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THE IMPACT OF TAX COMPLIANCE POLICIES ON FOREIGN INVESTMENT DECISIONS

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Introduction

The subject of Globalization and Compliance is the focus of Session 4 of the conference. One can think of this as two separate topics: (1) tax compliance of Latin American companies that are expanding globally, and (2) tax compliance of foreign-based multinational enterprises operating in Latin America.

Concerns about the tax compliance of domestic taxpayers tend to focus on the potential for avoidance of local tax and for hiding resources and income offshore. In recent years those concerns have led Latin America jurisdictions to enact new rules for taxing offshore operations of domestic taxpayers, particularly those in tax havens. Those reforms have taken several forms, including:

- requirements for disclosure of offshore investments,
- requirements for reporting of bank transfers,
- current taxation of income of foreign subsidiaries,
- heightened scrutiny of transfer prices on transactions with parties in low-tax jurisdictions, and
- higher withholding tax rates on payments to entities in such jurisdictions.

My remarks will focus on tax compliance concerns related to the activities of foreign-based multinational companies investing in Latin America. Unlike many local taxpayers, multinational companies based in Japan, Europe or the United States tend to make a serious attempt to comply with local tax rules when they invest in Latin America. Typically they pay their VAT and attempt to calculate their income tax liability in accordance with the law. At the same time multinationals can be formidable adversaries of the tax authorities for other reasons. Typically they have more tax-technical resources, more experience in tax planning and more exposure to a variety of tax planning ideas than local companies. In many cases they are also more sophisticated in understanding how to structure their operations so as to justify a particular tax result. Thus the tax compliance issues that the tax authorities face for those foreign investors tend to focus more on insuring that tax policies are properly tailored to international transactions - for example:

- to make sure that VAT applies properly to transactions with an international element,
- to make sure that the Latin American jurisdiction gets to tax a fair share of the income of the global enterprise or the income attributable to local operations,
- to make sure that mechanisms are in place to collect taxes owed by foreign parties, and
- to make sure that the tax laws are properly drafted to eliminate loopholes that foreign companies can exploit.

Recent trends and initiatives in Latin American countries to address these issues include:

- convergence of income tax rates,

- increased focus on transfer pricing reporting and enforcement,
- attempts to introduce more sophisticated income tax rules with regard to financial transactions,
- rules limiting the use of trusts, and
- a shift in certain countries (notably Venezuela and perhaps Brazil) away from the traditional Civil Law principle of honoring the form of a transaction toward examining its economic substance in to determine its tax effects, with statutory provisions similar to the "reality principle" that Argentina has had on its books for many years.

I have been asked to discuss tax planning and arbitrage in the global environment. I take that to mean that I am to discuss situations in which the tax rates or other factors related to the tax systems of various countries play a decisive role in decisions on where to locate international operations or how to structure them.

One might not think of tax planning and tax arbitrage as tax compliance topics. They call to mind issues related to the exploitation of differences between the tax rules or definitions in different jurisdictions in order to avoid tax or to reduce the tax burden, or the use of techniques involving tax havens or transparent entities to reduce the overall global tax burden. Tax authorities in Latin America and elsewhere often focus on how to respond to favorable foreign tax rules or to differences in tax concepts among different jurisdictions, in order to minimize the impact of taxation as a factor in luring investment away or in allowing companies to avoid bearing what the government may regard as a full tax burden.

There is an equally important set of questions, however, concerning the impact of a country's own tax rules and policies for promoting tax compliance on the decisions of multinational enterprises as to whether to locate operations in that jurisdiction. Those questions focus on the impact of the administrative burdens and related uncertainties that those policies can create for a foreign company and its local affiliates.

In particular I would like to focus on the need for rigorous analysis of the impact of tax compliance policies and enforcement programs that can have the effect of discouraging foreign investment in a Latin American jurisdictions without adequate revenue benefits. Such policies can be the result of deliberate choice, based on a perception or a hope of benefits due to greater revenue or a contribution to other policy objectives. Often unacceptable compliance burdens arise needlessly or inadvertently - as a result of poorly designed or misdirected tax measures.

My purpose is to identify for further discussion tax compliance issues have the potential for creating significant barriers to foreign investment in Latin America and to suggest some steps that local tax authorities and the international tax community can take if they decide to take this issue seriously.

It is important to distinguish this concern from a contention that countries should grant tax concessions to foreign companies in order to promote investment. There are good reasons that countries in Latin America are increasingly reluctant to buy direct investment with tax holidays or to engage in other forms of competition with each other to lower their tax rates. There is also good reason, however, for these countries to eliminate unnecessary administrative burdens and uncertainty that make them less attractive to foreign investors without sufficient benefit in the form of increased tax revenue.

Increasing Risks of Real Economic Costs from Burdensome or Uncertain Tax Compliance Policies

The increasing mobility of manufacturing activities creates an increasingly competitive environment for attracting foreign direct investment, in which burdensome or uncertain tax compliance policies have a growing potential to discourage foreign investment in Latin American jurisdictions that are not blessed with petroleum resources or large financial services sectors.

Latin American countries must compete among themselves and with scores of countries in other regions for export-oriented production, which is highly cost-sensitive and highly mobile. Economists have noted that export production is particularly sensitive to increases in tax rates.[1] Experience suggest that there is a similar sensitivity to uncertainty and administrative burdens in the tax law and regulations.

Moreover, this highly competitive atmosphere for attracting foreign investment in manufacturing activity extends to production for the domestic marketplace. As trade barriers fall, companies have a wider range of choices as to where to produce products for sale in Latin American countries themselves, and a multinational company's decisions about where to locate that production are increasingly affected by comparisons of the costs, including tax compliance costs, of locating that production elsewhere.

At the same time the potential for imperfect or misguided tax compliance programs that discourage foreign investment has been increasing in Latin American countries as a result of changes in the tax systems of those countries and changes in the issues that they are called upon to address:

1. The internationalization of the economies in Latin America raises complex new tax questions that must be a addressed in a coherent way, often without a corresponding increase the resources of the local tax administrations to address these issues.
2. The increasing focus on highly factual issues such as transfer pricing have a significant potential for creating administrative burdens, delays and uncertainty in the determination of tax results, particularly in the resource-constrained environment facing tax administrations in Latin America.
3. There has also been increasing attention in Latin American countries, particularly those with tax treaty networks, to pursuing foreign companies in order to tax income

[1] *See* Gary Hufbauer, "What Difference Do Taxes Make to Investment Decisions", remarks at the 2001 Latin American Tax Summit, 9 November 2001 (outline on file with Atlas Information Canada and with the presenter).

that is deemed to be attributable to a local tax presence, an inquiry that is not only highly factual but also lacking in meaningful principles of analysis for determining the amounts that are subject to tax.

4. Countries in the region feel pressure from the international tax community, largely consisting of international organizations such as the OECD, to implement modern tax rules, which those countries sometimes interpret as mandates to introduce rules and procedures that may be beyond their capacity to implement in a reasonable fashion.
5. Tax authorities have found it necessary to new rules to close perceived loopholes arising from new financial instruments and other techniques that were not an issue in the past.
6. The spread of tax treaties has led to uncertainty in the application of some taxes, due to interpretative issues regarding treaty provisions such as those defining the concept of permanent establishment or those limiting the application of withholding taxes on payments for technical assistance.
7. Because fewer Latin American countries now offer tax holidays or special exemptions for new investment, fewer companies escape compliance issues altogether as a result of being exempt from tax.

It requires vigilance and imagination to minimize the administrative burdens and uncertainty that can result from these factors and others.

Latin American countries clearly understand the importance of foreign investment and the importance of eliminating administrative barriers to such investment. Whereas 20 years ago many Latin American countries had highly bureaucratic rules for evaluating and approving applications for foreign investment, today such regulatory barriers have been virtually eliminated in the region in most sectors of the economy.

The convergence of tax rates in Latin American jurisdictions also suggests an awareness in the region that the size of the overall tax burden is an important competitive factor in attracting foreign direct investment. U.S. companies in particular can be sensitive to increases or decreases in the tax rate because the U.S. foreign tax credit limitation can limit the amount a foreign income tax that is eligible for a credit even if the nominal foreign tax rate is lower than the U.S. corporate tax rate of 35%.

There appears to be less awareness in Latin American jurisdictions of how burdensome tax compliance programs can negatively affect the investment decisions of multinational companies. Companies face a variety of unnecessary or excessive compliance burdens that create uncertainty and increase the cost of doing business. Companies regularly find themselves:

1. responding to repeated changes to the tax law and regulations that are designed to address a single perceived tax issue or abuse,
2. attempting to comply with rules addressing complex issues that raise more questions than they answer, because of flaws in the rules, because of imperfections in how those

rules relate to other elements of the tax regime, or because of the inability of the local tax administrations to administer more complex rules in a coherent fashion.

3. participating in factual investigations on issues such as transfer pricing and attribution of income to a permanent establishment without knowing the standards that the local tax authorities will use to address those issues, resulting in uncertainty as to the tax result, repetitious work, and delays of uncertain duration,
4. waiting for months or years for a resolution of how ambiguous rules will be interpreted, only to receive a resolution when it is too late to respond effectively,
5. responding to tax audits conducted under highly discretionary and variable standards,
6. attempting to anticipate the implications of other highly discretionary tax policies, such as policies that give the authorities the power to ignore the form of the taxpayer's transactions and to make adjustments based on judgments regarding economic substance,
7. struggling to obtain the implementation of tax treaty provisions according to their terms in the face of resistance from local tax authorities intent upon interpreting the treaty to apply concepts of domestic law that should not apply under the treaty,
8. paying VAT or other taxes more than once, with little prospect of obtaining a refund of the excess payment, due to the application of overly aggressive compliance rules,
9. suffering through arbitrary and uncertain delays in obtaining refunds for overpayments of tax (when such refunds are allowed at all),
10. complying with exchange controls and controls on repatriation of cash,
11. deciding how to respond to the prospect of automatic penalties for underpayment of tax without proof of willful evasion or negligence, which, when combined with inflation adjustment of the tax liability and interest, can double or triple the tax deficiency, and
12. seeking judicial declarations on an individual basis, due the lack of binding precedent, regarding the constitutionality of tax provisions that the courts have already declared to be unconstitutional in cases brought by other taxpayers.

Too often the challenges of tax administration and of noncompliance discussed elsewhere in this conference lead governments in the region to ignore the administrative costs and uncertainties arising from compliance rules that they adopt in order to improve their tax collections. This tendency is compounded in some countries in the region by turnover and continuing lack of professionalism in the leadership of the tax authority itself.

Excessive administrative costs and uncertainty are greater concerns for multinational companies than the possibility of facing tough and efficient enforcement of the tax laws. Generally multinational companies are not put off by strong and competent tax enforcement, which they are accustomed to finding in their home jurisdictions. Indeed multinational companies generally welcome serious enforcement of the tax laws in countries where they invest because they know that a country that succeeds in collecting tax from domestic taxpayers is less likely to single out foreign companies as special targets for needed revenue.

A skeptic might ask how a company can take the prospect of administrative burdens and uncertainty about tax results into account in making investment decisions. Indeed, often tax authorities in the region seem to act on the assumption that these issues are invisible to investors or at least that they are sufficiently obscure that companies will not be able to take them into account in making their investment decisions. This ignores both the extent of the due diligence that companies undertake in assessing the costs of undertaking proposed operations in different jurisdictions and the extent to which a country is dependent for foreign direct investment on the expansion of operations by companies that are already operating in that country and in many others. Companies often start out with a small operation in a country precisely to enable it to assess the administrative costs of operating there.

The Impact of Uncertainty as to the Tax Results

Uncertainty is a particularly insidious feature of the tax landscape in Latin America, and reducing uncertainty deserves the constant attention of tax authorities in Latin America.

Uncertainty can arise from many sources. We have observed an increasing tendency for tax authorities to react to new challenges by postponing a decision, by enacting temporary rules, by making more frequent changes in the tax laws, by enacting complex rules that are a challenge to administer coherently or predictably, or by granting broader discretion to tax authorities without defining adequate standards for exercising that discretion. The result of all of these tendencies is to increase uncertainty as to the tax results for domestic taxpayers and foreign investors.

Tax authorities must be vigilant to avoid or to eliminate unnecessary uncertainty as to the tax results because the costs of uncertainty to the local economy are disproportionately large. While it would be helpful to have more systematic research on the point, experience suggests that, in making their investment decisions, multinational companies tend to react to uncertainty regarding the tax results by assuming the worst. That is, if company analysts are told that the tax burden could range from a low of x to a high of y, they will feel obliged to assume that the answer will be y in comparing the projected after tax return in two jurisdictions. Of course in most cases of such uncertainty, the country in question will achieve tax collections consistent with a result somewhere between x and y. Thus, if investment decisions are sensitive to assumptions about tax rates, as economic data suggests, then the net impact of uncertainty for the country in question will almost inevitably be worse than that associated with enacting clear rules leading to the more detrimental tax result, because the country will not obtain the revenue associated with the tax result that the multinational company has been forced to assume in making its projections.

Particularly troublesome uncertainties arise from delays in developing definitive tax rules. Planning horizons for multinational companies, particularly Japanese multinationals, are long, often 5 or 10 years or more. Therefore, the resolution of an issue that applies only for the next two or three years may be almost irrelevant to a company’s investment decisions, unless the company is willing to assume that the temporary resolution will be extended permanently.

Example – Taxation of Maquiladora Operations in Mexico

One situation that we have observed provides examples of both a recognition of the need to eliminate excessive administrative costs and uncertainty regarding the tax results and the difficulty of achieving that result when the tax results continue to depend on factual determinations under standards that are inherently ambiguous. This example concerns the extraordinary steps that the United States and Mexico have taken to eliminate the unacceptable administrative burdens and uncertainty that would follow from Mexican taxation of foreign companies that use the manufacturing services of a Mexican maquiladora company, based on determinations that those companies have permanent establishments in Mexico. Unfortunately the steps that the United States and Mexico have undertaken thus far to implement the new tax regime are themselves characterized by unacceptable delays, inherent uncertainties and unreasonable administrative burdens that have had a negative effect on foreign investment in the export sector of the Mexican economy.

In the 1960's Mexico implemented the "maquiladora program", which provide for temporary importation of materials, assemblies and machinery and equipment, free of duties and value added tax, for the purpose producing products for export. These "maquiladora operations" have always been characterized by cross-border processing contracts between a foreign company and a Mexican maquiladora company under which the maquiladora processes inventory owned by the foreign company using machinery and equipment owned and provided by the foreign company. Historically foreign companies have enjoyed a statutory exemption in Mexico from exposure to Mexican asset tax or to having a permanent establishment for Mexican income tax purposes as a result of undertaking arrangements of this kind with a maquiladora.

In the vast majority of cases, the parties to a maquiladora processing agreement are a U.S. company and the maquiladora, which may or may not be an affiliated company. Most multinational groups from Japan and Europe that participate in the maquiladora program employ a processing agreement between a U.S. affiliate and the maquiladora company under which the U.S. company owns the inventory and the machinery and equipment and makes it available to the maquiladora on a free bailment.

During 1998 and 1999 Mexico attempted to implement a permanent establishment tax regime for foreign companies that use the manufacturing services of a maquiladora to process products in Mexico for export, through repeal of the statutory exemption. In October 1999, however, Mexico entered into a generalized existing mutual agreement on maquiladora taxation with the United States that establishes the conditions under which Mexico will continue to grant exemptions from permanent establishment and from Mexican asset tax for U.S. companies participating in Mexico's export production sector through processing contracts with a maquiladora. (Mexico's rules implementing this agreement have in effect generalized it to apply to foreign companies from any country.)

Although Mexico and the United States extended the effectiveness of the mutual agreement indefinitely in August 2000, the Mexican rules implementing the mutual agreement were at first limited to temporary fiscal regulations, which could be modified or repealed at a moment's notice at the discretion of Mexico's Ministry of Finance and Public Credit. When a statutory exemption was restored through legislation enacted on January 1, 2002, it was enacted in "Transitory Articles" that impose burdensome administrative requirements and uncertainties that are not consistent with the mutual agreement and that by their terms are in effect only for years 2002 and 2003.[2]

Moreover, in defining the conditions that a maquiladora must meet in order to preserve the necessary Mexican tax exemptions for a U.S. company that uses its processing services, the United States and Mexico needlessly linked these exemptions to transfer pricing issues by providing for the maquiladora to obtain an APA under modified conditions, which have not been fully defined. The extended APA proceedings that Mexico and the United States have employed to implement this new tax regime have resulted in administrative costs, delays and attendant uncertainties wholly out of proportion to the compliance costs that companies can afford to bear in connection with their decisions on where to locate these cost-sensitive export manufacturing operations.

The result, in part because of the ongoing uncertainty and risk of unacceptable tax treatment of these operations, has been a significant reduction in foreign investment in the maquiladora sector during the past two years, including withdrawals from Mexico by some leading Japanese electronics manufacturers. This has led to a 20% decline in the number of people employed in the maquiladora industry, which has accounted for most of Mexico's manufacturing exports and a majority of the growth of Mexico's manufacturing sector over that last decade. (According to Mexico’s National Institute of Statistics, Geography and Information, employment in the maquiladora sector fell from 1,310,171 in January 2001 to 1,060,173 in March 2002.)

Developing Cost-Effective Tax Compliance Policies

I would like to propose twelve steps that it would be in the self-interest of tax authorities in Latin America to take, in order insure that they are properly balancing the revenue potential and administrative burdens and uncertainties that will follow from their tax compliance policies:

1. Implement a process of assessing the cost-effectiveness of all tax compliance policies and procedures through constant evaluation and reevaluation of the revenue potential and compliance costs and uncertainties resulting from particular compliance measures.

2. Seek out and respond to expressions of taxpayer concerns about tax compliance burdens and uncertainties. Tax authorities will not always be aware in advance of the factors that magnify the burden of particular compliance rules or that make uncertainty about certain tax rules particularly burdensome for a multinational company. One important way to get this

[2] On May 2, 2002, Mexico modified its temporary fiscal regulations on maquiladora taxation to address on a temporary basis some but not all of the inconsistencies between the mutual agreement and the Mexican legislation, once again in a fashion that is subject to change at any time at the discretion of the tax authorities.

taxpayer input is to establish the practice of seeking taxpayer comment on proposed tax changes in advance of issuing them, so as to benefit from their insights on how the rules can be improved to reduce the compliance burden and avoid unintended effects.

3. Apply conservative standards for determining the levels of administrative costs and uncertainty that can be justified in order to raise a given amount of revenue. Given that information on these points will always be incomplete, tax authorities should act on the assumption that it is always beneficial to place a high priority on minimizing compliance burdens and uncertainties in designing tax compliance policies and procedures.

4. Root out and transform bureaucratic requirements that have grown up as a part of the tax compliance system but that are not essential to obtaining necessary information or to discouraging corruption within the tax authority.

5. Embrace new technology to streamline compliance procedures when possible, through techniques such as electronic filing, while avoiding extra burdens that can result from thoughtless implementation of new technology.

6. Expand to the extent possible the use of rulings to particular taxpayers, so as to provide certainty of tax results and to reduce the compliance costs for taxpayers and the tax authorities in dealing with issues on audit after the fact. For example, countries should consider following the lead of Mexico in issuing APA's to provide certainty to taxpayers in the application of the transfer pricing rules that countries throughout the region are adopting.

7. Choose carefully what issues to address in tax reform efforts and in designing tax compliance rules. An overly ambitious agenda can drive the process toward careless implementation characterized by unnecessary administrative burdens and less certainty than can be achieved with a more thoughtful approach.

8. Avoid over reacting to perceived abuses with broad-based measures that impose administrative burdens and uncertainty on a range of taxpayers, or a range of transactions, that is out of proportion to the abuse in question. Put a different way, tax authorities must accept a reasonable level of doubt as to whether compliance rules being implemented are sufficiently broad or intrusive in order to avoid driving away potential taxpayers that could make an important contribution to the country's development.

9. In crafting the tax rules themselves, recognize the inevitable trade-off between conceptual purity and administrative simplicity, and err in favor of adopting rules that are simple to administer so that compliance can be achieved at reasonable cost.[3] Tax authorities in Latin America have taken this idea to heart in the past, often with good results. One example of the

[3] For further discussion of this point, *see* Sheldon S. Cohen, "Tax Administration and Tax Policy in Developing Countries: How to Increase Domestic Finance for Development", remarks at the Interregional Seminar on Improving Revenue Administration in Developing Countries, United Nations Department of Technical Cooperation and Development, Harare, Zimbabwe, 5 to 9 November 1990 (transcript on file with presenter).

creative use of this principle is the enactment of an asset tax in many Latin American jurisdictions, as a kind of alternative minimum tax with respect to the income tax. First of all the asset tax is relatively simple to administer, compared with the income tax. Second, by allowing taxpayers to offset income tax payments against their asset tax liability, the imposition of the asset tax creates a self executing enforcement mechanism for the income tax, especially for affiliates of U.S. companies, for which the asset tax is not a creditable tax.[4]

10. Be slow to change tax laws and regulations, and in deciding whether to make a change take into account the high cost of uncertainty that accompanies changes in the tax laws. In the bast of circumstances, this uncertainty can be minimized by careful drafting and sensible implementation of new tax rules, but more often change is accompanied by administrative costs and uncertainties that significantly reduce the net benefits that can be achieved by the change.

11. In making changes in tax laws and regulations, have the discipline to think through and define the rules to be implemented before beginning the processes of implementing them.

12. Eliminate the practice of financing the government through unreasonable and unprincipled limitations or delays in paying tax refunds to which taxpayers are entitled under the law. This is a particularly shortsighted practice. Not only does it impose huge administrative burdens in vindicating rights that the taxpayer has under the law, but it also encourages taxpayers to adopt aggressive or even unjustified tax positions on other issues as a kind of self help, given that a tax deficiency on that issue will be offset by the unpaid tax refund. Of course the government is often the loser in such situations, if the taxpayer eventually gets its refund and the tax auditors fail to challenge the aggressive position that the taxpayer has taken on the other issues.

In many cases taking these steps will provide a double benefit, by allowing the tax authorities to make better use of their own resources while reducing the compliance burden on taxpayers as well.

What International Organizations Can Do

There are also things that international development organizations can do to help countries to implement tax compliance programs with an adequate level of certainty and realistic administrative burdens. They can hold conferences like this one. They can address these issues in their programs of assistance in tax administration, such as the ones that the International Monetary Fund, the World Bank and CIAT have pursued so successfully for many years.

They can also emphasize the concerns that we have been discussing in their own agendas with respect to the tax policies of developing countries in Latin America and elsewhere. The international tax community should not promote conceptual purity in the tax laws of these jurisdictions to the point that they are perceived as requiring a level of factual analysis or administrative complexity that is out proportion with the ability of the tax authorities in these

[4] *See* Rev. Rul. 91-45, 1991-2 C.B. 336.

countries to formulate or to administer on a daily basis with all of the taxpayers that come for them.

In one sense this is a variation of the Hippocratic oath – an international development organization should do no harm.

But that is not all. I would contend that it is in the mutual interest of the developing countries and the developed countries for the OECD in particular to place an affirmative emphasis on encouraging simplified approaches to tax administration and tax compliance in the countries of Latin America and in other developing countries. The OECD should lead the way toward a forthright recognition that in many cases a simple rule is preferable and should be encouraged, instead of pressing for the conceptually pure result.

This is particularly true in addressing highly factual issues, such as implementing transfer pricing rules in a developing country or designing principles (which do not yet exist) for attributing income to a permanent establishment in a developing country. In these areas the OECD, the IDB, CIAT, and other international organizations, as well as Japan and the United States, should in many cases promote the use of simple rules, even at the expense of conceptual purity.

At present some tax officials in the region rightly or wrongly cite OECD pressure toward conceptual purity as a reason for not adopting more streamlined tax rules. To the extent that this reflects a confusion about OECD's agenda or a misunderstanding of the relevance of OECD principles in particular cases, then it would be helpful for the OECD to take steps to clarify the situation.

To illustrate the point, I will return to the example that I mentioned earlier.

Example – Taxation of Maquiladora Operations in Mexico

As I have mentioned, the mutual agreement on maquiladora taxation between the United States and Mexico defines the terms that Mexico may impose as a conditions for allowing a U.S. company to retain an exemption from permanent establishment and asset tax exposures arising from owning assets (usually machinery and equipment) that the U.S. company makes available to a maquiladora for use in processing the U.S. company's products in Mexico. The conceptual underpinning for the agreement is that in exchange for maintaining those exemptions for 2000 and future years, Mexico is allowed to require that the maquiladora receive additional payments from the U.S. company, over and above the normal transfer price that it a maquiladora is entitled to receive for its processing services, so as to give to the maquiladora an element of the economic return on the foreign-owned assets.

The mutual agreement implements that general idea through an election under which the maquiladora agrees either (1) that its taxable income will meet a safe harbor threshold, which will be no less than 6.9% of the total value of the foreign-owned assets and maquiladora-owned assets used in Mexico in the maquiladora operation or (2) that it will obtain an APA from the Mexican tax authorities based a new methodology, to be developed jointly by the United States and Mexico, under which Mexico will "take into consideration" the value of the foreign-owned assets in determining the transfer price that the maquiladora should receive for its processing services.

This resolution should first be praised for recognizing that the use of a safe harbor as a permanent feature of the new tax regime allows many companies to obtain the necessary exemption from permanent establishment without unreasonable uncertainty or administrative costs. Recent refinements in the Mexican rules implementing the safe harbor have also contributed to making the safe harbor a reasonable alternative for many companies, as contemplated by the mutual agreement.

As presently structured, the safe harbor is not a complete solution, however, because it does not generally provide an appropriate result for a capital intensive maquildora operation, which of course Mexico is particularly eager to attract. This is because in the case of a capital intensive operation, a 6.9% taxable return on all of the assets, including the foreign-owned assets, will result in a markup on costs that is not acceptable, in many cases exceeding 20%. The mutual agreement provides an alternative for such companies of obtaining an APA under the new principles described above.

The flaw in this resolution is the unnecessary link that it establishes between obtaining a permanent establishment exemption for the U.S. companies and modifying the transfer pricing rules that the companies must satisfy. This flaw is compounded by both the lack of standards for implementing the principle that the maquiladora should receive some portion of the economic return on the U.S.-owned assets and the requirement that a maquiladora choosing this alternative must obtain an APA in order for the U.S. company to qualify for an exemption from permanent establishment. In this regard the mutual agreement adopted a framework that Mexico had previously employed for defining the conditions on which a foreign company would obtain the exemptions from permanent establishment and asset tax exposure, with the exception that Mexico's maquiladora APA's for 1999 and prior years were issued on the basis of normal transfer pricing principles, without taking into consideration the foreign-owned assets in determining the transfer price to be paid to the maquiladora.

In assessing this agreement and in considering how it should be implemented, it is important to remember that maquiladora companies are generally affiliates of multinational companies and that generally they manufacture products for export from Mexico, so that Mexico is subject to the most intense international competition to be the low-cost jurisdiction, in order to attract and retain these manufacturing operations. This is not a favorable circumstance for creating highly ambiguous standards that will inevitably involve substantial uncertainty, coupled with a requirement that the maquiladora bear the cost of obtaining an APA as a condition for preserving the permanent establishment exemption for the U.S. company.

Because obtaining a maquiladora APA now has the unique consequence of securing the Mexican tax exemptions for the foreign company, as well as confirming the maquiladora's transfer price satisfies Mexico's transfer pricing rules, hundreds of maquiladoras have requested APA's, both before and after the mutual agreement. It is perhaps not surprising that consideration and issuance of these hundreds of APA's has not proceeded quickly. Many APA's for the period 1995 through 1999 were issued relatively recently, and many others for that period have still not been issued, leaving many companies in a state of uncertainty regarding their tax results for the past several years.

The United States and Mexico continue to discuss how they should implement the general idea that maquiladora APA's for 2000 and later years should grant Mexico some portion of the economic return on the U.S.-owned assets, pursuant to the bargain struck under the mutual agreement on maquiladora taxation. Meanwhile the unilateral and bilateral APA's that have been requested for 2000 and later years have not yet been issued, and consideration of hundreds of them has not yet begun.

Almost inevitably the uncertainty and costs inherent in this new tax regime have been compounded by flaws in the analysis that Mexico proposes to apply to take into account the foreign-owned assets in issuing a maquiladora APA. The methodology that Mexico has announced that it plans to implement for its unilateral maquiladora APA's for 2000 and later years is not acceptable for capital intensive operations in which large amounts of relatively new machinery and equipment is owned by the foreign company.[5] This has had the effect of driving more companies to get a bilateral maquiladora APA, thereby increasing the administrative costs associated with determining the tax results for these cost-sensitive operations

Senior Mexican officials continue to suggest that Mexico will postpone implementing these new rules until 2003, by extending through 2002 the clearer and less aggressive rules for 1999 and prior years that provided for an exemption from permanent establishment for the foreign company if the maquiladora received a payment for its processing services that satisfied normal OECD transfer pricing standards. Extending those old rules through 2002 would have the advantage of allowing Mexico and the United States to decide upon new rules before they are required to implement them.

Postponing the implementation of new standards for issuing maquiladora APA's to 2003 would not solve the problem, however, if it merely had the effect of postponing the implementation of unreasonably burdensome standards.

[5] For a more complete discussion of the problems presented by the methodology that Mexico has announced that it will apply in maquiladora APA's issued under the mutual agreement on maquiladora taxation, *see* Robert S. Kirschenbaum and John A. McLees, "New Maquiladora APA Guidelines: Are We There Yet?," The Transfer Pricing Report, 14 November 2001.

A more reasonable and cost-effective approach for requiring maquiladoras to take into account the foreign-owned assets in 2003 and future years would be to continue to apply normal transfer pricing principles in those years and simply to require foreign company to make an additional annual payment to the maquiladora equal to, say, 2% of the value of the foreign owned assets that the foreign company makes available to the maquiladora on free bailment, as a condition for maintaining the foreign company's exemptions from permanent establishment in those years. This would achieve the results contemplated by the mutual agreement without the need to define new transfer pricing principles or to require that each maquiladora obtain an APA. Maquiladoras could resolve this thorny issue at a tiny fraction of the administrative costs of the current approach, while virtually eliminating the massive delays and ongoing uncertainty that results from the current rules.

Mexico could implement the substantive rule under its domestic law as a maximum amount that Mexico could require the U.S. company to pay in addition to a normal transfer price as a condition for obtaining the Mexican tax exemptions, or the United States and Mexico could amend the mutual agreement to establish this standard, in effect as new kind of safe harbor. There is little doubt that the United States would also agree to change the mutual agreement to eliminate the requirement that a maquiladora get an APA in order for the foreign company to get the benefit of the Mexican tax exemptions.

Note that such legislation would not do violence to Mexico's transfer pricing principles because the special rule would be limited to defining a payment that the foreign company would be required to make to the maquiladora as a condition for obtaining a statutory exemption from permanent establishment and from the Mexican asset tax. Indeed, it is important to note that the question of what conditions should be satisfied in order to preserve permanent establishment exemption for the foreign company, which is the question that the mutual agreement was intended to answer, is not in itself a transfer pricing question. The apparent connection between the two has resulted from the happenstance that Mexico's rules and later the mutual agreement chose to link the exemption with the transfer price in an unusual way.

When industry representatives have advocated the streamlined condition for obtaining a permanent establishment exemption that is described above, Mexican tax officials have replied that OECD transfer pricing policies prevent the United States and Mexico from agreeing to implement the simpler rules. Some Mexican tax officials argue that if the United States and Mexico adopted this approach, then Mexico would be subject to OECD criticism under the OECD's peer review process for violating its obligations under OECD rules.

In the view of those officials, the consequence is that Mexico and the United States are stuck with a unreasonably burdensome tax regime for this very cost-sensitive industry and an unreasonable level of uncertainty as to the tax results for most companies in the industry, in spite of the availability of a vastly simplified tax regime for this industry that would accomplish both countries' tax objectives and eliminate the drag on the growth of the Mexican economy.

Some of these officials may have a sincere concern about the prospect that OECD would criticize Mexico for departing from the more complex factual analysis and burdensome process characterized by an APA proceeding, based on their genuine confusion between the need to maintain arm's-length transfer prices and a false notion that Mexico is somehow constrained as to the conditions that it may require companies to meet in order to obtain a permanent establishment exemption. Of course a supposed concern about OECD intervention also provides a cover and an excuse for those in the Mexican tax administration that favor the complex bureaucratic solution that they have implemented and that do not understand the damage that they are doing to the Mexican economy.

This is a case in which it would be quite useful for the OECD to make clear that nothing in the OECD tax rules or principles, or in the obligations that Mexico has undertaken as an OECD member, would prevent Mexico from defining simpler conditions for a foreign company to meet in order to obtain the benefit of exemptions from permanent establishment and assets tax. In particular it would be useful for the OECD to make clear that it would not violate OECD rules for Mexico and the United States to agree upon a requirement that a U.S. company make an additional annual payment to the maquiladora equal to 2% of the value of the foreign-owned assets that it makes available to the maquiladora on free bailment, as a condition for obtaining a permanent establishment exemption, instead of mixing the conditions for obtaining a permanent establishment exemption with rules for establishing a proper transfer price.

Only if tax authorities and the international tax community take seriously the need to eliminate unreasonable administrative costs and unreasonable levels of uncertainty in cases such as this will the countries of Latin America be able to realize their potential for attracting foreign direct investment and improving the lives of their people.