Bloomberg BNA

Tax Management
Transfer Pricing Report™

Safe at Last? Transfer Pricing Safe Harbors on the Horizon

The author builds on a 2011 article advocating wider use of safe harbors, exploring past resistance to those mechanisms and analyzing the Organization for Economic Cooperation and Development's June 6 draft, which not only endorses the simplification measures but sets forth three sample memoranda that countries may use to negotiate bilateral safe harbors for specific services.

BY PATRICIA GIMBEL LEWIS, CAPLIN & DRYSDALE

With the release last month of a discussion draft on proposed revisions to Chapter IV of its transfer pricing guidelines,[1] the OECD is poised to reverse course and endorse the use of transfer pricing safe harbors in appropriate situations. Comments from top officials indicate that the Internal Revenue Service is moving in the same direction. It is time.

''Safe harbors'' refer to a variety of possible legislative or regulatory approaches for simplifying taxpayer compliance with and tax authority administration of transfer pricing tax rules. Based on the ''arm's length'' mantra—requiring cross-border, related-party transactions to be priced as if the parties were unrelated—transfer pricing rules embody more principle than precision and inherently depend on complex and individualized facts.

The wide range of possible results is a breeding ground for disagreement among taxpayers and tax authorities, leading to potential double taxation. Tax authorities around the world devote extensive rulemaking and enforcement resources to the task, and the competent authorities of countries in the global income tax treaty network are largely devoted to attempting to resolve the resulting double taxation cases.

The burden on taxpayers to comply with the varying transfer pricing rules of the many jurisdictions in which they operate is immense, ranging from documentation required as part of tax returns or for minimizing tax penalty exposure to cooperation with lengthy and deep tax examinations. The accounting firms who evaluate corporations' tax provisions and courts that operate as the last resort in contested cases are kept busy as well.

As transfer pricing enforcement and documentation requirements have metastasized with the globalization of commerce in recent decades, the need to rationalize transfer pricing rules to manageable proportions has become acute. This is not to say transfer pricing rules are not needed—they are, to ensure an appropriate fiscal balance among nations and fair treatment among taxpayers—but rather that simplification is imperative. Given that the arm's-length principle, rather than a formulary approach, remains at the heart of most transfer pricing regimes today,[2] simplification rests on the development of safe harbor approaches that emulate arm's-length results.[3] This obviously will work most readily for relatively routine or low-risk situations, allowing tax authorities to focus their resources on more complex and potentially abusive situations. Tax authorities' vastly expanded experience with transfer pricing rules and comparables definitely has increased the comfort level in designing safe harbors.

The concept of transfer pricing safe harbors is not entirely new. The U.S. transfer pricing rules under Internal Revenue Code Section 482 have long included safe harbor interest rates for intercompany loans[4] and a ''cost only'' safe harbor permitting routine intercom-

[1] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Organization for Economic Cooperation and Development, July 2010. The discussion draft was issued June 6, 2012, by Working Party No. 6 of the Committee on Fiscal Affairs within the OECD Center for Tax Policy and Administration. See 21 *Transfer Pricing Report* 371, 8/9/12. Paragraph references hereinafter are to this draft unless otherwise indicated.

[2] Continued strong support for the arm's-length principle was evinced in the 2010 guidelines. See para. 15 of the preface, as well as Chapter 1 of the guidelines, especially paras. 1.14 and 1.15.

[3] Documentation simplification is another key element, addressed to date largely by exemption approaches for small taxpayers, but also increasingly under review and part of the current OECD simplification initiative, discussed below.

[4] Regs. § 1.482-2(a)(2)(iii).

 ISSN 1063-2069

pany services to be performed without a profit markup.[5] The OECD conducted a survey last year and found similar safe harbors in 10 countries, along with a few transfer pricing exemptions for small taxpayers.[6] But while the impetus for safe harbors has grown, implementation has been slow. Until recently, both the OECD and the IRS expressed serious reservations about safe harbors and, from a broad perspective, rejected them. As the following excerpts from the carefully worded draft guidelines revision demonstrate, the OECD has now reset the table:

> When these Guidelines were adopted in 1995, the view expressed regarding safe harbour rules was generally negative. It was suggested that while safe harbours could simplify transfer pricing compliance and administration, safe harbour rules may raise fundamental problems that could potentially have perverse effects on the pricing decisions of enterprises engaged in controlled transactions. It was suggested that unilateral safe harbours may have a negative impact . . . [and] that safe harbours may not be compatible with the arm's length principle. Therefore, it was concluded that transfer pricing safe harbours are generally not advisable, and consequently the use of safe harbours was not recommended.
>
> Despite these generally negative conclusions, a number of countries have adopted safe harbor rules . . . They are generally evaluated favourably by both tax administrations and taxpayers, who indicate that the benefits of safe harbours outweigh the related concerns when such rules are carefully targeted and prescribed and when efforts are made to avoid the problems that could arise from poorly considered safe harbour regimes.
>
> . . .
>
> *Recommendations on use of safe harbours*
>
> Transfer pricing compliance and administration is often complex, time consuming and costly. *Properly designed safe harbour provisions, applied in appropriate circumstances, can help to relieve some of these burdens and provide taxpayers with greater certainty*.[7]

Moreover, the proposed OECD revisions go one critically important step further, and provide sample memoranda of understanding that treaty partners can use to actually implement specific *bilateral* safe harbors. By thus confronting head-on the major stumbling block to truly effective safe harbors—the need for the countries on both sides of the transaction to agree on the same result and thus automatically avoid double taxation—the OECD has dramatically advanced the cause and jump-started the proliferation of simplifying safe harbors.

This article walks through the analysis in the draft guideline revisions after first silhouetting the earlier positions of the IRS and OECD for contrast. The last section provides observations on the draft's features and approach, responding to the OECD's public request for comments.[8]

All told, the OECD, with the IRS at its side, has taken a vital step toward the desperately needed simplification of global transfer pricing rules.

Famous Last Words

The U.S. Treasury Department and the IRS took a broad look at safe harbors in the 1988 Section 482 white paper.[9] Chapter 9 of the paper—''The Need for Certainty: Are Safe Harbors the Solution?''—was answered ''no.'' The white paper's conclusion embodied the impression that safe harbors tend to be non-arm's-length and thus subject to adverse selection. It stated that safe harbors ''all have one common element that makes them both attractive to the taxpayer and potentially troublesome to the government: they generally would serve only to reduce tax liability.'' It found that no single safe harbor or combination of safe harbors had yet been proposed that would be useful but not potentially abusive. And, although the possibility that useful safe harbors could be developed was not categorically rejected, additional safe harbors (beyond the existing ones for interest and non-integral services) were not recommended.

The IRS nevertheless floated a small-taxpayer safe harbor in the 1993 temporary section 482 regulations,[10] but dropped it in the 1994 final regulations. The 1993 provision contemplated IRS issuance of appropriate profit-level indicators through revenue procedures, and would have applied, upon taxpayer election, to any related-party transactions if either party had less than $10 million of gross receipts. The IRS' ultimate concerns, as explained in the preamble to the final regulations, were as follows:

> First, treaty partners had expressed concern that the safe harbor might cause taxpayers to overreport their U.S. taxable income and underreport their foreign taxable income . . . Second, it would have been necessary to add a number of anti-abuse provisions

---

[5] The 1968 regulations under section 482 permitted cost-only pricing of services that were not an ''integral part'' of a controlled entity's business activity, measured under various tests (Regs. §1.482-2(b)(3) (1968)); this approach was replaced by a similar, albeit more detailed, regime, referred to as the ''services cost method,'' when the intercompany services regulations were revised in 2009 (Regs. §1.482-9(b)).

[6] The initial survey results were released in June 2011. See 20 *Transfer Pricing Report* 159, 6/16/11. An updated version reflecting responses from eight additional countries, for a total of 41 OECD and non-OECD countries, was released on June 6, 2012. See 21 *Transfer Pricing Report* 148, 6/14/12. Over half of the countries responding to the survey also had simplified documentation rules, primarily for small taxpayers or small transactions.

[7] Paras. 2, 3, and 33 [emphasis supplied].

[8] More background and the author's earlier entreaties on this topic are set forth in ''Short Cuts for Small Fry: Why the IRS Should Consider Transfer Pricing Safe Harbors for Small and Mid-Sized Taxpayers,'' 19 *Transfer Pricing Report* S-3, 4/21/11.

[9] Treasury, IRS, ''A Study of Intercompany Pricing,'' Notice 88-123, 1988-2 C.B. 458 (10/18/88). Two decades earlier, Stanley S. Surrey, Assistant Secretary of the Treasury for Tax Policy, commenting on the soon-to-be-finalized (1968) proposed transfer pricing regulations, had explained: ''A typical suggestion is that the Regulations should supply a 'mechanical safe haven' . . . Much as this solution appeals as blissful to our tax administration as to the taxpayers who suggest it, we have not taken this route. The reason is that no satisfactory device has yet been suggested or worked out.'' ''Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of Section 482,'' 28 *Journal of Taxation* 75 (February 1968).

[10] Regs. §1.482-1T(f)(1) (1993).

   ISSN 1063-2069

in order to eliminate the possibility of inappropriate use of the provision by large taxpayers . . . The final concern was that both taxpayers and the IRS might give undue weight to the published measures of profitability in cases not governed by the safe harbor.

The OECD was considering safe harbors around the same time, in developing the 1995 version of the guidelines. After examining the pros and cons, the guidelines concluded in section IV, paras. 4.120-4.122:

> ''The foregoing analysis suggests that while safe harbours could accomplish a number of objectives relating to the compliance with and administration of transfer pricing provisions, they raise fundamental problems.
>
> . . . In view of the above considerations, special statutory derogations for categories of taxpayers in the determination of transfer pricing are not generally considered advisable, and consequently the use of safe harbours is not recommended.

But Now We Say . . .

In March 2011, the OECD's Committee on Fiscal Affairs, reacting to proliferating transfer pricing burdens, announced a broad project on the administrative aspects of transfer pricing, with a view ''to strike a balance between the development of sophisticated guidance for complex transactions and the cost-effective use of taxpayers' and tax administrations' resources for improved compliance and enforcement processes.'' Part of the project was a review of the 1995 guidance on safe harbors. Initial steps were to survey existing safe harbor and other simplification measures in both OECD and non-OECD countries[11] and to invite comments from interested parties.

The next step—the subject of this article—was the release, in remarkably short order, of the June 6, 2012, draft, proposing revisions to the safe harbor section in Chapter IV of the guidelines. OECD Working Party No. 6 has emphasized that this is an interim draft and ''not necessarily a consensus document.'' The draft, it said, ''does not necessarily reflect the final view of the OECD and its member countries'' and has not yet been considered by the CFA itself. Comments on the draft have been requested by September 14, 2012, and a public consultation likely will take place in November 2012.

The key aspects of the draft are as follows:

1. Increasing recognition of the need for safe harbors.

Recognizing that applying the arm's-length principle can be a resource-intensive process, the drafters acknowledge that despite the reservations in the 1995 guidelines, a number of countries have adopted safe harbor rules that have been favorably evaluated. Focusing on smaller taxpayers and less complex transactions, the benefits have been found to outweigh concerns if the provisions are ''carefully targeted and prescribed.''[12]

Although traces of the earlier trepidation can be found in the statement that safe harbors ''primarily benefit taxpayers,'' the draft acknowledges that safe harbors can benefit tax administrations ''by providing for a more optimal use of resources.''[13]The basic trade-off is expressed as between certainty and administrative simplicity for all on the one hand versus the possibility of tax revenue erosion on the other.[14]

2. Safe harbor concept.

At the core of the draft's definitional section[15] is the concept that a safe harbor should be *elective*. Structurally, the draft explains, a safe harbor can substitute simpler rules than those more generally applicable, or can exempt a category of taxpayers or transactions from otherwise applicable rules. Another formulation could involve a rebuttable presumption, whereby a taxpayer would have the right to demonstrate that a designated pricing target is not arm's-length in its particular situation. However, the draft adds that any such rebuttable presumption approaches must be combined with a treaty-based mutual agreement resolution process, signaling the importance of an external arm's-length judgment.

Although the draft notes that safe harbors often are accompanied by relief from or simplification of documentation requirements, it does not include stand-alone provisions of that sort (that is, provisions that do not directly involve pricing determinations) within its scope. Nor are advance pricing agreements or thin capitalization rules covered.

3. Benefits.

Taxpayer benefits in the form of simplified compliance, reduced compliance costs, and tax certainty are stressed. Compliance relief is considered particularly appropriate where the administrative complexity of compliance is disproportionate to the transfer pricing exposure.

Resource rationalization is the only type of benefit noted for tax administrations. The potential for a net increase in revenue is quite muted and indirect, at best: ''A safe harbor may also increase the level of compliance among small taxpayers that may otherwise believe their transfer pricing practices will escape scrutiny.''[16]

4. Concerns.

The draft lists four concerns:[17]

- *Non-arm's length results*. An example given is application of a profit-based method when an available comparable uncontrolled price (CUP) would be preferable under the best method approach of an arm's-length system. This concern arises from the inherent trade-off between administrability and precision. The draft notes that *taxpayers* can avoid income in excess of arm's-length amounts through the electivity feature—but that the tax administration may get the short end of the fiscal stick, in the other direction, with taxpayers choosing the safe harbor when it is less than arm's-length. One design feature noted that can moderate this effect is to impose conditions on using the safe

[11] See note 6 above.
[12] Para. 3.

[13] Para. 5.
[14] Para. 31.
[15] Paras. 7-10.
[16] Para. 15.
[17] Notably, ''problems,'' per the 1995 guidelines, have been downgraded to ''concerns.''

harbor, such as advance notice of election or a commitment to use the safe harbor for a certain number of years.

■ *Increased risk of double taxation or double non-taxation*, absent a bilateral or multilateral approach. If the safe harbor results in above-arm's-length pricing, the safe harbor country will be benefited at the expense of the counterpart country, which may challenge the result, increasing its own administrative burden. (Although not mentioned, it can be observed that the use of ranges, rather than points, both in designing safe harbors and in the typical counterparty transfer pricing regime, should mitigate this concern.) However, felicitously reversing the 1995 guidelines' stance that access to competent authority relief should be prohibited for elective safe harbors, the draft now urges the offering country to make mutual agreement procedures available to mitigate the risk of double taxation—or, at a minimum, to clearly state its double taxation posture in advance so taxpayers can make informed decisions about whether to elect the safe harbor. In the opposite case, where a safe harbor results in income below arm's-length levels, the concern is that the taxpayer may not report income that is correspondingly above arm's-length levels in the partner jurisdiction, and that such jurisdiction is unlikely to be able to require it, leading to double non-taxation—a taxpayer windfall. That situation, says the draft, could result in distortions of investment and trade.

■ *Opening avenues for inappropriate tax planning*, as taxpayers attempt to take advantage of desirable safe harbors. Examples cited include breaking transactions apart to qualify for small or simple standards of a safe harbor, shifting excess income to lower-tax jurisdictions, or routing transactions through countries with favorable provisions via ''safe harbor shopping.''

■ *Issues of equity and uniformity*, as between those eligible for the safe harbor and those who are not. The draft cites the potential for ''discrimination and competitive distortions,'' but without examples.[18]

5. Bilateral and Multilateral Approaches to the Rescue.

The draft sees the solution to the first two concerns above as the adoption of safe harbors on a bilateral or multilateral basis between countries. The draft proposes sample MOUs for this purpose. The beauty of this approach is that there is, in effect, arm's-length bargaining—between the tax authorities—to design a fair and balanced safe harbor. The draft notes that ''the rigor of having two or more countries with potentially divergent interests agree . . . should serve to limit some of the arbitrariness that otherwise might characterize a unilateral safe harbor.''[19] Bilateral safe harbors also could mitigate the concerns in the third point above by limiting safe harbors to transactions involving countries with ''similar transfer pricing concerns'' and, preferably, similar tax rates, as well by requiring consistent reporting in both countries, though steps to avoid safe harbor shopping through such networks would need to be considered.[20] The only contrary note is that bilateral agreements might possibly exacerbate the equitable concern in the fourth point above by affording different treatment to similar transactions carried out by the same taxpayer with related parties in different jurisdictions.[21]

6. Recommendation.

At bottom, the draft acknowledges that properly designed safe harbors can lessen compliance and administrative burdens of transfer pricing rules, and provide greater certainty to taxpayers.[22] Bilateral or multilateral safe harbors are specifically encouraged because they avoid problems with double taxation or double non-taxation. Electivity is recommended to limit divergence from arm's-length pricing, and availability of the mutual agreement process to limit the risk of double taxation is considered advisable in all events.

The benefit versus concern scale is tipped in a favorable direction for small taxpayers or less complex transactions. The draft states that for more complex and higher-risk transfer pricing matters, ''it is unlikely that safe harbours will provide a workable alternative to a rigorous, case by case application of the arm's length principle.''

In several places, the draft stresses that unilateral or bilateral safe harbors are ''in no way binding on or precedential for countries which have not themselves adopted the safe harbour.'' This is, of course, correct, and its emphasis should help the drive toward consensus.

Framing the Solution—MOUs

The sample MOUs (explained in paras. 40-49 and set forth in several exhibits) are intended to provide a starting framework for tax authorities without being either mandatory or prescriptive. They deal with three kinds of transactions, described as ''important classes of transfer pricing cases that now take up a great deal of time and effort when processed on a case by case basis'':

- low-risk distribution functions;
- low-risk manufacturing functions; and
- low-risk research and development functions.

Reflecting that margins in these cases can sometimes be quite consistent across locations and industries, the draft observes that guidance on normal settlement ranges could substantially reduce various kinds of controversy if bilaterally agreed and published. The draft opines that double-tax and windfall concerns are likely to be pronounced if unilateral safe harbors are used in these common situations, whereas bilateral solutions present distinct advantages. In addition to ameliorating the concerns noted above, the draft importantly observes that bilateral safe harbors can be tailored to the economics of a particular market and circumstances compatibly with the arm's-length principle. They can be modified and updated from time to time to reflect pertinent developments. If desired, they could initially be

[18] Treaty nondiscrimination rules (for example, Article 24 of the 2006 U.S. Model Treaty) typically deal with discrimination between domestic and foreign persons, a different situation, so the noted concern seems more pragmatic than legal (aside from any constraints of local law).

[19] Para. 26.

[20] Para. 30. The draft does not suggest mechanisms to effect this, though it appears that some of the constraints in the sample MOUs are designed with this in mind.

[21] Para. 32.

[22] Paras. 33-39.

  TMTR ISSN 1063-2069

limited to small taxpayers and small transactions to limit exposures to tax revenues.

Of note in the current tax policy climate, the draft suggests that bilateral MOUs can provide a means for developing countries to protect the local tax base in common situations without an inordinate enforcement effort.

The draft finds authority for MOUs of this sort in treaty provisions based on Article 25(3) of the OECD Model Tax Convention, which, among other things, provides that the competent authorities ''shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.'' The 1999 mutual agreement between the United States and Mexico regarding safe harbor profit levels for maquiladora operations in Mexico,[23] is cited as a notable example of this type of provision.

Suggested elements to include in an MOU are:

- eligibility criteria, such as functions required or disallowed, risks to be assumed, permitted mix of assets, and description of excluded classes such as by size or industry (specifications of residence and locus of business operations also are included in the sample MOUs, as well as references to required intercompany contracts that specify the requisite risk assumption and compensation);
- qualifying transactions;
- determination of the arm's-length compensation range;
- reporting and monitoring procedures;
- documentation and information to be maintained;
- mechanism for resolving disputes;
- years to which the MOU applies; and
- a statement that the MOU is binding on the involved tax administrations.

The sample MOUs incorporate or have placeholders for all of these elements. In addition, they suggest fairly detailed criteria designed to limit eligibility to low-risk, limited-function, situations. For example, the contract manufacturing MOU limits annual research, development, and product engineering expense to a specified percentage of sales and provides that the enterprise must not engage in certain functions (for example, marketing, distribution, collection, or warranty administration, as well as managerial, legal, accounting, or personnel management functions not directly related to its manufacturing activities). It further precludes the bearing of transportation expense or risk of loss on finished products, and requires the enterprise's plant and equipment, raw material inventory, and work-in-process inventory to exceed a specified percentage of assets, while its finished product inventory must not exceed a specified percentage of sales.

Similarly, the low-risk distribution MOU limits marketing and advertising expense to a specified percentage of sales, and the R&D MOU requires all developed intangibles to belong to the related enterprise and precludes the R&D entity from using intangibles other than those made available by the related enterprise. Placeholders for additional possible exclusion criteria include specified industries, maximum annual sales or asset levels, maximum percentages of revenues from nonqualifying transactions, and recent transfer pricing audits resulting in adjustments exceeding a specified amount.

The sample MOUs go into some detail about how the elements of the applicable profit test are to be computed, specifying items such as which costs are to be included or excluded. The MOUs also describe the mechanics for electing the safe harbor, suggesting taxpayers be required to file a notice by the due date for the tax return for the subject year. The MOU specifies the information to be contained in the notice, such as a description of the subject transactions, audited financial statements and other information demonstrating qualification, and representations (for example, intent to be bound, consistent reporting in both jurisdictions, and prompt responses to resident country tax authority inquiries).

Two particularly important ancillary features of the sample MOUs are:

- agreement that the related party to the qualifying transaction is not deemed to have a permanent establishment in the country of the qualifying enterprise by virtue of the performance of the pertinent low risk activities on its behalf, and
- relief from the obligation to comply with otherwise applicable transfer pricing documentation requirements of *both* countries for the qualifying transactions.

Overall, the sample MOUs reflect comprehensive attempts at delineating clear safe harbors, in terms of both eligibility and effect.

Comments, Critiques

Overall, the draft demonstrates a willingness to tackle a difficult and controversial subject and does so in a measured but proactive way. Exposition of both challenges and opportunities by combining text and test drives should accelerate constructive discussion.

The author's specific comments are set forth below.

1. Sample MOUs turn principles into practicality.

The sample MOUs give real-time color to the concept of bilateral agreement. The bilateral approach, as set forth in the draft, ameliorates many of the concerns that have plagued the safe harbor concept in the past. By giving interested countries a detailed starting tool, the draft's approach seems likely to be quickly fruitful.

In effect, the MOUs serve much like ''class'' bilateral APAs, multiplying the impact of an agreement approach without the otherwise appurtenant negotiating and processing burdens.

The emphasis on bilateral MOUs facilitates the implementation of safe harbors by targeting situations where the trade-offs are relatively known and controllable—for example, as to trade balances, relative tax rates, and the scale and mix of transactions. The selected examples involve situations where comparables are reasonably well-developed and governments are experienced. Care must, however, be taken to properly develop low-risk ranges so that they do not unduly raise the bar for regular- or high-risk situations.

2. Types of MOUs.

The sample MOUs do not cover routine support services, which account for most existing safe harbors

[23] See 8 *Transfer Pricing Report* 626, 632, 11/10/99; 9 *Transfer Pricing Report* 276, 8/23/00

(other than loan interest)[25] and were the subject of a 2011 European Union Joint Transfer Pricing Forum report.[26] The MOUs are more ambitious: they add to the predictable limited-risk distributor and manufacturer the potentially more contentious contract research model. This reflects both a willingness to tackle harder issues and a recognition of common business arrangements. Presumably centralized support services are not far down the road; see point 11 below.

Initially, one would expect non-core activities to be most appealing to taxpayers and tax authorities alike, as such situations are more likely to present a high ratio of bothersome documentation to risk. However, to the extent an MOU deals with low-risk transactions, size limits (suggested in the MOUs) should be unnecessary, or at least generous. Indeed, it might be suggested that an MOU could include as a feature an exemption-type safe harbor for the smallest transactions of the type addressed in the safe harbor.

Hopefully the initial focus on low-risk transactions will not be permanent, if safe harbors start to prove their mettle. Higher-risk types of transactions—full-fledged distributors or manufacturers or even intangibles licenses—could be permitted, with exposure limited by constraints on the size of the taxpayer or transaction.[27]

3. Narrowness of MOUs.

The sample MOUs have many constraining features. Presumably this is in part to show that a safe harbor can be narrowly designed to avoid abuse or revenue loss, in part to acclimate the tax authorities to pertinent concepts, in part to minimize the risk of safe harbor shopping, and, at heart, to start the ball rolling. (It is telling, in this regard, that para. 47 notes that, if participating countries desire, bilateral safe harbors could *initially* be limited to small taxpayers and small transactions, suggesting that broader safe harbors could evolve as countries get more comfortable with them.) For these reasons, the overall approach to structuring the samples is creative and appropriate.

One must wonder, however, whether the package of suggested constraints is so narrow that few can qualify. For example, the samples require the *predominant business activity* of the qualifying enterprise to be the covered low-risk activity, and also require the enterprise to conduct business operations *exclusively* in the pertinent treaty country (a concept that may bear some explication). Other examples are precluding the contract research enterprise from using its own know-how or other intangibles, and limiting the contract distribution enterprise to selling products to customers in its home country (unless the ''predominant'' modifier applies here). Although these constraints are understandable, consultation with business may be needed to see if they are practical and feasible, and whether taxpayers are willing or able to reorganize their operations along such single-purpose lines. An alternative would be some kind of ring-fencing within enterprises. This might be practical in jurisdictions that have experience with pertinent allocation considerations.

4. MOU safe harbor method.

The sample MOUs suggest single-year operating margin or return on total cost tests. Although simple, this differs from the common multi-year average approach under the Section 482 regulations, which allows some variation for business cycles. Admittedly, multi-year approaches may be somewhat incompatible with single-year safe harbor elections, but might be viable if a safe harbor imposes a minimum temporal commitment. For now, a multi-year approach may be too ambitious, and it is not essential for early adopters.

5. Timing of safe harbor election under MOUs.

Although para. 19 of the draft suggests that potential for abuse of safe harbors could be reduced by requiring advance elections or a multiple-year commitment, this is not reflected in the sample MOUs. It might be preferable to tilt the default in that direction. Other conditions of this ilk could relate to multiple eligible transactions of the same taxpayer, or similar transactions by multiple related entities within the jurisdiction, though these types of conditions may not be immediately pertinent if safe harbor eligibility is as limited as in the sample MOUs.[28]

6. Compliance aspect of MOUs.

The sample MOUs do not directly address the distinction between book and tax accounting, but focus on reporting the appropriate amount of income on timely filed tax returns.[29] It would be desirable to explicitly acknowledge, assuming this to be the intent, that post-year-end adjustments can be made to bring the taxpayer within range, along the lines of self-initiated adjustments under Regs. §1.482-1(a)(3).

From a compliance perspective, the sample MOUs require the electing enterprise to provide pertinent information, on request, to the tax authority of its residence country. Presumably the intent is to pair this with a separate provision in the MOU providing that the competent authorities of the two countries ''may'' exchange information where necessary to carry out the agreement. To encourage governmental interest in MOUs, it may be appropriate to consider stronger provisions enabling the other country to obtain information it might need to verify eligibility for and compliance with the safe harbor.

7. Balancing detail versus simplicity with an anti-abuse rule.

The MOUs are quite detailed, and no doubt other features will be poised to creep in as sleeves are rolled up in actual design or negotiation. The challenge will be to winnow through the options so as to balance the desired simplicity with legitimate tax authority concerns.

---

[25] See para. 33 of the OECD survey report, note 6 above. The Section 482 services cost method described in note 5 above is a prime example.

[26] See 19 *Transfer Pricing Report* 964, 1/27/11. The report contains a detailed set of guidelines for taxpayers and tax administrations to evaluate such services and suggests that typically agreed markups on cost for such services fall within a range of 3 percent to 10 percent, often around 5 percent.

[27] See note 8 above.

[28] On the other hand, such rules might interfere with a group's clear global policy with respect to the other transactions. See note 8 above.

[29] See, for example, para. 60.

  TMTR ISSN 1063-2069

One possible antidote to excessive detail is to include an anti-abuse rule. While such a provision could be criticized as reinjecting some uncertainty, it would provide flexibility against end-runs by creative taxpayers. The small-taxpayer safe harbor briefly proposed in the 1993 temporary section 482 regulations, for example, provided that an ongoing election would be precluded if the IRS determined that the taxpayer had ''engaged in a pattern of transactions designed to abuse the provision.'' Some carefully considered examples in the text or accompanying explanation of an MOU could help mitigate taxpayer nervousness.

8. 'Mandatory' safe harbors.

The concept of a ''mandatory'' pricing target[30] incorporating a ''rebuttable'' presumption is troublesome, if not an effective oxymoron. Although theoretically equivalent to an elective safe harbor, the burden of proof (and administrative burden) on the taxpayer is likely to be heavy, and the practical result may resemble a formulary approach, imposing a minimum income requirement, that is inconsistent with the arm's-length standard. Accordingly, even though this type of approach would tip the scale more toward benefiting the tax administration, it would be preferable for the guidelines to incorporate a more cautious view.

9. Role of competent authority in unilateral safe harbors.

It remains to be seen how readily countries will be able to work out bilateral safe harbors. The draft's guidance for unilateral safe harbors should not be minimized by the focus on a bilateral solution.[31] In particular, retaining competent authority access with respect to safe harbors is essential, whether the safe harbor is elective or of the mandatory or rebuttable type. This may mean that only transactions with treaty partners should qualify. Moreover, the attractiveness and effectiveness of safe harbor provisions could be further enhanced by providing an expedited competent authority process. In any event, it is good to see the adverse attitude of the 1995 guidelines reversed; forcing double taxation risk as the ''price'' of using a safe harbor was simply wrong.

10. Role of the arm's-length standard.

The pros and cons of safe harbors reinforce the role of the arm's-length standard. The fairer the design of the safe harbor, the more the various concerns, including concerns with equity, will fade away. While the MOU concept rather automatically does this when bilateral agreements are feasible, the pressures also should be largely self-executing even in the unilateral context.

11. Safe harbors for headquarter or centralized services.

As noted by Joseph Andrus, head of the OECD's transfer pricing unit, in June, centralized services are another area ripe for safe harbors. The difficult issue here is addressing the determination of benefit to the payers, more so than the markup level itself. In addition, the multilateral nature of the centralization and related charges and allocations reduces the effectiveness of unilateral or bilateral safe harbors. From a taxpayer perspective, some kind of benefit assumption, even if subject to a formulaic cap, would be highly desirable. A global uniformity requirement could be an eligibility factor, to reassure dubious countries.

12. Applicability of safe harbor to ineligible or non-electing taxpayers

The draft appropriately emphasizes that safe harbor rates would not apply to ineligible or non-electing taxpayers; rather, such taxpayers would be subject to the regular arm's-length standard provisions. Countries should, nevertheless, be prepared for arguments by such taxpayers that what's good enough (and implicitly roughly arm's-length) for eligible taxpayers should be good enough for them. Tax authorities may want to issue guidance regarding factors that distinguish regular from safe harbor taxpayers, and the types of investigations or considerations they intend to apply to non-covered situations. This consideration (which is not unlike the situation where a taxpayer obtains one or more key-country ''leader'' APAs) underscores the need to be as arm's-length as possible in designing safe harbors.

13. Identification of enterprise.

It would be helpful to clarify the contours of the term ''enterprise'' in the safe harbor context, to minimize gaming or abuse. If the treaty definition of ''person'' (generally speaking, a legal entity) is intended to apply, this should be confirmed. The definition is pertinent in calculating limitations with respect to size or financial ratios as well as operational tests, in the sense of whether other business activities within the same legal entity or under common control need to be considered.

14. Updating MOUs or unilateral safe harbors.

The sample MOUs contain no provisions facilitating updating the target ranges or other features. Implicitly, this can be done only by formal modification of the MOU. One customization that countries may want to consider is embedding some adjustment provisions, specifying either an administrative procedure or some kind of dynamic external index or adjustment mechanism for this purpose. Updating of unilateral safe harbors would depend on the particular legal or administrative vehicle that established the safe harbor. It would be desirable for the guidelines to address the pros and cons of dynamic safe harbors—for example, in terms of certainty, administrative effort, and effect on elections.

15. Evaluation of safe harbors; potential revenue gains.

The draft should note the need to monitor the effectiveness of safe harbors and possibly suggest ways to do so. In addition to metrics relating to users, cost savings, and revenue effects, consideration should be given to before and after evaluations of competent authority case handling and results, as well as adjustment spreads and sustention rates for transfer pricing audits

[30] Para. 9.

[31] Unilateral safe harbors may make particular sense for transactions that affect many countries a little (such as headquarter allocations), or where cross-border transactions are small. However, one can readily imagine any unilateral safe harbor being limited to situations where the counterpart country has a similar tax rate.

and administrative appeals.[32] The author believes that concerns with adverse selection are overblown, and that many taxpayers will take advantage of safe harbor certainty even if they perceive they have an arm's-length argument for reporting less income. Indeed, taxpayers probably do not know with any precision where their transactions fall on the arm's-length scale, especially if relieved of the need to figure it out.

On the other side of the coin (literally), it is conceivable that tax authorities may use safe harbors in certain situations to attract business investment. In such cases, while the counterparty country would benefit from consistent reporting, reaching bilateral agreement seems less likely because of the reciprocal nature of an MOU. So the distortive effect would be organically tempered by the potential for double taxation.

Conclusion

The OECD discussion draft is a huge step in the right direction. For now, it may be just the right step to encourage countries to embrace the basic concept of bilateral safe harbors while having broader all-purpose language in the main text as experience grows. The OECD should be commended for moving so fast, and so ably, in this critically important area.

Bilateral safe harbors are getting close enough to touch.

[32] See note 8 above.

   ISSN 1063-2069