by African countries if they are to derive benefits from the application and implementation of safe harbour regimes. Their application to SMEs is impractical, as they are too small and do not come under the threshold for compliance with the transfer pricing rules. Also, in most cases, they do not have related entities in other countries, nor do they engage in cross-border economic activities with related entities. Given the revenue demands of African countries and the paucity of comparables for benchmarking purposes, it is recommended that safe harbour regimes be introduced for high value-adding sectors of the economy. This justifies the political will needed to negotiate bilateral or multilateral safe harbour regimes.

Second, introducing and implementing safe harbour regimes poses challenges. African tax authorities wanting to adopt safe harbour regimes must strive to achieve safe harbour price ranges or rates that approximate to the arm's length price that would be achieved under transfer pricing methodologies. They must be aware of the potential tax-planning opportunities from the application of safe harbour regimes. Also, given potential discrimination against other sectors or taxpayers, safe harbour regimes must be justifiable for the selected sectors. In addition, the potential for double taxation must be addressed when establishing a safe harbour regime.

Finally, as African countries rush to sign and ratify the AfCFTA, it is imperative to consider the tax implications of doing so under current transfer pricing rules. Under these, African countries are likely to lose significant tax revenue that may accrue to them from participating in the single market. To prevent this, an agreement on allocation of taxable income among countries in accordance with the principle that companies pay their fair share of taxes to countries where economic activities occur, and value is created, must be reached or adopted. In the absence of a complete overhaul of the global tax system, simplified transfer pricing methods, such as safe harbours, may offer a practical solution.

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