Evaluation of the application of the safe harbour on low value-adding services in Peru. Is the safe harbour on low value-adding services suitable for a developing country such as Peru?

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Acronyms and abbreviations

ALP: Arm’s Length Principle

BEPS: Base Erosion and Profit Shifting

C+: Cost plus method

CAN: Andean Community

CFC: Controlled Foreign Company

CIAT: Inter-American Centre of Tax Administrations

CIT: Corporate Income Tax

CUP: Comparable Uncontrolled Price method

DTC: Double Tax Convention

GAAR: General Anti-Avoidance Rule

G20: Group of Twenty is a political-economic forum for the governments of 19 countries and the European Union

GDP: Gross Domestic Product

INR: Indian currency (Indian Rupees)

Latam: Latin America

LVAS: Low Value-Adding Services

MEF: Peruvian Ministry of Economy and Finance

MNE: Multinational Enterprise

MTP: UN Manual on Transfer Pricing for Developing Countries

OECD: Organization for Economic Cooperation and Development

PEN: Peruvian currency (Peruvian Soles)

PS: Profit Split method

R-: Resale Price method

RPS: Residual Profit Split method

SUNAT: Peruvian Tax Administration

TNM: Transactional Net Margin method

TPG: OECD Transfer Pricing Guidelines

UN: United Nations

USD: American currency (United States Dollars)

1. Introduction

1.1. Introduction of topic

In the current era, the globalization and digitization of the economy have allowed greater and faster coordination between companies within the same group. However, after the 2018 economic crisis and the consequent decrease in tax revenues of the countries, the focus has been put on multinational groups. For instance, multinational companies have been highly questioned regarding their planning and actions to reduce their tax burden, shifting income from high tax countries to low tax states.

The significance of intercompany operations worldwide is an important factor to reduce the effective tax rate of multinational companies[1]. As a consequence, in 2013 the OECD and the G20 developed the BEPS Action Plan, which includes 15 actions with recommendations and guidelines that aim to tackle tax avoidance. The BEPS plan has been gradually incorporated into the national legislation of different countries, mainly developed countries members of the OECD.

The OECD indicates that one of the strategies to shift profits is through the provision of intercompany services. Companies can agree on a price that allows them to have a higher income in a low tax state; while the expense will be assumed by the counterpart located in the country where there is more tax burden. To combat this situation, the BEPS Plan includes in the Action 10 recommendations to address the issues of authenticity of the services and their valuation in compliance with the ALP.

Related to the intercompany services, the OECD proposes an optional simplified evaluation approach for the case of LVAS, seeking to align the resources invested in its evaluation with the profitability they generate for companies. As these type of services normally do not generate high returns, the idea is that the pricing and evaluation of them should be simple and not demand much time or costs for both the taxpayer and the tax administrations.

The recommendation of this and other measures given in the BEPS plan are also being implemented by developing countries. Even though, the OECD recognizes that developing countries have different needs[2] and has allowed their participation in global meetings to know their points of view, the elaboration of all the actions were done by developed countries. In this line, it is still questionable if these guidelines are suitable for developing countries.

For the purpose of this thesis, the case of Peru and its recent implementation in national legislation of the simplified approach on LVAS are evaluated. The incorporation of this norm is in line with other adaptations of the BEPS plan and with the country's objective of being part of the OECD in 2021.

The approach has been mainly criticized because, in the way it has been enacted, it does not follow

[1] It is estimated that about 70% of the cross-border trade is made by related parties. See more in: Ramage, S. (2005). *Serious Fraud and Current Issues, pp. 167.* iUniverse.

[2] OECD. (2014). *Part 1 of a Report to G20 Development Working Group on the Impacts of BEPS in Low Income Countries, pp. 25.* OECD Publishing.

the model suggested in Action 10. The safe harbour does not fulfil its nature of being optional[3], limiting the actions of companies. Likewise, it fails to meet its objective of reducing the documentary burden of taxpayers, since the Peruvian tax administration does not refrain from reviewing the benefits test, even if the documentary requirements are met[4]. In addition, it still requires the benchmarking study to support the mark-up chosen.

Finally, the studies carried out so far question that a deductibility rule for expenses has been included in the transfer pricing article of the Income Tax Law, when this is mainly related to the valuation of transactions[5]. This inclusion might generate uncertainty at the time of a possible audit.

This research analyses if this scheme is suitable for Peru, under the benchmark of the two main objectives of the safe-harbour: cost reduction and certainty. It follows the same line of the mentioned studies, and delves into aspects of international taxation and the current Peruvian tax system.

1.2. Research question and sub research questions

- Is the safe harbour on LVAS suitable for a developing country such as Peru?
  - Does the simplified approach on LVAS implemented in Peru strictly follow the recommendations of the OECD?
  - Does this structure correctly reflect the value creation of this type of services in Peru?
  - Does this structure consider the country's own risks assumed by the service provider?
  - Is the Peruvian tax framework adequate to implement the simplified approach?
  - Does this structure have a simple and understandable procedure for the taxpayers?

1.3. Motivation

The motivation of this study is to determine at what extent the guidelines provided by the OECD regarding LVAS should be followed by developing countries like Peru, taking into account the differences in the implementation and in a context where these guidelines have been criticized and considered to be in favour of developed countries. Moreover, it is taken into account that each country has its own particularities regarding tax and legal framework and the South-American country is not the exception.

The differences between developed countries and Peru are present in different aspects: most relevant economic activities, risks, capital intensive or labour intensive activities, provider or recipient of foreign investment, amongst others. Thus, it is important to define if the standardized approach suggested is also beneficial for the South American country. In addition to this, it is necessary to state that Peru is not part of the OECD countries, however is following different rules in order to

[3] Espinal, S., Ludeña, P., Quiroga, C. & Salvador, C. (2018). *El Test de Beneficio en los Servicios Intragrupo y su Aplicabilidad en la normativa peruana del Impuesto a la Renta.* Esan Graduate School of Business.
[4] Aragon, A. & Hinostroza, V. (2019). *La Distorsión del Test de Beneficio en Materia de Precios de Transferencia*. Universidad de Lima.
[5] For instance, in the Article 37 of the Income Tax Law it is stated the principle of causality, meaning that when there is relation between the costs or expenses and the generation of income, a deduction should be granted. However, the deduction rules related to low value-adding services are in Article 32 and do not make reference to the first article, only stating that no deduction should occur when the mark-up rules are not fulfilled. See more in Guerrero, S. (2019). *¿Es La Norma De Servicios Intragrupo Un Adecuado Mecanismo De Control De La Deducibilidad De Los Costos Y Gastos?* Universidad de Lima.

adapt to the standards given.

Another interesting points are to know if the implementation of these guidelines are not merely a political decision driven by the desire of being member of the OECD and if the deviations from the TPG are in line with the reality of the country and as a result taxpayers and tax administrations are better off.

1.4. Research method and limitation

The research question will be addressed under the legal research methodology. This methodology will consist on the revision of documents related to the main topic such as national law, international law, non-binding guidelines, academic reports and publications of tax related organisations.

In order to address the research question, this thesis uses the simplified approach on LVAS detailed by the OECD as a reference model. Specifically, in order to determine if it is suitable to the Peruvian reality, the benchmark to be taken into account is whether the context allows achieving the main objectives of this model: certainty and cost reduction for both the taxpayer and the tax administration. Thus, this study sets forth aspects related to these objectives that positively or negatively impact the South American country.

After the revision of the relevant information, this thesis will focus on the following main documents: OECD BEPS Action Plan 10 about the safe harbour on LVAS, Legislative Decrees N°1312 and N°1369; and Supreme Decree N°337-2018-EF. Namely, it will be limited to give conclusions and recommendations about the implementation of the simplified approach on LVAS in the Peruvian national law.

1.5. Outline

The outline of this thesis will be as follow: in the second and third sections, the theoretical framework to develop the research will be described. This includes international guidelines as well as the structure and hierarchy of national legislation. Likewise, it will detail the advances in tax matters that Peru has made with respect to the BEPS recommendations.

In the fourth section, the main analysis is done by setting forth the implications of the current application in the national legislation. Finally, in the last two sections, the recommendations and conclusions of the present investigation will be described.

1.6. Short description of results

According to the review of the studies and literature related to the research question, this thesis finds that the manner in which the simplified approach has been adapted in the Peruvian legislation encounters different issues.

One of the problems if that the Peruvian model does not take into account the national reality in various aspects. Peru being a developing country has different characteristics from developed countries, among which stand out a higher country risk and value creation peculiar of the region, few signed DTCs and the existence of multinational companies providing LVAS.

Furthermore, the scheme does not strictly comply with the TPG and there are differences such as the

obligation to apply this safe harbour and that the tax administration does not refrain from challenging the Benefits Test despite having the necessary documentation. In addition to this, companies must justify the chosen mark-up through a benchmarking study, a requirement that is excluded in the OECD model and is a key point in the justification of the existence of the simplified approach on LVAS.

Finally, taxpayers who apply this scheme cannot have completely certainty. The norm refers not only to the valuation of services through the mark-up but also refers to the non-deductibility of expenses that exceed the threshold, leads to a possible confusion with other deductibility articles in Peruvian law. This affects the taxpayer in a possible tax audit, because there is no clarity of which article prevails or if both have to be met.

The sum of these aspects spawns greater burden for the taxpayer and creates uncertainty in national and international situations. As a consequence, it is of utmost importance to create an adequate tax framework and amend the differences of the simplified approach. Moreover, the correct application of the ALP remains as the bedrock to support the economic reality of this type of transactions.

2. OECD and BEPS Context

2.1. OECD/G20 Plan BEPS

During and after the financial crisis of 2008, governments suffered a high reduction of their tax income, this decrease led the focus of attention to the contribution of the MNEs and its aggressive tax planning related to taking advantage of the loopholes in tax legislation and the shift of profits to low-tax territories. The OECD estimates that the tax revenue losses generated by these actions are between USD100 and USD240 billion per year[6]. Following this scenario and with the objective of tackling tax avoidance, the G20 and the OECD prepared a report with 15 actions, which was presented in 2015.

Table 1: Actions of the plan BEPS

BEPS Actions	
Action 1	Addressing the tax challenges of the digital economy
Action 2	Neutralising the effects of hybrid mismatch arrangements
Action 3	Designing effective Controlled Foreign Company Rules
Action 4	Limit base erosion involving interest deductions and other financial payments
Action 5	Counter harmful tax practices more effectively taking into account transparency and substance
Action 6	Prevention of treaty abuse
Action 7	Preventing the artificial avoidance of Permanent Establishment status
Action 8	Assure that transfer pricing outcomes are in line with value creation: intangibles
Action 9	Assure that transfer pricing outcomes are in line with value creation: risks/capital
Action 10	Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions
Action 11	Establish methodologies to collect and analyse data on BEPS actions to address it
Action 12	Requiring taxpayers to disclose their aggressive tax planning arrangements
Action 13	Re-examine transfer pricing documentation
Action 14	Make dispute resolution mechanisms more effective
Action 15	Develop a multilateral instrument to modify a bilateral tax treaties

Source: OECD. Own elaboration.

In line with this, the OECD created the Inclusive Framework on BEPS Actions, which allows other countries, not members of the OECD or the G20, to be part of the development and implementation

[6] OECD. (2017). *Background Brief: Inclusive Framework on BEPS*. OECD Publishing.

of the recommendations. The member of it must implement actions 5, 6, 13 and 14, the so-called "minimum standards". To date, in total there are 137 countries (between members and non-members of the OECD) that conform the Inclusive Framework[7].

One to the main advantages of the BEPS Plan is that it is possible to avoid aggressive tax planning that leads to a reduction in tax revenues through harmonized measures by countries, instead of each one implementing solutions separately. The harmonization of the BEPS Actions is also beneficial in the aspect that reduces the investment time in the development of measures and avoids possible disagreements due to non-standardization.

However, there has been critics related to the convenience of implementing these recommendations in developing countries. For instance, India does the remark that the rules are created by developed countries and have to be implemented by developing countries, even if these rules do not consider the real necessities of developing countries on base erosion matters[8]. Furthermore, the harmonization of policies has also been put into discussion because there are measures that still have been unilaterally implemented by countries such as France and the UK or by the EU, for example through the enactment of Anti-Avoidance Directive (ATAD)[9]. In addition, it is also criticized that despite the inclusion of non-OECD countries, they are not involved in the decision-making process in the same way as member countries[10], therefore not inclusive[11].

On the other hand, other studies suggest that BEPS matters are even more relevant for low and middle income countries, since these countries rely more on tax revenues derived from CIT[12] and especially transfer pricing recommendations are considered important to address BEPS issues[13].

2.2. BEPS in Latam

Table 2: BEPS in Latam

Partial (Ø) and total (X) implementation of the BEPS Actions in Latam and Caribbean															
Country/Actions	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**
Argentina	Ø		X	X	Ø	X	X				Ø		X	Ø	Ø
Barbados						Ø								Ø	Ø
Belize						Ø									Ø
Bermuda					Ø								Ø		
Brazil					Ø	Ø	X					X		Ø	
Chile		Ø	X		X	Ø	Ø				Ø	Ø	Ø	Ø	Ø
Colombia	Ø		X	Ø	Ø	X	Ø			X			X	Ø	Ø
Costa Rica	Ø	Ø		X	X	Ø	Ø				Ø		X	Ø	Ø
Curacao															X
Dominican Republic										Ø					

[7] According to the update in December 2019 of the OECD document called "Members of the OECD/G20 Inclusive Framework on BEPS".
[8] UN. (2014). *Questionnaire about Countries´ Experience Regarding Base Erosion and Profit Shifting Issues: India.* UN.
[9] Fung, S. (2017). *The Questionable Legitimacy of the OECD/G20 BEPS Project.* Erasmus Law Review.
[10] Lennard, M. (2016). *Base Erosion and Profit Shifting and Developing Country Tax Administrations.* Intertax.
[11] Burgers, I. & Mosquera, I. (2017). *Corporate Taxation and BEPS: A Fair Slice for Developing Countries?* Erasmus Law Review.
[12] Crivelli, E.; De Mooij, R. & Keen, M. (2015). *Base Erosion, Profit Shifting and Developing Countries*. IMF.
[13] Peters, C. (2015). *Developing Countries' Reaction to the G20/OECD Action Plan on BEPS*. IBFD.

Partial (Ø) and total (X) implementation of the BEPS Actions in Latam and Caribbean															
Country/Actions	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**
Ecuador				Ø	Ø	Ø		X	X	X		Ø			
El Salvador						Ø	Ø								
Jamaica					Ø	Ø	Ø								Ø
Mexico	Ø	Ø	Ø		X	X	X	Ø	X	Ø	Ø	Ø	X	Ø	Ø
Panama					X	Ø							Ø	Ø	Ø
Paraguay						X								Ø	
Peru				Ø	Ø					Ø			X		Ø
Trinidad & Tobago					Ø										
Uruguay					X	Ø	Ø				Ø		Ø	Ø	Ø

Source and elaboration: CIAT

In order to understand the analysis of this thesis, it is necessary to understand what is happening in the region: the panorama of Latam countries with respect to the implementation of BEPS actions. As shown in table 2, the actions may have been partially or fully implemented in national legislation. Mexico leads the board with 14 actions partially or totally implemented; while Curacao and the Dominican Republic have only implemented one of the actions. On the other hand, in the region the actions that have been most implemented are those required by the Inclusive Framework (actions 5, 6, 13 and 14).

This scenario shows that the countries of the region are not alien to the implementation of BEPS actions, although only three belong to the OECD[14]. Likewise, all the countries observed are part of the Inclusive Framework, with the exception of Ecuador and El Salvador.

To conclude, it is prudent to state that in the neighbourhood there is a trend to comply with OECD recommendations through the implementation of actions in national laws. As a highlight, the actions required by the Inclusive Framework are the priority for the countries of the region and, as will be seen later, Peru is also following this trend.

2.3. Developing countries and UN

As mentioned earlier, one of the critics of BEPS actions is that it does not consider the primary needs of developing countries. This aspect is well-known by the OECD, and it expressly believes that "Developing countries also face issues related to BEPS, though the issues may manifest differently given the specificities of their legal and administrative frameworks"[15].

Given this situation, in 2013 the UN Tax Committee established a Subcommittee on BEPS for developing countries, in order to ensure that their experiences are considered in the BEPS project and in the tax cooperation work of the UN, among other functions.

In 2015, the UN Subcommittee on BEPS conducted a questionnaire to certain developing countries[16]

[14] Chile, Mexico and recently incorporated, Colombia.
[15] UN. (2015). *Report of the Eleventh Session of the Committee of Experts on International Cooperation in Tax Matters*. UN.
[16] The participants were: Bangladesh, Brazil, Chile, China, Ghana, India, Lesotho, Malaysia, Mexico, Singapore, Thailand, Tonga and Zambia.

about the impact of BEPS actions on them. The results of this showed the importance of transfer pricing recommendations and the difficulty of forming teams in tax authorities with the appropriate specialization.

The UN function as the link between the OECD and developing countries, so that experiences and perspectives are not left aside. A case to mention is the development of the MTP by the UN, in which it details, in some cases, alternative measures to those indicated in the BEPS Plan, especially in relation to transfer pricing.

An important aspect that is considering in favour of the developing countries is that unlike the OECD, the UN has a broader scope because it has 193 members compared to the 37 countries belonging to the first organization. However, it should be noted that the 193 members are not in the Committee of Experts on International Tax Cooperation.

2.4. Intercompany services[17]

The TPG of OECD, among the topics mentioned above, refers to the nature and recommendations related to intercompany services. Specifically, it refers to a balance that must exist between payments for intercompany services and the need to protect the tax base of the company that receives the services, avoiding an overpayment for the services.

On the other hand, in 2013, and in line with the UN Model Convention, the Committee of Experts on International Tax Cooperation published the MTP, here it addressed the doubts of developing countries about intercompany transactions within MNE groups.

This MTP was updated in 2017 by the Subcommittee on Transfer Pricing in order to include feedback made to the first version and recent developments in the area, including those related to BEPS Actions. Here, the UN includes a detailed description and suggestions about the treatment of intercompany services.

Both the TPG and MTP refer to the following two important points on this topic:

- The determination if the services have been rendered: The key issue here is that through the benefits test, the companies are able to demonstrate that the service provided is expected to generate economic or commercial value to maintain or enhance the business position of the recipient company. Moreover, in case of the absence of the provision of the services evaluated, the recipient would have paid for the services to a third party or would have performed it for itself in order to cover the real necessity.
- The fulfilment of the arm´s length principle: Following the ALP concept, both reports indicate that the treatment of the intercompany services should be the same if the transaction occurred between independent parties. The UN puts special emphasis on the incorporation

[17] This section is based on the following book: OECD. (2015). *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project* & UN. (2017). *Practical Manual On Transfer Pricing for Developing Countries.* Department of Economic & Social Affairs, United Nations.

of functional analysis when setting the intercompany price. Likewise, both the TPG and the MTP indicate that each case must be analysed separately depending on the conditions and characteristics of each transaction.

2.4.1. Low value-adding services

The specific treatment of LVAS is also set forth in the TPG and MTP, for this purpose the OECD/G20 and UN consider LVAS, those services which:

- Are of a supportive nature
- Are not part of the core business of the multinational group
- Do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles
- Do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider

The following tables show some examples for non-LVAS and LVAS:

Table 3: Non-low value-adding services

Services	OECD	UN
Core business services	X	X
Research and development (R&D)	X	X
Manufacturing and production	X	X
Purchasing activities relating to raw materials used in manufacturing	X	
Sales, marketing and distribution	X	X
Financial transactions	X	X
Extraction, exploration and processing of natural resources	X	X
Insurance and reinsurance	X	
Service of corporate senior management	X	X
Construction services		X

Source: OECD and UN. Own elaboration.

Table 4: Low value-adding services

Services	OECD	UN
Accounting and auditing	X	X
Processing and management of accounts receivable and payable	X	
Human resources such as staffing and recruitment, training and employee development, remuneration services, amongst others	X	X

Services	OECD	UN
Monitoring and compilation of data relating to health, safety, environmental and other standards regulating the business	X	
Information technology services where they are not part of the principal activity of the group	X	
Internal and external communications and public relations support	X	
Legal services	X	
Activities with regard to tax obligations	X	X
General services of an administrative or clerical nature	X	
Data processing		X

Source: OECD and UN. Own elaboration.

2.4.2. Simplified approach

The UN and the OECD took into account the large number of intercompany services that could exist within a multinational group, as well as the burden and time of setting prices by the taxpayer and the review of these transactions by the tax authority. Therefore, both parties recommend the implementation of an elective safe harbour regarding LVAS.

In general terms, the safe harbour implies that the taxpayer establishes a fixed margin on the costs and expenses incurred in the provision of LVAS. This margin at the same time is considered as a market margin, which is accepted as valid for the tax administration, under certain conditions.

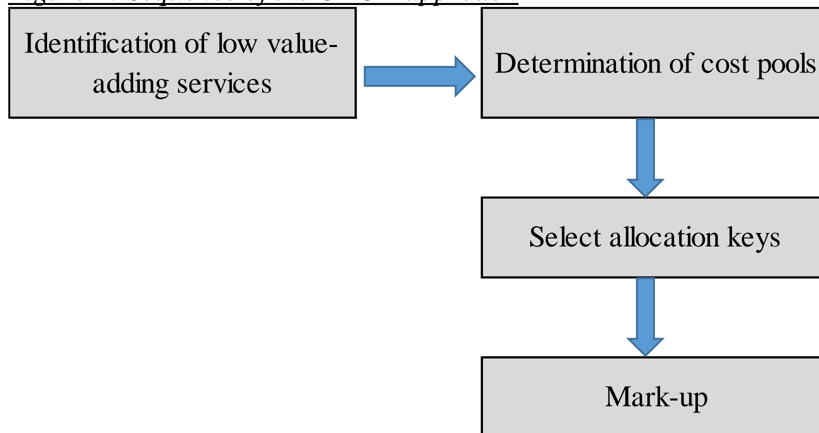
The benefits of implementing this alternative are:

- Certainty: The taxpayer does not have to concern about any possible audit regarding the services and the tax authority does not have to worry if there is an implicit tax misbehaviour, because the price it is considered to be set as if it would have been made between independent enterprises.
- Cost saving: The reduction of compliance burden for the taxpayer could be seen in the needlessness for a benchmarking study to show that the price is according to market conditions[18]. Namely, there are no benchmarking costs related to the evaluation of the services. In addition, the certainty of this approach implies the saving of costs and resources of avoiding a tax audit. For the tax authority, time and resources could be better allocated to evaluate other type of transactions that involve higher revenues[19].

[18] Lang, M.; Cottani, G.; Petruzzi, R.; and Storck, A. (2000). *Fundamentals of Transfer Pricing: A Practical - Guide*. Section 2.3.2. Wolters Klumer.
[19] Feinschreiber, R.; Kent, M. (2012). *Transfer Pricing Handbook: Guidance for The OECD Regulations*. Chapter 20. John Wiley & Sons, Incorporated.

2.4.2.1. OECD approach

Figure 1: Sequence of the OECD approach



Source: OECD. Own elaboration.

The OECD approach specifies the steps that have to be followed in this safe harbour. The first step is to identify that, according to the definitions, the services to be evaluated correspond to LVAS. The second step is to identify all the costs and expenses related to the provision of the service. After this, an allocation key has to be applied in order to distribute the expenses to the companies that benefit from the provision of the service. In both reports it is indicated that the allocation key must be chosen according to the category of each service and must demonstrate the most precise distribution according to the nature of the services.

The TPG states some examples of allocation keys: share of total users (IT services), share of total group headcount (services related to people), share of total vehicles (fleet management services), share of total assets (accounting support services) and in many cases the share of total turnover can be considered as the main key.

Finally, once the costs and expenses have been distributed, a fixed mark-up of 5% must be added, which results in the price to be charged for the provision of the service.

An important part to employ correctly the simplified approach is the supportive documentation, which includes: (i) description of categories of services provided, (ii) beneficiaries, (iii) reasons why the services add low value, (iv) benefits or expected benefits, (v) descriptions of allocation keys and reasons why they were chosen for each case, (vi) confirmation of the mark-up applied, (vii) written contracts or agreements and (viii) calculations showing the cost pool and application of allocation keys.

2.4.2.2. UN approach

Unlike the OECD approach, the UN does not indicate specific steps to implement the safe harbour neither suggest a fixed mark-up, but rather establishes two situations in which it could be applied to benefit the parties involved. However, there are two important remarks: the mark-up must be a fixed profit margin accepted in every country and the service has to be supported by consistent documentation.

The two situations addressed by the UN are:

- LVAS: Applicable when the service follows the concept of value-adding services previous defined. For this situation, there has to be a fixed profit margin that must be accepted in all the countries where the service is rendered and must exist documentation to support the provision of the intercompany services.
- Level of costs incurred: This safe harbour indicates that if the total cost of receiving or providing a service is below a determined threshold, the tax authorities could agree not to make a transfer pricing adjustment. The thresholds can be calculated based on a percentage of the total deductions for a tax year of the receiving enterprise (inbound services) or a percentage of the taxable income of the supplier enterprise (outbound services).

3. Peruvian Tax System

3.1. Framework

In order to understand better the analysis developed in this thesis, in this section a brief introduction of Peruvian tax system is set forth. A key point before explaining the Peruvian Tax System is to indicate that Peru is composed by a hierarchical structure of governments, based on the following order:

- Central Government (led by the president, congress and judiciary)
- Regional Governments (led by regional governors, there are 25 in total)[20].
- Local Governments (led by provinces and district mayors, there are 1,891 in total).

The Peruvian Political Constitution is the legal source of Peruvian legislation with utmost importance, any legal provision against its content is considered unconstitutional. In the Article 74[21] it is stated that the taxes are created, amended or derogated exclusively by Legislative Decree or Law. Following this, in 1994, the Legislative Decree N° 771[22] was enacted, describing that the Peruvian Tax System has three main objectives:

- Increase collection.
- Provide the tax system with greater efficiency, permanence and simplicity.
- Equally distribute the income that corresponds to the municipalities.

Moreover, through the mentioned Decree, the Peruvian Government defined that the base source of the Tax Law is the National Tax Code. In addition, it establishes the tax category division for the Central Government, Local Governments and other aims.

The second level is occupied by the National Tax Code, a supplementary law. Here, there are rules that regulates the relationship between taxpayer and tax authority and its juridical and economic consequences[23]. For instance, it includes the definition of the different taxes, the sources of the national tax law, interpretation of the tax law, amongst others rules that complement the National Political Constitution.

The third level in the hierarchy is occupied by the complementary norms[24]:

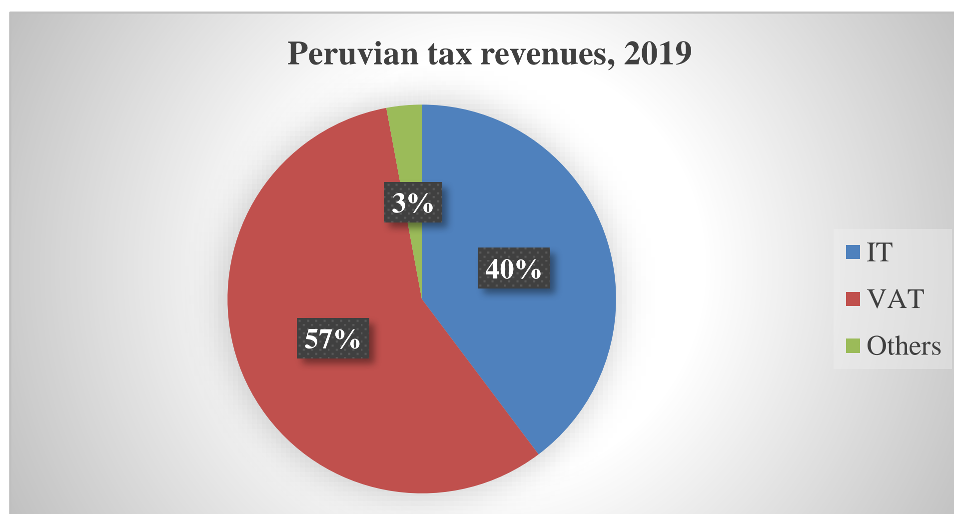
- Law: norm approved by the Congress of the Republic in the exercise of its legislative powers and through the procedure indicated in the Constitution. For example: Income Tax Law or VAT Law.
- Legislative Decree: norm with the rank and force of law that emanates from express authorization and power delegated by Congress, is limited to the specific matter (included taxation) and must be issued within the period determined.
- Supreme Decree: a norm of a general nature that regulates norms with the rank of law.

[20] A Regional Government comprises number of districts and provinces.
[21] Peruvian National Law, Peruvian Political Constitution, Chapter IV, Art. N°74, 1993.
[22] Peruvian National Law, Legislative Decree N°771, 1994.
[23] Bravo, J. (2007). *Sistema Tributario Peruano: Situación Actual y Perspectivas*. PUCP.
[24] MEF. (2020). *Normatividad*. Retrieved from https://www.mef.gob.pe/es/normatividad-sp-1449. Accessed 29 February 2020.

In conclusion, the Peruvian Tax System has a three-level hierarchy. The most important one is the National Political Constitution, followed by the National Tax Code (supplementary law) and finally the complementary law. For the purpose of this paper, the analysis will be based mostly in Law, Legislative Decrees and Supreme Decrees, as the enactment of these laws put in force the different tax regulations.

Regarding the general structure of tax revenues in Peru, this is mainly comprised by two components: Income Tax (IT) and Value Added Tax (VAT). Figure 2 shows that in 2019 the Income Tax represented 40% of the total tax revenue (USD13,338 million); while VAT totalled 57% (USD19,244 million).

Figure 2: Structure of Peruvian tax revenues[25]



Source: SUNAT. Own elaboration.

However, within the Income Tax there are various categories depending on the type of income:

Table 5: Type of income tax[26]

Income Tax	Type of income
First Category	Lease and sublease of property
Second Category	Dividends, shares and capital gains
Third Category	Business activities
Fourth Category	Independent work
Fifth Category	Dependent work
Non residents	People classified as non-residents
Micro and small enterprises	Companies with annual sales of less than USD2,200

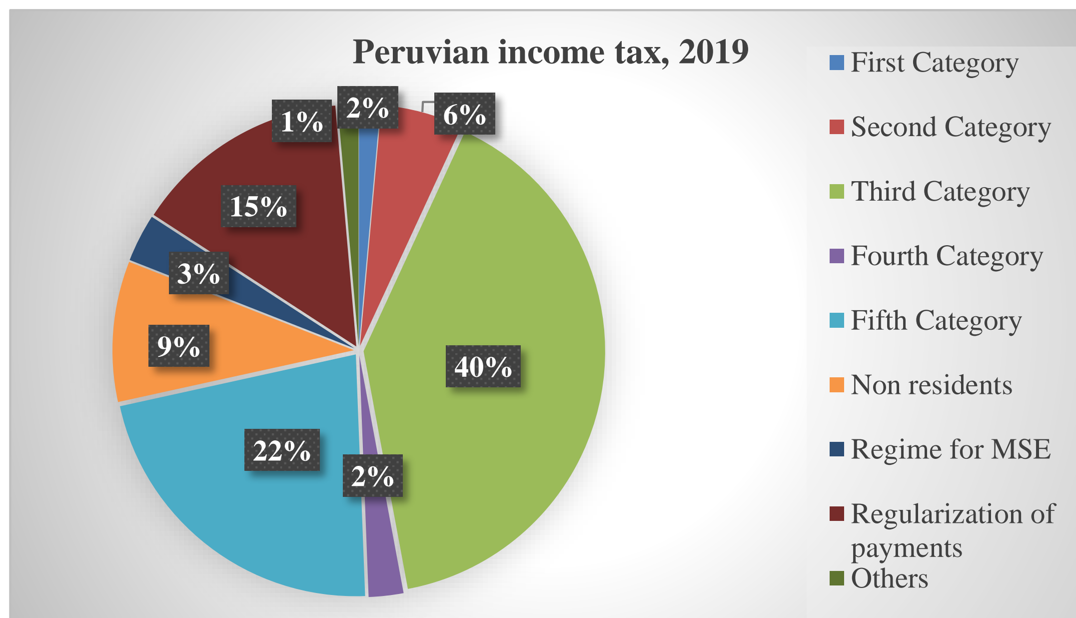
Source: SUNAT. Own Elaboration.

As it is shown in Figure 3, the tax income derived from companies' subject to analysis in this thesis (third category) is of utmost importance for the Peruvian government, since it represented 40% of the total Income Tax revenue and 16% of the total tax revenues in 2019 (USD5,357 million). Therefore, the measures that the government takes and addresses these types of companies will have

[25] SUNAT. (2020). *Informacion Tributaria: Ingresos Recaudados*. Retrieved from: http://www.sunat.gob.pe/estadisticasestudios/ingresos-recaudados.html
[26] SUNAT. (2020). *Impuesto a la Renta - Personas*. Retrieved from: http://orientacion.sunat.gob.pe/index.php/personas-menu/impuesto-a-la-renta-personas-ultimo

a high impact on total tax revenues. For instance, as a way to encourage business activity in 2015, the general tax rate was reduced from 30% to 28% of the net income, however, from 2017 to the present, it is 29.5%.

Figure 3: Structure of Peruvian income tax



Source: SUNAT. Own elaboration.

Finally, it should be noted that Peru, as most of the South American countries, started with the territorial tax system, namely only income derived within the country was taxed. Nonetheless, in 1968 the Peruvian tax system changed from the territorial system to the worldwide tax system and the country adopted the approach of Capital Export Neutrality[27].

3.1.1. Transfer pricing in Peru

The application of transfer pricing in Peru began in 2001 with the enactment of the Law N° 27356[28], which modified the Income Tax Law. It introduced the rules for the evaluation of intercompany transactions and transactions with companies located in tax havens. Nonetheless, the rules did not follow the OECD TPG[29] and there was not enough clarity to be implemented. After some amendments[30], in the year 2006 the rules were completely implemented and it was established to be mandatory the presentation of the corresponding documentation with the information required. In addition to this, in the Regulation of the Income Tax Law it was included the Chapter XIX with detailed explanation of the rules about adjustments, comparability analysis, determination of the interquartile range, information to be presented in the Transfer Pricing Study, amongst others[31].

[27] Luyo, K. (2015). *The Role of the UN Model in Peru's Tax Treaties*. IBFD.
[28] The scope of the transactions and methods to the economic analysis are included in the Art. 32 (4) and Art. 32-A of the Income Tax Law.
[29] García, M. (2001). *Precios de Transferencia en el Perú: ¿Estamos Verdaderamente Preparados?* Ius et veritas.
[30] In 2003, the Legislative Decree N° 945 made changes to the legislation incorporating the obligation to present the Transfer Pricing Study (nowadays, Local File). Moreover, it states that the OECD TPG are source of interpretation. In 2005, through the Supreme Decree N° 190-2005-EF the presentation of the Transfer Pricing Study was pull off until the beginning of 2006.
[31] Peruvian National Law, Regulation of the Income Tax Law, Chapter XIX.

The overview of the transfer pricing rules in Peru can be summed up in the following points:

- Scope: Transactions between related companies or those made from, to or through countries or territories with low or no taxation.
- Methodology: Based on the ALP, the taxpayer can choose the more appropriate methodology to do the economic analysis as long as this reflects the "economic reality of the operation". The methods allowed are in line with the international guidelines (CUP, R-, C+, PS, RPS and TNM). Additionally, there are other methods that can be included if the mentioned methods are not suitable for operations under analysis.
- Price range: The analysis has to consider the application of the interquartile range in order to determine if an intercompany price is according to ALP.
- Adjustment: Adjustments will take place only if the operations under scope result in a reduction of the tax base or deferral of tax payment.
- Legal sources of interpretation: the OECD TPG are indicated to be source of interpretation as long as these do not oppose the disposition of the Income Tax Law.
- Documentation: Local File, Country-by-Country Reporting and Master File.

3.1.1.1. Latest transfer pricing changes subject to analysis

The last changes in transfer pricing began in 2016 with the enactment of the Legislative Decree N°1312 with the main purpose of "adapt the national legislation to international standards and recommendations issued by the OECD on the exchange of information for tax purposes, international taxation, tax base erosion, transfer pricing and combat tax avoidance"[32]. The main changes in the Income Tax Law derived from this Legislative Decree are the following:

- Inclusion of the sixth method for the exportation and importation of commodities.
- The presentation of Transfer Pricing Study is replaced by the Local File
- Incorporation of additional documentation Masterfile and Country-by-Country Reporting
- Inclusion of the Benefits Test for intercompany services.
- Definition of LVAS according to TPG and establishing a maximum margin of 5% over the total costs.

In August of 2018, the Legislative Decree N°1369 specified that the Benefits Test has only to be made for intercompany transactions and is not applicable for services that involve tax havens. Furthermore, it indicated that the deduction of costs and expenses for the LVAS cannot exceed the sum of costs and expenses plus the margin of less than 5%[33].

Later that month, the Government broadened the scope of transfer pricing, now including

[32] Peruvian National Law, Legislative Decree N°1312, 2016.
[33] Peruvian National Law, Legislative Decree N°1369, 2018.

transactions that involve non-cooperating countries or territories. Moreover, it made some details about the deadlines of the documentation related to the transactions of commodities[34].

Finally, at the end of that year, the enactment of the Supreme Decree N°337-2018-EF modified the Regulation of the Income Tax Law. Here, the Supreme Decree included definitions for the subsection about intercompany services. For instance, it included the concept of Benefits Test, allocations key for costs and expenses, minimum documentation to be presented to prove that the provision of services meets the Benefits Test and a list of activities that cannot be classified as LVAS[35].

Table 6: Safe harbour on LVAS: comparison between OECD and Peru

Characteristics	OECD	Peru
Mark-up	5%	Up to 5%
Definition of LVAS	TPG	TPG
Example of LVAS	Table 4	No list
Example of non-LVAS	Table 3	Table 3
Documentation	Section 2.4.2.1.	Section 2.4.2.1., but no explicit mention of a detail of benefits or expected benefits created
Benefits	If documentation is fulfilled, tax administrations refrain from reviewing benefits test No benchmarking study required	If documentation is fulfilled, tax administrations could review and challenge benefits test Benchmarking study required to support the choice of mark-up
Optional approach	Yes	No

Source: OECD and Peruvian national law. Own elaboration.

Table 6 shows the details of the safe harbour implemented in Peru compared to the one indicated by the OECD. As seen there are certain differences, which will be subject to analysis in this thesis. Among the most outstanding are the eligibility of this approach, as well as the benefits and documentary burden that it implies. Likewise, Peruvian legislation allows choosing a mark-up between 0% and 5%, while the TPG recommends a fixed 5%. Finally, unlike the recommended model, Peru does not show a list of LVAS but only set forth those that cannot be classified as such.

3.1.2. BEPS in Peru

Peru's intentions to enter to the OECD began around 2014, when the former Minister of Economy estimated that the access to this group would be given in 2021[36]and signed the Country Programme with the OECD. Even, in the 2016 presidential message, one of the promises was that the country would be part of the OECD in 2021, the bicentennial year of independence[37].

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[34] Peruvian National Law, Legislative Decree N°1381, 2018.

[35] Peruvian National Law, Supreme Decree N°337-2018-EF.

[36] America Economia. (2014). *Peru proyecta ingresar a la OCDE en el año 2021*. Retrieved from https://www.americaeconomia.com/economia-mercados/comercio/peru-proyecta-ingresar-la-ocde-en-el-ano-2021

[37] Diario Peru21. (2016). *PPK anunció que el Perú será miembro de la OCDE al 2021, pero ¿es posible esto?* Retrieved from https://peru21.pe/economia/ppk-anuncio-peru-sera-miembro-ocde-2021-posible-esto-224455-noticia/

Peru focuses mainly on five relevant areas to achieve this objective: economic growth; public governance, anti-corruption and transparency; human capital and productivity; and environment[38]. The tax implications are closely related to the economic growth and anti-corruption and transparency objectives.

However, in order to get this achievement, Peru has to lead with two main hurdles: high informality and low tax revenue. In 2016, informality represented 72% of the total employment, one of the highest rates in Latam[39]. Moreover, the tax revenue to GDP ratio in 2017 was 15,3%, lower than the average of Latam and Caribbean (33,8%) and the OECD (34,2%)[40].

In order to tackle these issues, the Ministry of Economy together with SUNAT have developed a Strategic Plan with the objective of improving the tax revenue to GDP rate, through a broader tax base. In 2014, one of its actions was the creation of the International Taxation and Transfer Pricing area, which currently has more than 40 people and has been responsible for preparing the aforementioned legislative decrees on transfer pricing[41].

In 2018, the fifth meeting of the Inclusive Framework took place in Lima, reaffirming Peru's commitment to implement the minimum standards to tackle BEPS. To date, Peru has implemented the following OECD recommendations on tax matters:

- Action 4: Action 4 has been gradually implemented in national legislation. In 2018, the measure that limits the deduction of interest generated by loans with related companies and third parties was issued. Until the end of 2020, the limit is three times the equity of the previous year; while as of 2021, 30% of EBITDA is considered as a rule[42]. It should be noted that this rule only applies to companies that exceed PEN10.5MM of net income (approximately EUR2.8MM).

- Action 5: According to the work of the OECD Forum on Harmful Tax Practices, Peru reviewed differentiated tax regimes and it determined that none of them has BEPS risk.

- Action 6, Action 14 and Action 15: In June 2018, Peru signed the MLI to be able to implement the minimum standards of Actions 6 and 14. However, it is not yet in force, due to the lack of ratification before the OECD[43].

- Action 8-10: Regarding these actions, Peru has partially implemented Action 10 focusing on

[38] OECD. (2020). *The OECD and Latin America & The Caribbean: Peru.* Retrieved from: https://www.oecd.org/latin-america/countries/peru/

[39] OECD. (2019). *Multi-dimensional Review of Peru: Volume 3. From Analysis to Action*, *Chapter 1*. OECD Publishing. Retrieved from https://www.oecd-ilibrary.org/sites/c6c23d2c-en/index.html?itemId=/content/publication/c6c23d2c-en&_csp_=5edea2c556aeffee86651a0b32fb39cd&itemIGO=oecd&itemContentType=book

[40] OECD. (2019). *Revenue Statistics in Latin America and the Caribbean 1990-2017.* OECD Publishing.

[41] In TP Minds Americas 2020 Forum, the manager of International Taxation and Transfer Pricing indicated that there are more than 100 transfer pricing audits in the pipeline. See more in SUNAT. (2020). *Peruvian Transfer Pricing Control and Anti-BEPS Measure*. Slides of the presentation of the Manager of International Taxation and Transfer Pricing area in TP Minds Americas 2020, USA.

[42] Peruvian National Law, Legislative Decree N°1424, 2018.

[43] Becerra, F. (2018). *El Compromiso del Perú con el Marco Inclusivo BEPS y su Adhesión al Instrumento Multilateral*. Revista Análisis Tributario.

the incorporation of the intercompany services guidelines, subject to analysis in this thesis. Regarding the other two Actions (8 and 9), it is not adopting any recommendations yet.

- Action 13: The enactment of the Legislative Decrees in the period of 2016-2018, put into effect Action 13 of the BEPS plan, related to the documentation of intercompany transactions. According to SUNAT, to date there are more than 3,400 Local Files and more than 800 Master Files presented[44].
- CFC rules: Although Peru is a country importer of capital, the CFC rules were in force since 2013. Like most of these rules implemented in different countries, passive income is considered in the tax base if the CFC is owned by taxpayers who are resident in Peru and if the CFC is constituted or established in a territory considered as a tax haven or in a territory in which the income tax is equal to or less than 75% of the income tax of Peru[45].
- GAAR: GAAR was introduced in the Tax Code at first in 2012 under the name of Rule XVI. However, derogations due to the stagnation of the economy and legal discussion delayed the implementation of this rule that aims to tackle tax planning together with tax avoidance. As of May 2019, GAAR was in force with a retroactively scope[46].

Additionally, to date Peru has signed seven bilateral Double Treaty Conventions[47] and one multilateral[48]; and has Automatic Exchange of Country-by-Country Reporting with 38 countries[49].

[44] SUNAT. (2020). *Peruvian Transfer Pricing Control and Anti-BEPS Measure*. Slides of the presentation of the Manager of International Taxation and Transfer Pricing area in TP Minds Americas 2020, USA.
[45] SUNAT. (2018). Informe N.° 097-2018-SUNAT/7T0000.
[46] Peruvian National Law, Supreme Decree N°145-2019-EF, 2019.
[47] Namely, DTCs signed with Brazil, Canada, Chile, South Korea, Mexico, Portugal and Switzerland.
[48] Namely, DTC signed with the Andean Community (CAN) which is conformed by Bolivia, Colombia, Ecuador and Peru.
[49] Diario Gestión. (2019). *SUNAT Intercambia Información Con 38 Administraciones Tributarias Para Combatir la Elusión*. Retrieved from https://gestion.pe/economia/SUNAT-intercambia-informacion-38-administraciones-tributarias-combatir-elusion-272107-noticia/

4. Implications of safe-harbour on LVAS in Peru

4.1. Peruvian legislation deviates from OECD TPG

As seen in section 3.1.1.1., although the implementation of the safe harbour on LVAS in Peruvian legislation tries to follow the OECD recommendations, it does not fully adopt the scheme and sets forth certain differences. Among these are (i) there is no list of examples of LVAS, (ii) a mark-up up to 5% over costs and expenses is allowed, (iii) the tax administration can challenge the Benefits Test even if the required documentation is met, (iv) the benchmarking study is still required to support the chosen mark-up; and (v) non-optional approach.

To understand this deviation from the TPG, it is necessary to analyse the purpose of the legislators when they proposed and approved the adaptation of this structure.

In the document of the explanatory statement of the reasons for the enactment of the intercompany service rules, the Parliament highlights two main problems with the situation at that time. First, it is indicated that there are companies that belong to the same economic group that contract services for prices that are far from market conditions in order to reduce or eliminate their tax impact. More crucial, these companies deduct these expenses, which may even be associated with non-existent services or services of doubtful need[50].

The second problem is related to the fact that the national legislation lacked of a regulation that requires the taxpayer to support the services with documentation and comply with the Benefits Test to ensure the deduction of expenses for intercompany services. In this context, the adaptation of regulations that establish the requirement of documentation is considered a condition for the deduction of costs and expenses.

Taking into account these two purposes, it can be deduced that Peru seeks to protect, through the requirement of documentation, its tax base from actions that try to deduct expenses related to non-existent intercompany services or that are received unnecessarily. Policy makers give great importance to documentation and this can be seen in the identical documentation requirements between the Peruvian legislation and OECD TPG. This reasoning goes in line with statements indicated by other authors that this Legislative Decree has the objective to address deduction of expenses rather than valuation of services[51]. In other words, the rules are mainly focused on avoiding the deduction of expenses that do not correspond, rather than ensuring that the value of intercompany services are at market value. This could explain why the ALP is not completely embodied in this particular rule.

Regarding the margin of up to 5%, in the problematic of the explanatory statement, the legislators explicitly refer to what the OECD suggested in Action 10 of the BEPS Plan. However, in the proposal of the Legislative Decree 1312 they state that "in the case of low value-added services, the

[50] Peruvian National Law, Explanatory statement of DL 1312.

[51] Aragon, A. & Hinostroza, V. (2019). Interview of EY Peru Transfer Pricing Partner in *La Distorsión del Test de Beneficio en Materia de Precios de Transferencia*. Universidad de Lima.

profit margin *may not exceed 5%* over the costs and expenses incurred by the service provider. The indicated limit has been taken from the 2015 Final Report of the OECD"[52]. There are no explanations that support this difference, however, the intention could have been to provide greater flexibility to taxpayers or simply an error in adapting the recommendations due to haste or misunderstanding.

Finally, there are no documents that make reference to the motives behind the deviation in the benchmarking study, the Benefits Test review and the non-optional approach. However, according to what was indicated at the beginning, it could be concluded that the prevalence and relevance of the documentation that supports the provision of intercompany services is further reinforced with these types of conditions. Although a greater burden is generated on the taxpayer, the tax administration could ensure that it has all the elements to be able to assess the correct deductibility of expenses.

4.2. Alignment of LVAS with value creation

One of the particular characteristics of the Peruvian LVAS safe harbour is that the mandatory margin up to 5%, does not give the alternative option to apply the ALP. From the perspective of a company providing LVAS, it is understood that there is a limitation of the value creation in Peru, therefore also of its profit margin. As the rule is redacted in Peru, these type of services cannot exceed 5% over the total costs and expenses, even if the taxpayer can demonstrate whether it is at market value. In this sense, the objective of the LVAS in Peru collides with the concept of value creation. It is important to remember that BEPS Action 10 seeks to align transfer pricing outcomes with value creation. Moreover, this plight could be also seen as a breach of fairness taxation.

The concept of fairness is based on the benefit principle and the ability to pay principle[53]. First and under the benefit principle, the value generated by Peruvian companies in the country should not be limited by a percentage. Since Peru has provided the conditions for companies to adequately provide LVAS, it has the right to impose taxes on those gains made. This is of utmost importance especially for developing countries, since the taxes collected are the source of financing investments in key issues such as health, education or infrastructure.

On the side of expenses paid to associated companies for services received, the reasoning to follow is that the expenses have been used to generate income that is subject to taxes. Capping them at a maximum of 5% or refusing to deduct expenses that are set under market conditions and have been used to create wealth goes not only against the ability to pay principle, but also the principle of causality. Thus, the application of this scheme under the concept of fairness is questionable.

The margin restriction goes against the most important principle behind transfer pricing: ALP. Likewise, article 32, section 4 of the Income Tax Law refers to this principle: "(Market value is considered) For transactions between related parties or carried out from, to or through from non-cooperative countries or territories with low or no taxation; or that are made with subjects whose

[52] Peruvian National Law, Explanatory statement of DL 1312.
[53] Maslove, A. (1993). *Fairness in Taxation: Exploring the Principles*. University of Toronto Press.

income, income or gains from said transactions are subject to a preferential tax regime; *the prices and amount of the consideration that have been agreed with or between independent parties in comparable transactions*, under the same or similar conditions, in accordance with the provisions of Article 32 -A"[54].

Pursuant to the ALP, it should not be a mandatory restriction on the mark-up, but rather the safe harbour should be elective for taxpayers[55], as recommended in the OECD TPG. This will give the option for service providers to choose either this approach or a normal benchmark.

Moreover, the ALP is stated to be neutral for capital exporting and developing countries since the idea behind is the market forces and in principle it does not favour developed or developing countries[56].

4.3. Alignment of LVAS with risks assumed

Another issue related to the limitation of the mark-up for companies that provide LVAS is the convenience of the 5% cap established by SUNAT. As previously mentioned, the OECD establishes this percentage as a fixed margin, while Peru gives the possibility that the profitability could be between 0% and 5%. As mentioned before, even though the Parliament explicitly states that this mark-up follows the Action 10 of BEPS plan[57], there are no arguments for this distinction. The question that goes without saying is whether this 5% reflects the economic reality of LVAS, especially in a developing country like Peru.

The 5% established is based on benchmarking studies carried out[58]; however, the OECD does not indicate exactly the sample or comparables used. Other studies, such as the one carried out by the European Commission, proposes a more flexible margin between 3% and 10%[59], which is based on a benchmarking carried out between 1999-2007 of European companies that provide routine services[60]. Likewise, an update was made for the period 2012-2014, resulting in an interquartile range between 1% and 8.7%, including companies with operating losses; and between 1.9% and 10.1% including only companies with profits[61].

From these studies it could be concluded that the 5% established by the OECD and the SUNAT is within the interquartile range, so it should not justify any problem. However, there are two aspects

[54] Peruvian National Law, Income Tax Law.
[55] Espinal, S., Ludeña, P., Quiroga, C. & Salvador, C. (2018). *El Test de Beneficio en los Servicios Intragrupo y su Aplicabilidad en la normativa peruana del Impuesto a la Renta.* Esan Graduate School of Business.
[56] Monsenego, J. (2015). *Introduction to Transfer Pricing.* Wolters Kluwer, Law & Business.
[57] Peruvian National Law, Explanatory statement of DL 1312.
[58] Schwarz C.; Stein, S.; Holinski, N.; and Hoffmann, S. (2016). *Cost Plus Markups for Low Value-Adding Intercompany Services.* Bloomberg BNA.
[59] European Commission. (2010). *JTPF Report: guidelines on low value adding intra-group services.* EU Joint Transfer Pricing Forum.
[60]Examples of routine services in the study mentioned are: Legal, Accounting, Finance, Research and Development, IT, Management, Marketing and Public Relations, Transport, Back-office and Human Resources. See more in European Commission. (2009). *BM Contribution to Illustrate Available Generic Evidence Relating to Intra Group Services Profit Margins.* EU Joint Transfer Pricing Forum.
[61] Schwarz C.; Stein, S.; Holinski, N.; and Hoffmann, S. (2016). *Cost Plus Markups for Low Value-Adding Intercompany Services.* Bloomberg BNA.

that weaken the convenience of this mark-up: country risk in developing countries and the dynamic behaviour of the economy.

The first point is a direct questioning of the companies' sample used. As mentioned, the calculation of the interquartile ranges shown above includes only European companies; therefore, companies in the Latam region, where Peru is located, are not represented. Against this aspect, it could be alluded that the functions, assets and risks of the companies that provide intercompany LVAS are similar and; thus, the interquartile range should be applied in a standardized way throughout the world, regardless of the location of the company. However, the fact that a company is located in a developing country implies an assumption of risks specifically related to the country, for example the political conditions, legal security or conditions to set up a business. This additional risk should be reflected in a higher profitability that is not considered in the benchmarking studies shown[62]. Namely, the interquartile range should include an adjustment considering the country risk of developing countries.

Another applicable solution for this point is the creation of a benchmarking study of companies dedicated to provide this type of service in the region[63]. In this way, the economic reality and the risks assumed from these activities could be better reflected.

One of the critical points of this solution is the lack of information and comparables in Latam or the lack of specialization by the tax administrations. In this situation countries opt to embrace type of solutions like this simplified approach. However, the simplicity of the solution should not undermine the importance of reflecting the reality of the transaction and its comparability.

The second point that weakens the convenience of the 5% mark-up is the dynamic of the economy. The reason behind this argument is that the economic behaviour of a country is not constant, there are periods of prosperity as well as periods of stagnation and downturn (for example, as a result of the current Covid-19 crisis). In a similar way, companies of all kinds tend to perform cyclically and directly related to the economic growth of the country. Support services are not the exception since their provision is related to the behaviour of the main business activity[64].

Under this reasoning, establishing a range of up to 5% as implemented by Peru does not consider possible macroeconomics changes and how they impact on the performance of companies, but rather assumes a linear behaviour. For instance, there might be cases in which a company has losses due to a downturn of the economy; however, the company is still required to meet the margin of up to 5%.

On the other hand, there are counterarguments that state that these type of services are insulated from

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[62] Becerra, F. (2016). *Who Took Away My Comparable? Considerations for an Analysis of Transfer Pricing Comparability in Latin America*. CIAT.
[63] Ibid.
[64] A study conducted by the European Commission found a positive correlation between the GDP growth and the profitability of the routine services. Specifically, the statistics shows that for every additional percentage point in the GDP growth, there is an increase of 0.24 points of the median profitability. See more in: European Commission (2009). *BM contribution to illustrate available generic evidence relating to intra group services profit margins.* EU Joint Transfer Pricing Forum.

the full volatility of the economy[65], in other words, that in general the performance generally has a linear average behaviour. However, this is seen cumulatively and in Peru, as in most countries, the results are evaluated on an annual basis.

Again, under the ALP this behaviour could be justified as it is understandable and predictable that the same performance will be achieved by companies that are in comparable circumstances and conditions. Another solution is to consider a wider interquartile range or, under certain conditions, allow justifications in case of not fulfilling the mandatory mark-up.

These two points regarding the mark-up show that a possible solution could be to maintain the ALP as a fundamental basis to evaluate LVAS transactions. Likewise, if an interquartile range or margin is established, this should be broader in order to consider possible fluctuations in the economy or adjustments that should be made to the set of comparables for risks not considered. In this line, the UN's approach about the safe harbour can be found, in which it does not establish any defined range or mark-up, but requires a fixed profit margin accepted by both countries[66]. With these recommendations the countries have the freedom to set the mark-up according to every specific situation.

4.4. Double taxation and the need of DTCs

One of the main criticisms of the simplified approach is that if it is not implemented multilaterally, it can cause double taxation. This happens especially in those cases when a country considers a service to be low value-adding and the other state classifies differently the same service depending on its national legislation, or when both countries apply different market valued margins based on their respective legislation[67].

As an example of this situation, within the five countries considered to be top in the provision of services through shared service centres[68], only India and Poland follow a model similar to the one proposed by the OECD. Furthermore, Spain and China have been considered in the table since Peru has a significant number of operations with these countries, however, both do not have exactly the simplified approach on LVAS.

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[65] European Commission. (2009). *BM Contribution to Illustrate Available Generic Evidence Relating to Intra Group Services Profit Margins.* EU Joint Transfer Pricing Forum.

[66] UN. (2017). *Practical Manual on Transfer Pricing for Developing Countries.* Department of Economic & Social Affairs, United Nations.

[67] Lang, M.; Cottani, G.; Petruzzi, R.; and Storck, A. (2000). *Fundamentals of transfer pricing: A practical guide.* Section 2.3.2. Wolters Klumer.

[68] A ranking of the top countries that host Shared Services Centres are shown in Deloitte. (2019). *Global Shared Services Survey Report, 11th Biennial Edition.* Deloitte Development LLC. & Statista. (2019). *Where Are the Top Locations You Would consider for A New SSC Location or Relocation?* Statista. Retrieved from: https://www.statista.com/statistics/788303/shared-services-centers-top-locations/

Table 7: Simplified approach on LVAS in top Shared Services Centres Countries

Simplified approach in top Shared Services Centres countries		
Country	**OECD Model**	**Comments**
United States	No	Alternative Service Cost Method allows "low margin covered services" and "specified covered services" to be charged with zero margin[69]
India	Yes	Mark-up up to 5% for reception of LVAS is allowed for transactions up to INR 10MM[70]
Poland	Yes	Mark-up not higher than 5% (reception of services) and not lower than 5% (provision of services)[71]
Costa Rica	No	It has not implemented any recommendation of Action 10[72]
Mexico	No	Mexico is elaborating a draft regulation about the LVAS[73]
Spain	No	EU Joint Transfer Pricing Forum on LVAS and TPG may be used as source of interpretation[74]
China	No	Six tests have to be used to determine the ALP nature of services: "Benefits Tests", "Necessity Test", "Duplication Test", "Value Creation Test", "Remuneration Test" and "Authenticity Test"[75]

Source: Footnotes. Own elaboration.

As it is known in case of double taxation in transactions between enterprises located in different countries, DTCs can be applied. In this specific situation, Article 9 of the DTC Models of both the OECD and the UN related to Associated Enterprises can be taken as a reference.

In general terms, both models indicate that if the commercial or financial conditions agreed by associated companies differ from what would have been agreed between independent companies, the profits must be attributed in such a way that market conditions are met. Likewise, if adjustments are applied, the other provisions of the Model will be taken into account and the competent authorities may consult each other[76].

[69] Lang, M.; Cottani, G.; Petruzzi, R.; and Storck, A. (2000). *Fundamentals of transfer pricing: A practical guide.* Section 2.3.2. Wolters Klumer.
[70] Ministry of Finance of India. (2017). *Notification No. 46/2017.*
[71] CMS. (2019). *CMS Expert Guide to International Transfer Pricing Documentation, Poland*. CMS. Retrieved from https://cms.law/en/int/expert-guides/cms-expert-guide-to-international-transfer-pricing-documentation/poland
[72] CIAT. (2019). *Transfer Pricing in Latin America and Caribbean.* CIAT.
[73] Ibid.
[74] OECD. (2017). *Spain: Transfer Pricing Country Profile*. OECD
[75] OECD. (2018). *China: Transfer Pricing Country Profile*. OECD
[76] OECD. (2017). *Articles of the Model Convention with Respect to Taxes on Income and on Capital*. OECD Publishing & UN. (2017). *United Nations Model Double Taxation Convention between Developed and Developing Countries*. Department of Economic & Social Affairs, United Nations.

As we can see the two models embody the ALP, the difference is that the UN model includes a third paragraph that limits the application of the provisions in the event of fraud, gross negligence or wilful default[77].

It is here where a problem could arise for Peru. As previously mentioned, to date Peru has only signed eight DTCs, of which five follow the UN model; and three, the OECD Model.

Table 8: Article 9 of Peru DTCs

Article 9: Associated enterprises		
Country	**OECD**	**UN**
South Korea		X
Chile		X
Canada		X*
Brazil	X**	
Mexico		X
Switzerland	X	
Portugal		X
Andean Community***	X	

Source: Peruvian DTCs. Own elaboration.

*Based on domestic law, includes a time limit for any modification or adjustment on income.

**Not includes the paragraph about the corresponding adjustment.

***In this DTC the topic of associated enterprises is in article 7.

In view of this, there might be cases in which a national company provides services to a related party that is located in a state in which the safe harbour has not been implemented and with which Peru has not signed a DTC. This situation could generate double taxation if the economic evaluation of the LVAS provided by the Peruvian company is governed by current legislation and if the other state has a different approach for the evaluation of those services.

This situation is likely to happen if we take into account that the majority of multinational groups with parent companies in Peru mainly have commercial operations in the region[78] and, as previously mentioned in Latam, only Peru and Argentina have implemented the simplified approach on LVAS[79].

Additionally, if a national company provides this type of services to another company located in a country which it has a DTC with Peru, but this country has not implemented the simplified approach, the result will be that the intercompany price will have to be determined according to the ALP, as stipulated in article 9 of the DTC models.

If we see the global trend and Peru's goal of being part of the OECD, it can be inferred that in the

[77] Ibid.

[78] Diario El Comercio. (2016). *Empresas peruanas que se atrevieron a ir al exterior.* Retrieved from: https://elcomercio.pe/economia/negocios/empresas-peruanas-atrevieron-exterior-349577-noticia/.

[79] According to the Inter-American Centre of Tax Administration (CIAT), until June 2019, only Argentina, Chile and Peru have implemented rules related to LVAS. However, Chile informed the OECD that the simplified approach will be governed by article 41E of its national legislation. In addition, Mexico is elaborating a draft regulation about the LVAS. See more in CIAT. (2019). *Transfer Pricing in Latin America and Caribbean.* CIAT.

coming years, a great number of DTCs signed by the South American country will be expected. Moreover, these DTCs will follow either the model of the OECD or the UN, i.e. the ALP will continue to prevail in double taxation disputes between transactions carried out by related companies.

Furthermore, based on the Vienna Convention on the Law of Treaties and on the decisions of the national Tax Court, international agreements, such as DTCs, should prevail over domestic legislation, such as the implemented safe harbour[80].

In the same line, we can find in article 32-A section C of the Peruvian Income Tax Law that if a transfer pricing adjustment is made in accordance with the provisions of a DTC signed by Peru, "the related party domiciled in Peru may submit a corrective statement reflecting the corresponding adjustment, even when such adjustment determines a lower tax in the country"[81]. Namely, under this section, the validity of Article 9 of the DTCs with respect to the ALP and its corresponding adjustments is rectified.

That said, a possible solution to avoid double taxation due to the lack of multilateral adoption of the simplified approach is firstly to continue the trend of signing more DTCs and in second place to allow the prices of LVAS to be set according to the ALP. Another complementary advantage derived from the increase of DTCs is the stable climate for investors that is created since they have more certainty about double taxation and the procedures to be follow in case of any dispute or controversy. However, it is important to note that the decision to extend the number of DTCs in the South American country must not only depend on the application of the ALP, but that the country achieves a right allocation of taxing power, taking into account that it is considered "the source country "and that the OECD Model primarily benefits residence countries.

4.5. Complexity of the simplified approach: documentary burden and tax audits

As the safe approach in Peru is redacted, taxpayers do not enjoy the advantages that this scheme should provide. The first point is that companies are still obliged to support the choice of the mark-up through a benchmarking study[82]. This can be read in the section of the documentation required for intercompany services (including low value-adding) detailed in the Regulation of the Income Tax Law, article 118-A, section d. In other words, if a company selects 2% within the range determined between 0% and 5%, it must justify why this percentage was chosen. Following the transfer pricing rules, it is understood that the justification of this margin would have to be through a benchmarking study.

In the same way, within the same article, the presentation of documentation that supports the Benefits Test is required, despite the fact that the OECD recommends that the tax administration should

[80] Delgado Ratto, C. (2012). Peru. In M. Lang, P. Pistone, J. Schuch, & C. Staringer (Eds.), *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties.* Cambridge Tax Law Series.
[81] Peruvian National Law, Income Tax Law, Article 32A, section C.
[82] Espinal, S., Ludeña, P., Quiroga, C. & Salvador, C. (2018). *El Test de Beneficio en los Servicios Intragrupo y su Aplicabilidad en la normativa peruana del Impuesto a la Renta.* Esan Graduate School of Business.

refrain from reviewing the benefit test if it complies with the documentation and the indicated conditions[83]. However, the Regulation indicates that the compliance with the Benefits Test must be supported in addition to the documentation required in the simplified approach. By not following the OECD recommendations, the Peruvian regulations generate a double documentary burden on the taxpayer. Although the burden of proof remains in the tax authority[84], this situation creates an inefficiency that has a greater impact on this type of services that in principle do not have high profitability for the company.

Related to the absence of certainty in this approach, most of the critics highlight the contradiction between rules in the legislation: "a rule of deductibility in an article of valorisation in transfer pricing matters" [85]. For instance, in the Article 37 of the Income Tax Law it is stated the principle of causality, meaning that only when there is a relation between the costs or expenses and the generation of income, a deduction should be granted. Moreover, in the Article 44 there is an exhaustive list of expenses that are not considered deductible for a company.

However, as it has been mentioned before, the rules of intercompany services mention explicitly the non-deduction of expenses in case the mark-up exceeds the limit imposed or the benefits test is not fulfilled. These rules related to LVAS are in Article 32-A and do not make reference to the Article 37. An example could be when a company receives a LVAS that is used to create wealth, but the mark-up exceeds the mandatory threshold.

This plight raises doubts and creates uncertainty to the taxpayer, that if in case of a tax audit, SUNAT will only consider Articles 37 and 44 to evaluate the deduction of an expense or if it will consider also Article 32-A[86]. As the rules are new in the national legislation there are is no case law to consider the positon of the Tax Court in these cases.

[83] Aragon, A. & Hinostroza, V. (2019). *La Distorsión del Test de Beneficio en Materia de Precios de Transferencia*. Universidad de Lima.
[84] Guerrero, S. (2019). *¿Es La Norma De Servicios Intragrupo Un Adecuado Mecanismo De Control De La Deducibilidad De Los Costos Y Gastos?* Universidad de Lima.
[85] Aragon, A. & Hinostroza, V. (2019). *La Distorsión del Test de Beneficio en Materia de Precios de Transferencia*. Universidad de Lima.
[86] Guerrero, S. (2019). *¿Es La Norma De Servicios Intragrupo Un Adecuado Mecanismo De Control De La Deducibilidad De Los Costos Y Gastos?* Universidad de Lima.

5. Recommendations

Peru's objective to be part of the OECD has led it to progressively implement the different OECD recommendations given in the BEPS Plan, the analysis of this thesis is focused on the simplified approach on LVAS. From the development of this thesis, it has been shown that the model has not been adopted in the Peruvian legislation according to the guidelines of the OECD.

As mentioned before, multilateral implementation is important, as this could generate discordance and possible double taxation. In this sense, throughout the region the simplified approach has been implemented only by two countries and out of the top service provider countries only two have a model similar to the OECD. Therefore, the haste in implementing this scheme is questionable, since it would cause uncertainty in international operations. This haste may have led to an inaccurate adaptation in national legislation, which has been seen in the previous sections.

An important remark here is that the bedrock recommended by the OECD is to comply with the actions of the Inclusive Framework, within which Action 10 is not included. After there is an improvement in the tax framework, such as a larger number of signed DTCs, a multilateral implementation of the safe harbour and a solid basis of the Inclusive Framework, the LVAS approach would have a greater benefit for SUNAT and taxpayers and also would spawn an international framework that facilitates the implementation of other Actions.

Since neither the time nor the national context are adequate for the implementation of the simplified approach, an option to consider would be to suspend its application to first create an adequate tax framework that allows the correct implementation and meet the objectives, as well as avoiding possible double taxation problems.

However, in addition to the changes in the tax framework, it is necessary that the conditions of the safe harbour should be modified since, as they are implemented now, they do not generate a benefit for neither the taxpayers nor the tax administration. As implemented now, this scheme is strongly focused on the supporting documentation as a tool to address the problem of deduction of expenses and the differences compared to the OECD Model are causing burden and uncertainty to the taxpayers.

The first and most important point is that the simplified approach should be optional for taxpayers. This can be accomplished by strictly following the guidelines given by the OECD. The optional approach gives the taxpayers the freedom to decide how to analyse this type of transaction, for example if they have an internal comparable or can demonstrate through another methodology that their profitability does not necessarily have to be between 0% and 5%. The approach as it is developed now forces taxpayers to establish a margin between the indicated interquartile range, however, this may not reflect the economic reality of the transaction nor the value that the service adds, taking into account different aspects derived from a functional analysis.

The second recommendation is related to the margin. As detailed in Section 4, the 5% suggested by the OECD does not necessarily reflect the reality of Latam, i.e. it would not be in line with the risks

or circumstances involved in establishing a business in the region. For this, the first suggestion is that it seeks to establish a sample of comparables with countries in the region, which would show a result closer to reality[87]. Another option is not to establish a fixed margin but that the simplified approach is guided by the ALP, in such a way that the profitability has a support that can reflect the reality of the transaction; moreover, when governed by the ALP it should have more chances to be accepted by the tax administration of the counterparty, even if the other state has not implemented the simplified approach. This idea is found in the UN model, when the mark-up is not set but depends on the agreement of the two countries involved. However, an important difference between the two options is that the second one would imply the elaboration of a benchmarking study, which would go against one of the advantages of the simplified approach, which is saving costs and time through the exemption of benchmarking.

The current Peruvian model requires that the chosen margin between 0% and 5% must be supported with a benchmarking study. As mentioned above, the OECD model does not require benchmarking if the fixed margin is chosen. If Peru continues to choose a model with a defined range, it is necessary that the elaboration of a set of comparables is not mandatory, since the suggested range would have an economic support behind it. In this way, the taxpayer would save the related costs and SUNAT would be sure that the profitability reflects the economic reality of the transaction while not investing resources on reviewing it.

The last point is related to the documentation required in the simplified approach. The first aspect is that even in the OECD model the required documents are similar to those requested in a tax audit (supporting the existence of the service, the chosen allocation key, the costs and expenses base, amongst others); so there is no comparative advantage. However, the benefit would be that if the taxpayer complies with the supporting documentation, the tax administration will not challenge the validity of the Benefits Test. This implies that the taxpayer has to prepare this initial documentation anyway. Nonetheless, the South American country does not include this advantage in its model, because the Benefits Test is still required and can be challenged, even if the taxpayer has the detailed documentation. Therefore, in order to circumvent a greater documentary burden, the Peruvian model should follow the OECD guidelines in this matter and, if the requirements are met, SUNAT should refrain from challenging the Benefits Test of the taxpayer.

To sum up, the analysis of this thesis allows to see certain shortcomings in the implementation of the simplified approach on LVAS, as a consequence the recommendations are related to the temporary suspension of this scheme while Peru should improve its national and international tax framework and correct the characteristics described of the model. This would prevent further uncertainty and increased burden for both taxpayers and the tax administration.

[87] Becerra, F. (2016). *Who Took Away My Comparable? Considerations for an Analysis of Transfer Pricing Comparability in Latin America*. CIAT.

6. Conclusions

From the analysis developed in the following study it is possible to draw the following conclusions regarding the implementation of the safe approach on LVAS in Peru:

- Peru has been implementing a series of measures recommended by the OECD as part of its objective to become a member of this organization in 2021. By being part of the OECD, Peru would extend its participation in international policy discussions, in addition to benefiting from the guarantee that this organization gives to potential investors.
- One of the measures implemented is the simplified approach on LVAS related to the OECD model. However, this thesis has shown that there are certain differences in the implementation, which results that the objectives of this structure are not fully achieved: certainty and cost reduction. This ends up causing that its implementation is not totally adequate for the South American country.
- A first different aspect is that the safe harbour is not optional for taxpayers, meaning that although they have an economic support to demonstrate that their profitability is outside the range between 0% and 5%, it will not be accepted as valid and they are compelled to meet that range. Therefore, the taxpayer will have uncertainty at the time of carrying out their commercial operations and establishing the profit margins since these could be not accepted by the tax administration even though they might comply with the ALP.
- Another point related to the suggested range is that this does not necessarily reflect the inherent risks of the country that are assumed by the company at the time of doing business. It should be noted that the fixed mark-up given by the OECD does not segment by world regions and a standard percentage is used without considering other variables that could affect the profitability of the business. The obligation of a company to meet the mandatory margin implies that there can be no external events that deviate its profitability, when in the economic reality there are several factors that cannot be controlled by the company and that affect profitability positively or negatively.
- An additional difference between the OECD model and the Peruvian legislation is that the second one does not exempt from the elaboration of a benchmarking study to support the chosen mark-up. This goes against the cost reduction that the simplified approach seeks, on the contrary, it causes the taxpayer to assume this cost and the tax administration has to invest time and resources to evaluate the benchmarking.
- Likewise, the Peruvian tax administration does not refrain from challenging the Benefits Test, even if the taxpayer complies with the documentation required by the legislation. This spawns a documentary burden to be presented by the taxpayer and reviewed by the tax administration.
- The tax framework that Peru currently has is not fully adequate for the implementation of the simplified approach on LVAS. The low number of DTCs signed with other countries as well as the lack of multilateral implementation of this scheme could generate potential double taxation problems. Namely, the taxpayers do not have the certainty of which legal

source will prevail in case of discordance.

- Another problem that has been noted by various authors is that there is no clarity about which articles of the Income Tax Law a taxpayer should use as a reference source at the time of a tax audit. This is because the nature of the simplified approach in Peruvian legislation encompasses deductibility aspects with respect to intercompany services, however, there are other articles in the Income Tax Law that refer to the deductibility of expenses in general for a company. Therefore, for the taxpayer there is uncertainty about which source of interpretation should prevail.
- As seen to make this model suitable for Peru, it is necessary to make some modifications that are in accordance to a certain extent with the economic reality and the OECD guidelines. In a similar way, it is necessary to have a clearer tax framework for taxpayers, also considering the increase of DTCs signed at the extent that Peru is not worse off regarding its taxing rights as a source country. By complying with these, the objectives of the simplified approach will be more feasible for the benefit of both the taxpayer and the tax administration.

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