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a closer look

Global Tax Weekly – A Closer Look

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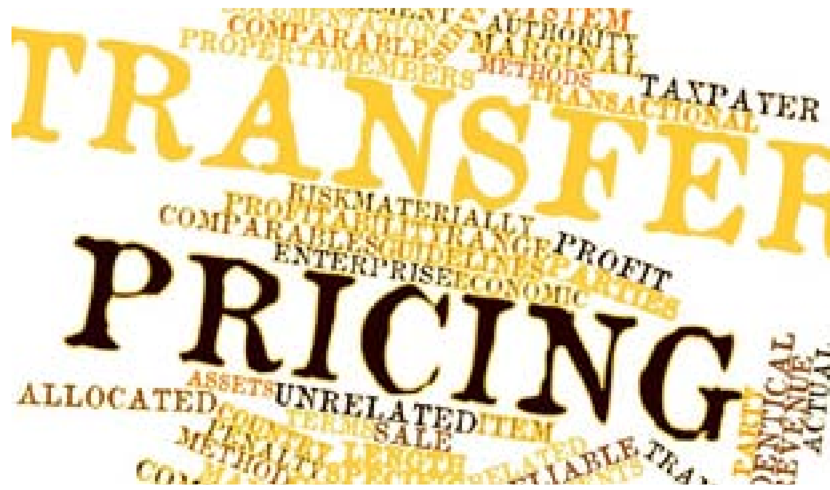
Transfer Pricing Safe Harbors: The New Arm's Length Standard?

by Jared Walls, a partner of the firm Peters Advisors, LLC, based in New Jersey

As the number of countries with unique transfer pricing rules and local documentation requirements continues to increase, transfer pricing compliance is becoming a growing area of concern for multinational corporations (MNCs) and tax administrations. In addition, differing interpretations of shared transfer pricing concepts, such as the arm's length standard, can lead to disputes among tax administrations with regard to the taxable income that should be reported by MNCs in the various jurisdictions in which they operate.

In light of this growing compliance, enforcement and dispute resolution burden, both the Organization for Economic Cooperation and Development (OECD) and the United States Internal Revenue Service (IRS) have recently announced initiatives aimed at simplifying and harmonizing transfer pricing compliance requirements. One such initiative is the proposed implementation of safe harbors.

The OECD initiative was released on June 6, 2012 through the publication of a Discussion Draft on the proposed revision of Chapter IV of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). The Discussion Draft endorses the use of safe



harbors for certain low-risk transactions as an alternative to traditional transfer pricing compliance analyses. The OECD publication is a significant development as it effectively reverses the OECD's long-standing opposition to safe harbors.

The OECD paper also contains a sample safe harbor Memorandum of Understanding (MOU) for routine distribution, contract manufacturing and contract research and development services. Tax administrations are encouraged to use these MOUs as the basis for establishing bilateral, pre-defined pricing safe harbor agreements.

Following the lead of the OECD, the IRS issued a news release on March 15, 2013 outlining its intention to separately develop a sample bilateral safe harbor MOU for low-risk distribution services.[1] The IRS news release specifically references the efforts of the OECD and requests comments from the business community in recognition that safe harbors can support sound tax administration.

The OECD and IRS publications together suggest that – like them or not – safe harbors will play a more significant role in the global transfer pricing landscape going forward.

The remainder of this article provides an overview of the historical application of transfer pricing safe harbors, an analysis of their advantages and disadvantages, as well as an opinion regarding a potential path forward.

1 Safe Harbors in Theory

Tax administrations tend to enact pricing safe harbors in order to reduce or eliminate the need for taxpayers to prepare and submit traditional transfer pricing compliance analyses.Assuming the conditions of a safe harbor are satisfied, taxpayers can be assured that the governing tax administration(s) will not challenge the covered transaction(s).

Safe harbors come in many shapes and sizes, with a wide degree of variance in their precise objectives and underlying parameters. The most common type of safe harbor in transfer pricing is a pre-defined pricing parameter, which sets forth an acceptable price or range of prices that may be charged in an intercompany transaction. The current OECD and IRS initiatives are examples of this type of safe harbor.

There are also numerous examples of other safe harbor parameters, such as intercompany transaction volume, enterprise assets, total revenue, and capital structure, among others.Frequently, these types of parameters are used to determine whether a controlled entity or intercompany transaction may qualify for an exemption from the applicable transfer pricing requirements.

Despite their diversity, all safe harbors can be broadly characterized by two key considerations: (i) whether they are enacted unilaterally by a single tax authority or jointly by two or more tax authorities, and (ii) whether the application of the pre-defined parameters is voluntary or mandatory.

1.1 Unilateral vs. Bilateral/Multilateral Safe Harbors

Almost all of the transfer pricing safe harbors in use today are unilateral – *i.e.*, enacted by a single tax authority without regard to the treatment of the covered transaction by any other tax jurisdiction. Establishing bilateral or multilateral safe harbors is a more difficult task because they require an agreement to be reached among tax authorities whose objectives, economic conditions and fiscal concerns may not be aligned. However, the advantage of bilateral and multilateral agreements is that they ensure that the involved tax administrations will not disagree *a posteriori* over the arm's length compensation of a covered transaction, thus effectively eliminating the risk of double taxation.

1.2 Safe Harbors vs. Mandatory Apportionment

An important distinction must be made between a safe harbor, which is voluntarily, and mandatory apportionment, which is not. In the case of a safe harbor, to the extent that the results reported by a taxpayer differ from the agreed parameters, MNCs may elect to carry out a traditional transfer pricing analysis to support their intercompany pricing without being subjected to automatic adjustments. Conversely, mandatory apportionment requires that the pre-defined parameters be satisfied without exception.

2 Safe Harbors in Practice

Although the OECD and IRS communications have generated renewed interest and publicity, safe harbors have been a part of the U.S. transfer pricing regulations for more than 40 years.[2] Since that time, a number of foreign jurisdictions have also adopted similar provisions.

Below are some key examples of pricing safe harbors that have been introduced by the IRS and foreign tax administrations.[3]

2.1 U.S. Safe Harbor Examples

2.1.1 Applicable Federal Rate "Safe Haven"

The first safe harbor was introduced as part of a major revision of the U.S. transfer pricing regulations in 1968.[4] The "safe haven," as it is referred to in the Internal Revenue Code (IRC) Section 482 regulations, is a provision that allows taxpayers to set the interest rate on certain intercompany financing transactions by reference to the applicable Federal rate (AFR).

Specifically, interest rates on U.S. dollar-denominated debt that fall between 100 percent and 130 percent of the AFR are exempt from traditional transfer pricing analysis and IRS scrutiny.

The U.S. regulations allow companies to elect not to use the AFR safe haven if it can be determined that an alternative approach to establishing the arm's length interest rate is more appropriate.[5]

2.1.2 Services Cost Method

In August 2006, the IRS extended its use of pricing safe harbors with the introduction of new temporary and final intercompany services regulations.[6] The regulations introduce the Services Cost Method (SCM), which allows MNCs to calculate the intercompany charge certain low margin services as the sum of the total direct and indirect costs incurred by the service provider without markup.[7]

Like the AFR safe haven, the SCM is unilateral and voluntary. Taxpayers may elect to apply a markup on low margin services that would otherwise qualify for the SCM if the markup can be economically supported by a traditional transfer pricing analysis.

2.2 Non-U.S. Safe Harbor Examples

- In 1999, the Australian Taxation Office (ATO) released Taxation Ruling 1999/1, which provides for a safe harbor markup on total direct and indirect costs of 7.5 percent on "non-core" services provided or received where the volume does not exceed 15 percent of the Australian group's total revenue (in the case of a service provider) or expenses (in the case of a service recipient).
- In 2000, the New Zealand Inland Revenue Department finalized Transfer Pricing Guidelines[8] that generally follow the intercompany services safe harbor established by the ATO in Taxation

Ruling 1999/1. However, taxpayers may elect to disregard the safe harbor and follow the normal application of the arm's length standard in determining their transfer pricing for services.

- While the Swiss Federal Tax Authority (FTA) discontinued the use of a safe harbor for intercompany services in 2004,[9] a safe harbor covering intercompany interest rates continues to be applied.The FTA sets the applicable maximum and minimum rates annually by reference to the prevailing interest rates in the Swiss market.
- In Mexico, U.S. enterprises are not considered to have a permanent establishment on their toll manufacturing operations if the taxable income of the local Mexican entity exceeds the greater of (i) 6.5 percent of total costs and expenses, or (ii) 6.9 percent of the assets used in the toll manufacturer's operations, including assets owned by foreign residents or related parties.[10]
- The Brazilian transfer pricing rules, which were first released in 1996, diverge significantly from the U.S. regulations and the OECD Guidelines. Specifically, as an alternative to market-based analyses, taxpayers may rely on pre-defined pricing margins to satisfy their transfer pricing reporting requirements. While these margins are purportedly based on the arm's length standard, in practice they often yield results that are inconsistent with those that would have been obtained through the normal application of the arm's length standard.

2.3 OECD Position on Safe Harbors

Despite the successful adoption of safe harbors by a number of tax administrations, many of which are OECD member countries, the OECD has historically taken a negative position toward the concept. According to Joseph Andrus, Head of the Transfer Pricing Unit of the OECD, the inclusion of language overtly in opposition to safe harbors in the 1995 version of the OECD Guidelines was at least in part due to the concern that, if undeterred, mandatory fixed margin safe harbors – such as those included in Brazilian legislation – would supplant the arm's length standard as the globally accepted transfer pricing framework.[11]

Even the most recent version of the OECD Guidelines, published in July 2010, states that "special statutory derogations for categories of taxpayers in the determination of transfer pricing are not generally considered advisable, and consequently the use of safe harbors is not recommended."[12]

2.4 Summary

Although safe harbors have long been part of transfer pricing, the OECD and IRS releases are novel because they mark the first large-scale effort to promote bilateral and multilateral agreements between and among multiple tax administrations.Moreover, the proposed revisions to Chapter IV of the OECD Guidelines are historic in that they reverse the OECD's long-standing opposition to safe harbors.

If the present initiatives proposed by the OECD and IRS are successful, the resulting proliferation of safe harbors as an alternative to traditional transfer pricing compliance would represent a considerable shift in the global transfer pricing paradigm.

3 Utility And Constraints Of Safe Harbors

In light of the recent efforts undertaken by the OECD and IRS, it would seem that the question is not *whether* new safe harbors will be introduced, but *when*. The next logical consideration is whether they provide a net benefit to taxpayers and tax administrations, all things considered.

3.1 Advantages

If designed properly, safe harbors can provide a number of advantages over traditional transfer pricing compliance.

- Safe harbors can reduce or even eliminate the need to document covered transactions, enabling MNCs to focus their resources on achieving broader and more comprehensive compliance coverage. Likewise, by removing safe harbor transactions from the scope of a tax audit, tax administrations are free to redirect resources to higher priority transactions.
- Even if a taxpayer prepares detailed documentation in every country in which it operates, there is still no certainty that the tax administrations will agree with the conclusions set forth in the reports. Safe harbors provide a level of certainty *a priori* that can otherwise be achieved only through an Advance Pricing Agreement.
- In the event of an audit, taxpayers and tax administrations frequently expend an inordinate amount of resources disputing subjective transfer pricing issues, such as the selection of comparable companies or transactions. While fixed margins may not always derive the most accurate measure of the arm's length value of an intercompany transaction, they are at a minimum an objective means to solve an inherently subjective problem.
- The application of pre-determined safe harbor margins would ensure that taxpayers are treated uniformly. A small taxpayer with limited resources would be guaranteed the same treatment and outcome as a large MNC with an extensive audit defense budget.

3.2 Disadvantages

Despite their noted advantages, safe harbors also present discrete challenges, particularly in cases where the results may not be consistent with the arm's length standard.

- The U. S. regulations and OECD Guidelines require that taxpayers carry out very detailed, fact-driven analyses in support of their intercompany pricing policies. Given that one of the primary purposes of a safe harbor regime is to reduce or eliminate the need for such an analysis, there is a natural trade-off. While accepting the safe harbor trade-off may reduce compliance expenditures, depending on the facts and circumstances the results may artificially benefit or penalize the taxpayer or the tax administration. This is particularly true in the case of mandatory safe harbors as they do not provide for the possibility of testing the covered transaction(s) in an alternative manner.
- A secondary symptom of pre-defined pricing ranges is that they can result in double taxation, under-taxation or double non-taxation, particularly if they are implemented unilaterally. For example, imagine that in accordance with

a safe harbor provision in Country A, a routine distributor is obligated to report an operating margin between four and seven percent on the commercialization of products purchased from a related party supplier in Country B. However, based on a traditional transfer pricing analysis, it can be demonstrated that an operating margin between one and two percent would be more appropriate. On the other side of the transaction, if the tax administration in Country B does not accept the safe harbor range and instead reallocates the income of the supplier in Country B based on the arm's length range of one to two percent, double taxation could arise.

- The above example is a common issue that could occur where the transfer pricing rules or unilateral safe harbors are based on mandatory fixed pricing margins. To the extent that the government-sanctioned margins differ from the arm's length results established by a traditional transfer pricing analysis, the reduced compliance burden may be effectively supplanted by the need to engage in costly dispute resolution measures. Sometimes a mutually equitable solution can be reached, but tax administrations may also reach an impasse due to a fundamental disagreement regarding the way in which the transfer prices should be calculated.
- Disequilibrium in the transfer pricing rules and valuation mechanisms available among tax administrations can also lead to tax arbitrage and other potentially unintended tax planning strategies. For example, MNCs may be encouraged to establish an unnatural transaction flow, routing invoices through favorable jurisdictions in order to exploit tax-efficient safe harbors that would not otherwise be available if the transactions were carried out in accordance with their commercial reality.
- Establishing and maintaining agreeable unilateral fixed margins can in itself be a cumbersome process. This would only be exacerbated in the event of bilateral or multilateral safe harbors. Continuing with the previous example, imagine that in Country A there is substantial economic contraction over an extended period of time and that Country A and Country B previously established a bilateral safe harbor mandating a distribution operating margin of four to seven percent. Suppose that over the same period, Country B experienced strong economic expansion. Two potential issues could arise.
- First, the tax administrations may be compelled to consider one (lower) profitability range for Country A and a different (higher) range for Country B. However, the tax administration in Country A may not be inclined to accept a lower profit margin than that of the tax administration in Country B for the same business activities.
- Second, it is unlikely that safe harbors would conceivably encompass negative margins, given that such a policy would create a breeding ground for unnatural tax planning and double non-taxation. However, it is well-documented that low-risk, uncontrolled enterprises are not invulnerable to operating losses. Consequently, absent a special exemption for taxpayers that can demonstrate acutely abnormal economic circumstances, safe harbors could artificially inflate the taxable profits of routine entities.

- Finally, it is safe to assume that not all OECD member countries will be willing to adopt bilateral or multilateral safe harbor arrangements. Moreover, establishing cross-border safe harbor regimes may be an even greater challenge outside of the OECD, where more divergence exists with regard to transfer pricing rules and regulations. As a result, paradoxically, the transfer pricing simplification and harmonization initiatives of the OECD and IRS could actually encourage MNCs to apply disjointed transfer pricing policies in an attempt to satisfy conflicting safe harbor regimes.

4 Conclusion

The OECD and IRS have undertaken an immense, ground-breaking project that, if managed properly, could result in a significant reduction in the compliance burden of MNCs and the enforcement burden of tax administrations around the world.

In the author's opinion, a bilateral, voluntary safe harbor regime can succeed as long as the interested parties are willing to accept the trade-offs that exist between the administrative efficiencies of pre-defined pricing and the inherent lack of precision that accompanies them.

Perhaps more importantly, taxpayers and tax administrations must recognize that there is no *perfect* safe harbor. Some of the key shortcomings outlined in this article can be mitigated or even eliminated by (i) limiting the scope to bilateral or multilateral agreements, (ii) covering only relatively low-risk, straightforward transactions, and (iii) preserving the integrity of the arm's length standard by allowing MNCs to apply traditional transfer pricing analyses as an alternative to a safe harbor if the results of such analyses can be demonstrated to be more appropriate under the facts and circumstances. However, any heroic attempt to correct all of the potentially negative side effects of safe harbors will undoubtedly be counterproductive; serving only to add complexity to a process whose primary purpose is to reduce administrative complexity.

Finally, the call for safe harbors is at least partially attributable to a lack of uniformity among tax administrations with regard to transfer pricing. With that said, the OECD and IRS have announced separate safe harbor initiatives. If the OECD and IRS are truly committed to the principles of safe harbors, as it would seem, they should consider consolidating their efforts into a single process.

More specifically, the IRS should consider whether the existing work of the OECD is sufficient to serve as a consensus framework. After all, if there is any time for the OECD and IRS to work together, wouldn't it make sense for it to be on a transfer pricing harmonization initiative?

Endnotes

1 IR-2013-30, March 15, 2013.

2 Treas. Reg. §1.482-2. (33 FR 5849).

3 The examples listed in this article are limited to pre-defined pricing margin safe harbors and are not intended to represent an exhaustive list of the safe harbors that are in use as of the date of this article.

4 Treas. Reg. §1.482-2. (33 FR 5849).

5 Treas. Reg. §1.482-2(a)(2)(iii)(B)(3).

6 Temp. Treas. Reg. §1.482-9T.

7 Temp. Treas. Reg. §1.482-9T(b).

8 The Transfer Pricing Guidelines are a guide to the application of section GD 13 of New Zealand's Income Tax Act 1994.

9 Circular No. 4, March 19, 2004.

10 Peer Review of Mexican Transfer Pricing Legislation and Practices, OECD.

11 BNA Tax Management Transfer Pricing Report, Volume 20 Number 872, February 9, 2012.

12 OECD Guidelines, Paragraph 4.122.