THE COMMENTS RECEIVED WITH RESPECT TO THE DISCUSSION DRAFT ON THE REVISION OF THE SAFE HARBOURS SECTION OF THE TRANSFER PRICING GUIDELINES

29 OCTOBER 2012

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
CENTRE FOR TAX POLICY AND ADMINISTRATION
This document has been revised to include comments which were not compiled in the previous edition. (Added comments are marked *.)

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PROPOSED REVISION OF THE SECTION ON SAFE HARBOURS IN CHAPTER IV OF THE OECD TRANSFER PRICING GUIDELINES

Comments to the OECD

Discussion Draft on Safe Harbours

August 2012
Introduction

The Spanish Association of Tax Advisers (AEDAF), created in 1967, gathers university graduates who are specialists in taxation and tax consulting, working whether as self-employed or as an employee.

The main purpose of the AEDAF is to provide its members with the best instruments and consulting issues to carry out an excellent professional activity. The members of the AEDAF come from both the professional and the university sector. The AEDAF offers its members a great added value though a constant and quality education and information to be applied in their day to day activity, publications of interest, professional meetings regarding fiscal matters and the regular exchange of information and knowledge among its members.

AEDAF develops regular knowledge management activities through different specialised work groups being one of them focussed on transfer pricing issues. The members of the transfer pricing working group are professional specialised in advising multinational groups in international taxation and transfer pricing.

The following members of the AEDAF’s Transfer Pricing Working Group have participated in the preparation of these comments:

Eduardo Gracia Espinar, Lawyer
José Manuel Calderón Carrero, Lawyer
Carlos Diéguez Nieto, Lawyer
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Teresa Ruiz de Azúa Basarrante, Economist
David Soriano Rubio, Economist
Comments to the OECD Discussion Draft on Safe Harbours

The Spanish Association of Tax Advisers ("Asociación Española de Asesores Fiscales" or "AEDAF") considers that the discussion draft on the proposed revision of the section on safe harbours in Chapter IV of the OECD transfer pricing guidelines (the "OECD Discussion Draft on Safe Harbours" or the "Discussion Draft") released by the Working Party No. 6 of the OECD Committee on Fiscal Affairs, is a very interesting and useful document that contributes to the reduction of the taxpayers obligations in the field of transfer pricing as it reduces the burden of proof necessary to comply with the transfer pricing obligations and goes in the right direction to provide legal certainty to taxpayers.

Notwithstanding this, the Spanish Association of Tax Advisers would like to make a number of comments on the Discussion Draft, which are set out below classified in the four following sections:

(a) Comments in relation to the definition of transfer pricing safe harbours

(b) Comments in relation to the application of the transfer pricing safe harbours by the taxpayers

(c) Comments in relation to the adoption of the transfer pricing safe harbours by countries

(d) Comments on the unilaterality of the transfer pricing safe harbours versus their bilaterality or multilaterality

1. COMMENTS IN RELATION TO THE DEFINITION OF TRANSFER PRICING SAFE HARBOURS

The Spanish Association of Tax Advisers would like to highlight that the OECD Discussion Draft on Safe Harbours does not contain a complete and precise definition of transfer pricing safe harbours. We are of the view that within the OECD a consensus on what precisely a safe harbour is, should be reached.

In our opinion, transfer pricing safe harbours should have the following characteristics:

(a) **Safe harbours should be linked to qualifying transactions and not to a given category of taxpayers:**

According to the text of the Discussion Draft, a safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions.

However, we think that safe harbours should not be linked to certain taxpayers since they could lead to privileged treatments which could be considered as State aids for distorting competition and trade inside the EU. The reason for this is that if only a given category of taxpayers were allowed to benefit from the application of safe harbours, such taxpayers could be obtaining an advantage over their competitors.

Therefore, we consider that safe harbours should be limited to qualifying transactions rather than linking it to categories of taxpayers. By the same token and
given the preliminary stage at which the use of safe harbours is, we are of the opinion that they should confine to low value added transactions which are carried out frequently, such as, so called “management services”, toll manufacturing or limited risk distribution services and simple intragroup financial transactions.

(b) **Safe harbours should be optional for taxpayers but binding for the Tax Administrations:**

Taxpayers should be allowed to choose to apply safe harbours or not. If taxpayers choose to apply them, then the safe harbours should be binding for the Administration, except if a mutual agreement procedure takes place under a tax treaty and provided that the purpose of the negotiation between the Tax Administrations is to eliminate double taxation or to prevent double non-taxation.

(c) **Safe harbours should have a permanent nature in time:**

Safe harbours should be permanent in time, but subject to the ongoing monitoring by the Tax Administrations as to its continuous alignment with market values.

If as a result of such monitoring, safe harbours are updated, the new safe harbours should be: (i) subject to publicity; and (ii) applicable with no retroactive effect.

(d) **Safe harbours should consist of a value range:**

Safe harbours should consist of a value range (all values of the range being equally valid) rather than a specific point in the range.

(e) **Safe harbours should be public and transparent:**

Safe harbours should be public in order to make them transparent and avoid: (i) distortion competition practices (as had happened in the past with tax rulings); and (ii) aggressive tax planning.

In addition, the publicity would help to: (i) generate momentum in the application of safe harbours (as has happened with the thin capitalisation rules as well as is starting to happen now with management fees in the EU after the publication of the Commission Communication 2011/16, adopted on 25 January 2011, on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 including proposed guidelines on low value adding intra-group services); and (ii) get an alignment between the taxpayers and the Administration, which would result in an elimination or reduction of costs for both parties and, in particular, monitoring costs for Tax Administrations and compliance costs for taxpayers.

2. **COMMENTS IN RELATION TO THE APPLICATION OF TRANSFER PRICING SAFE HARBOURS BY THE TAXPAYERS**

In relation to the application of transfer pricing safe harbours by the taxpayers, the Spanish Association of Tax Advisers would like to make the following comments:
2.1 **No need to communicate to the Tax Administration the application of safe harbours**

We are of the view that there should be no obligation to communicate to the Tax Administration the option for the application of safe harbours (especially if they have a permanent nature in time), which would imply a reduction of the taxpayers obligations in the field of transfer pricing.

However, if taxpayers would opt for not applying or stop using them, tax authorities could impose a reporting obligation to the Tax Administration.

This characteristic of the safe harbours would contribute to improve legal certainty and mitigate compliance costs, which are considered as some of the main advantages that taxpayers may gain as a result of the application of the safe harbours.

2.2 **Interaction between safe harbours and accounting rules**

The Discussion Draft should clarify the relationship between the tax legislation regulating the safe harbours and the accounting rules, taking into account that there are many countries where the taxable income, for Corporate Income Tax purposes, is determined by the accounting rules (conformity systems).

2.3 **Incidence of safe harbours for other tax purposes**

Furthermore, we think that the application of safe harbours should not only have tax incidence in relation to the Corporate Income Tax of the companies, but also in relation to the indirect taxation of the corresponding transactions (in particular, those indirect taxes whose tax base is referred to the market value of the goods and services which are the object of the transaction). This incidence of safe harbours for other tax purposes would help to simplify the tax obligations of the taxpayers.

It would be recommendable that, at this stage of development in the use of safe harbours internationally, safe harbours only apply to transactions of low value added which are carried out frequently and which, consequently, have a lower tax collection risk.

2.4 **The application of safe harbours will simplify taxpayers' documentation obligations**

We consider that the Discussion Draft should state clearer that the use of safe harbours will serve to prevent taxpayers from producing documentation directly involved in the determination of arm's length prices, as this is the key benefit that taxpayers may obtain from the application of safe harbours.

In the light of what is set out in the draft samples MOU (paragraphs 60-61 and 75-76), we would like to point out that paragraph 10 of the Discussion Draft should specify more clearly what are the documentation obligations from which taxpayers are exempt.
3. COMMENTS IN RELATION TO THE ADOPTION OF THE TRANSFER PRICING SAFE HARBOURS BY COUNTRIES

In relation to the adoption of the safe harbours by countries, the Spanish Association of Tax Advisers would like to make the following comments:

3.1 The adoption of safe harbours should not be conditioned to the taxation of the income/expense that they may generate

The adoption of a safe harbour by a particular country should not be conditioned to the taxation of the income/expense that it may generate. Therefore, the advisability of adopting a particular safe harbour should be independent of the tax treatment of the income/expense that this safe harbour may generate.

3.2 Assumption of non-existence of a permanent establishment

We are of the view that in qualifying transactions in which safe harbours are applicable, it should be assumed, unless proved otherwise by the Tax Administration, the non-existence of a permanent establishment.

We have noted that such assumption is mentioned in the draft sample memoranda of understanding on certain low risk services, therefore we consider that it should also be contained in the OECD Discussion Draft on Safe Harbours as a best practice for its Members.

4. COMMENTS ON THE UNILATERALITY VERSUS BILATERALITY OR MULTILATERALITY OF THE TRANSFER PRICING SAFE HARBOURS

With regard to the unilaterality versus bilaterality of the transfer pricing safe harbours, although we agree with the OECD when it mentions in the Discussion Draft that safe harbours have to tend to be negotiated on a bilateral basis, we would like to add a few remarks in relation to unilateral and multilateral safe harbours.

4.1 Unilateral safe harbours

We think that unilateral safe harbours are also advisable when applied in purely internal transactions, provided that taxpayers are aware that their extension to cross-border transactions may lead to double taxation.

4.2 Multilateral safe harbours

We also consider that the Discussion Draft should raise more ambitious goals such as the possibility to negotiate safe harbours on a multilateral basis, since bilateral safe harbours also have limitations, particularly when they are to be applied by multinational companies.

We understand that it can be very difficult to achieve consensus on a worldwide basis in this area, but at least regionally there are good examples of them.

Thus, for example, it must be mentioned as a multilateral safe harbour that today has great value within the EU, the existing safe harbour for low value adding intra-group services contained in the Commission Communication 2011/16, adopted on 25 January 2011, on the
work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 including proposed guidelines on low value adding intra-group services.

Finally, it should be noted that even if it is very difficult to agree a multilateral safe harbour in a binding document, as it may be a treaty, in practice multinational companies appreciate as enough that the safe harbour is agreed by means of a mere political commitment (e.g. through the endorsement made by the tax administrations involved by means of a common position paper where the safe harbour is set).

* * *
September 14, 2012

Mr. Joe Andrus  
Head, Transfer Pricing Unit  
OECD Centre for Tax Policy and Administration  
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75775 Paris Cedex 16  
France

Re: Reply to the Invitation to Comment on the OECD’s (1) Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and (2) Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours

Mr. Andrus,

Barsalou Lawson is a Canadian law firm specialized in corporate taxation for multinationals doing business in Canada, with a particular emphasis on transfer pricing. We are regularly involved in transfer pricing discussions with the Canada Revenue Agency.

Barsalou Lawson’s present submission to the OECD consists of (1) comments to the Proposed Revision of the Section on Safe Harbours; and (2) comments to the Sample Memoranda of Understanding.

Should the OECD decide to pursue the discussion with the business community, we would be pleased to further elaborate upon any of the comments and ideas raised in this submission, or otherwise assist the OECD.

Sheena Bassani       Pierre Barsalou  
Of Counsel        Partner

* Thank you to Sebastien Rheault and Nathalie Perron for their support and contributions.
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I. Barsalou Lawson Comments to the Proposed Revision of the Section on Safe Harbours

A. History of Safe Harbour Guidance

In the Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines (“Proposed Revision”), we see references to the negative view of safe harbours that was previously expressed in the 1995 version.1 Although these comments are helpful for readers unfamiliar with either the background or the intentions of WP6 in making changes to this guidance, we suggest neutralizing the language in the final version to be incorporated into the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Retaining the references to the negative history may, in perhaps a subconscious manner, serve to maintain a certain degree of skepticism and negativity surrounding safe harbours. Perhaps sufficient documentation now exists that can be consulted for those interested in understanding the history (e.g., the 1995 version and/or the Proposed Revisions), and there is therefore no need to include the historical references in the final safe harbour guidance to be published in Chapter IV.

B. Double Non-Taxation

The Proposed Revisions assert in multiple places that unilateral safe harbours may result in double non-taxation. More precisely, it is stated that “there would be no assurance that the taxpayer would report income in other countries on a consistent basis or at levels above arm’s length levels based on the safe harbour. Moreover, it is unlikely that other tax administrations would have the authority to require that income be reported above arm’s length levels.”2

We do not see the basis for this apprehension regarding double non-taxation, in the sense that, irrespective of the existence or inexistence of safe harbour rules, such conduct by a taxpayer would constitute fraud and tax evasion, which are severely sanctioned in most OECD countries.

From a legal perspective, once there is an agreement on pricing (verbal or written), and the transaction is definitively booked by one party at such a price, at that point, we see no legal basis that could be relied upon for booking that same transaction at a different price in the other jurisdiction without some act or initiative of the tax authority or competent authority of one or the other jurisdictions.3

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1 See, for example, par. 2 and 3 of the Proposed Revision.
2 Proposed Revision, par. 24.
3 There may be a cascade effect on certain other paragraphs. Par. 34 would therefore include such modifications as the following, since a higher profit in one jurisdiction will necessarily mean a lower profit in the other jurisdiction: “Safe harbour provisions may raise issues such as potentially having perverse effects on the pricing decisions of enterprises engaged in controlled transactions and implementing granting the safe harbour as well as...”
From a basic accounting and financial reporting perspective, it is our understanding that intercompany transactions must be recorded on a consistent basis and financial statements must comply with GAAP, IFRS or another accounting framework. We are not aware of any accounting/financial reporting frameworks that would allow otherwise.

We accordingly see no legal, tax, accounting, financial reporting or economic principles that would permit the booking of the transaction at two different prices, and unless there are specific examples of legislation or principles that would permit such double non-taxation, would therefore suggest all such references be removed from the Proposed Revisions.

C. Option to Price in Accordance with Arm’s Length Principle

In discussing whether taxpayers should retain the option to price their transactions in accordance with the arm’s length principle, the Proposed Revisions suggest that taxpayers “will pay tax only on the lesser of the safe harbour amount or the arm’s length amount.” However, this embodies an assumption that small taxpayers will engage in a comparative analysis and/or engage somewhat costly consulting services in order to make this choice. In reality, both seem unlikely given the probable size of the taxpayer to which a safe harbour is intended to apply, as well as the overall intention of all stakeholders to reduce the compliance burden. Should this language nevertheless be retained in the final revisions, we would suggest at a minimum replacing the word “will” with “may.”

We do, however, believe that it is important for the taxpayer to retain the option of pricing its transactions in accordance with the arm’s length principle. Unless the safe harbour provisions are enacted as part of the tax laws of the country or countries in question, it would be placing an unfair burden on taxpayers to have knowledge of safe harbour options pursuant to treaty commentaries. Furthermore, since the purpose of tax treaties is to relieve taxpayers of an unfair tax burden, and not to add to the tax burden, it follows that the taxpayer should have the option rather than the obligation to abide by the safe harbour rules. Treaty powers cannot be relied upon to make the safe harbour mandatory since there would be no guarantee that the safe harbour would uniquely serve as a tool to relieve the taxpayer from potential double taxation (as opposed to serving as a taxing tool).

Consequently, it is our view that OECD guidance should not be formulated to envisage the safe harbour becoming mandatory upon execution of the MOU.

D. Access to Mutual Agreement Procedures

The Proposed Revisions indicate that “Where countries adopt safe harbours, willingness to modify safe-harbour outcomes in mutual agreement proceedings to limit the potential risk of double taxation is controlled transactions with taxpayers electing a safe harbour. Further, unilateral safe harbours may lead to the potential for double taxation or double non-taxation.”

4 Proposed Revision, par. 19.
advisable.”⁵ Also, the draft MOUs include a clause that refers all disputes to the competent authorities of the signatory States.⁶

It could also be envisaged to take this one step further, and recommend that if and when a safe harbour case is referred to the competent authorities through MAP (i.e., in the event of double taxation), that a simplified fast track resolution process be provided so that these cases be dealt with expeditiously, and not require the same investment in time and resources by the treaty partners as the larger cases. In that regard, individual safe harbour cases are expected to be relatively easy for the competent authorities to resolve (low amounts, less complex transactions, etc.). It would be counter-productive to make taxpayers wait 2 or 3 years for a response on a situation that arose as a result of simplification measures for smaller taxpayers/transactions. The memoranda or memorandum of understanding could also make reference to this fast track process.

E. Expert Assistance
The Proposed Revisions as currently drafted could give a reader the impression that transfer pricing specialists need not be consulted if safe harbour provisions are followed. However, based on our experience, even seemingly straight-forward financial analysis can sometimes pose difficulties for taxpayers. We would suggest adding the following sentence to the end of the Proposed Revisions: “Taxpayers who believe they meet the safe harbour requirements must ensure they have met the criteria to benefit from the reduced documentation burden, and that the financial analysis has been properly prepared to reduce risk of non-compliance.”

Furthermore, for the sake of clarity, the Proposed Revisions and Draft Sample MOUs should describe the consequences of falling outside the safe harbour range due to inadvertent errors (e.g., revert to arm’s length principle; adjustment to a point in the safe harbour range; or adjustment of the inadvertent error).

II. Barsalou Lawson Comments to the Draft Sample Memoranda of Understanding
A. One MOU
We suggest that the various exhibits be combined into one memorandum of understanding with several parts, each of which would correspond to the main content of one of the current exhibits. In most cases, it is expected that only one agreement would be signed amongst the treaty partners, and therefore combining all the parts into one agreement would serve to simplify the process. Naturally, one or more parts could be removed by the States in negotiating their MOU.

⁵ We would suggest the following changes to this language at par. 35: “Where countries adopt safe harbours, willingness to modify safe-harbour outcomes in bilateral/multilateral mutual agreement procedures to limit the potential risk of double taxation is advisable.”
⁶ Par. 62, 77 and 92 of the Proposed Revisions state: “All disputes with regard to the application of this memorandum of understanding shall be referred to the competent authorities of [State A] and [State B] for resolution by mutual agreement.”
B. Requirement for Audited Financial Statements

The draft sample MOUs include a requirement for audited financial statements to be provided in the notice filed with the MOU signatory tax authorities.\(^7\) Many MNE affiliates do not otherwise engage their auditors to issue audited financial statements, even if the group financials are audited, and even if the audit firm has assisted in reviewing the affiliate financial information.

In light of the above, it must be evaluated whether the cost burden of having the financial statements audited outweighs the cost burden of preparing transfer pricing documentation. In fact, we understand the cost to be prohibitive in most instances,\(^8\) unless the taxpayer has otherwise planned to obtain audited financials. Unless this criteria is revisited, one might expect significantly fewer taxpayers to be able to reasonably benefit from these simplification measures. If there is a serious concern regarding the reliability of the financial information, we would recommend further exploring other means of addressing this concern without putting at risk the effective implementation of MOUs.

C. Exhibit 2: Low Risk Distribution Services

The draft sample MOU on low risk distribution services indicates that the predominant business activity of the Qualifying Enterprise shall be either the performance of marketing and distribution services or else the purchase of products for resale.\(^9\) This MOU also provides for a maximum ratio of marketing and advertising expenses to sales ratio being established, above which the Qualifying Enterprise criteria would not be met.\(^10\)

It is not uncommon for an MNE to commence foreign business operations as a marketing entity until sales become significant enough to justify putting into place a distribution arrangement. Furthermore, in some cases, such as the sale of services and software, a local distribution function is not required in the foreign country. As a result, in practice, it could be useful to modify the draft MOU to also cover enterprises which are solely performing marketing services, and to provide for an appropriate range of net cost plus markups for part or all of such services that are not distribution services.

D. Exhibit 3: Low Risk Research and Development Services

We have taken note of the intention to limit application of this draft MOU to Qualifying Enterprises who do not engage in “product manufacturing and assembly functions, marketing and distribution functions, credit and collection functions, or warranty administration functions.”\(^11\) We have also noted that the draft MOU is limited to scenarios where the Qualifying Enterprise does not use “proprietary patents, know-how, trade secrets, or other intangibles in performing its research and development services other than those made available to it by the associated enterprise.”\(^12\)

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\(^7\) Proposed Revisions, par. 59, 74 and 89.
\(^8\) In Canada, we understand that the cost to an affiliate of obtaining audited financial statements is significantly higher than the cost of obtaining transfer pricing documentation.
\(^9\) Proposed Revisions, par. 67(b).
\(^10\) Proposed Revisions, par. 67(f).
\(^11\) Draft Sample MOU, par. 82(d).
\(^12\) Draft Sample MOU, par. 82(e).
Although we understand the probable reasons for these limitations, we simply note here that in practice, there are very few operations that would meet all of the criteria. Most of the contract R&D arrangements seen in practice are typically coupled with another activity or were preceded by an activity that was performed on its own account prior to the sale of non-routine intangible assets to a related party.

If requested, we would be happy to provide further ideas on how to address this reality in order to optimize the breadth of the initiative while addressing concerns of the tax authorities.

E. Calculation of Profit Level Indicators
We have noted that the Draft Sample MOU for low risk manufacturing services and low risk R&D services provide some guidance on how to calculate the denominator of the net cost plus margin. However, consideration could be given to more precise guidance on how the numerator should be calculated, such as which costs should be considered “below the line” in calculating the operating profit for all three MOUs.

F. Financial Transactions
Perhaps WP6 will envisage adding MOUs for certain types of financial transactions below an identified threshold, if not at the present time, perhaps jointly with the future work that WP6 expects to undertake regarding financial transactions more generally. Perhaps the references to “safe harbour shopping” that is expressed in the Proposed Revisions is sourced in part from the fear that financial transactions can be more easily constructed to implicate countries with more favourable treaty and tax policies. We understand that there are a number of different approaches or criteria that could be leveraged in a draft MOU to address such concerns. Leveraging the conduit principle is one approach, which we noted has been used in the draft MOUs to avoid application of safe harbour rules to intermediaries in a transaction. Other approaches or criteria include a limitation of benefits clause or the beneficial ownership concept, but there are also other anti-avoidance rules that can be used to inspire potential solutions (e.g., local business purpose, step transaction).

We would be happy to engage in a more in depth discussion on how to overcome the perceived shortcomings of solutions analyzed by WP6, and to explore other possible solutions that may be incorporated into an MOU that would specifically address financial transactions.

III. Conclusion
We hope that our submissions will assist the OECD in their efforts to improve the administration of transfer pricing in particular with respect to safe harbours and the elaboration of concrete measures to continue to encourage greater cooperation between tax authorities around the world.

13 Paragraphs 55(a) and 85(a) of the Draft Sample MOUs both provide for exclusion from the base for computing profit percentage “only net interest expense, currency gain or loss, and any non-recurring costs.”
Dear Mr Andrus

Proposed revision of the section on safe harbours in Chapter IV of the Transfer Pricing Guidelines

BDO welcomes the OECD’s discussion draft of the updated paragraphs relating to safe harbours in Chapter IV of the OECD Guidelines on Transfer Pricing (‘the Guidelines’) (‘the Draft’) and the efforts undertaken by Working Party 6 to seek outside consultation. We appreciate the opportunity to comment on the Draft.

Overview

We support the OECD’s understanding that the current drafting of the Guidelines offers a negative tone towards transfer pricing safe harbours which is both unrepresentative of the number of countries now offering some of these kind of arrangements (33 of the 41 countries in the Multi-Country Analysis of Existing Transfer Pricing Simplification Measures dated 6 June 2012) and that safe harbours offer benefits to both taxpayers and taxing authorities.

These benefits are potentially greatest for smaller multinational enterprises (‘MNEs’) or those in the early stages of cross-border expansion. These businesses may not possess the resources for detailed transfer pricing studies in multiple territories but have the same desire for the certainty that comes from effective compliance. This question of resource extends to other administrative simplification, for example regarding transfer pricing documentation, although we agree with the OECD’s view that this issue should be considered separately from the question of safe harbours.

We also agree with what we understand from the Draft to be the OECD’s aims in this area, which are to create an environment which:

- Benefits both MNEs and taxing authorities;
- Does not create additional opportunities either for aggressive tax planning or double taxation;
- Is as consistent as possible with the arm’s length standard set out in the Guidelines; and
- Works effectively in practice.

We believe the Draft goes a long way to addressing the first three of these points; however the key will be to ensure that the final point is also achieved.
Types of safe harbour

The Draft, together with the proposed sample memoranda of understanding, are right to acknowledge that there are a number of ways to determine and set safe harbours, and that an ideal solution will combine all three elements effectively.

Transaction size and transaction type
A low level of transfer pricing risk can result from both a small transaction value (either relative to the MNE as a whole or the size of a fisc’s tax receipts) or from activities which are routine or ancillary to an MNE’s trade.

In practice this straight away gives rise to a number of permutations, for example:
- Comparatively low value activities from smaller MNEs
- Comparatively low value activities of smaller local operations of larger multinationals
- Higher value but routine activities which may be priced using a method that does not give rise to controversy
- Lower value routine and/or ancillary activities of smaller MNEs

We agree with the Draft’s efforts to incorporate in its proposed revisions safe harbours for both size and type of activity, as it would not seem appropriate to favour one over the other. As a result, all of the above options could be eligible if a tax authority (or tax authorities) agrees.

While we accept that the memoranda of understanding are presented as examples, these currently could be seen to focus on instances which are both routine and for smaller enterprises. This might limit the benefit where tax authorities seek simply to follow the examples given, both for ease of execution and their supporting precedent. We propose that greater flexibility might be incorporated into these agreements where possible, or that more detailed application guidelines might be incorporated into that appendix.

Mandatory pricing target
As set out in paragraphs 8 and 9 of the Draft, safe harbours might either relieve ‘a defined category of taxpayers or transactions from the application of all or part of the transfer pricing rules’ or ‘a mandatory price target would be established by the tax authority’.

We agree that both are valid approaches to be considered. For example the former might be appropriate for businesses below a certain size while the latter might best fit defined routine transactions.

While this is essentially reflected in the text of the Draft, again this does not come across in the sample memoranda of understanding (paragraphs 55, 70 and 85 respectively) which focus on the mandatory pricing target. As above, this might be addressed either through an additional example which covers a size exemption (although we accept that adding an example for every occasion would be impractical) or through more detailed application guidelines.

Unilateral, bilateral and multilateral agreements
We agree that the flexibility for tax authorities to make or enter into agreements as desired is the most effective way to expand the safe harbour environment.

From a consistency perspective, multilateral agreements are likely to be the most useful to MNEs. However, experience from Advance Pricing Agreements shows that multilateral
agreements are rarer and more labour intensive to conclude than bilateral equivalents. As such, the OECD’s focus on providing bilateral sample memoranda of understanding is a practical one.

However, the greater the number of agreements and differences between them, the more difficulties may arise from managing the practical consequences of their interaction. This is considered in more detail below.

Practical implications - achieving an effective outcome

We strongly agree with the OECD’s aim in the Draft that safe harbours should ‘follow a simple set of prescribed transfer pricing rules’ (paragraph 7). The challenge for the Guidelines and tax authorities implementing safe harbours will be to achieve an effective outcome that preserves tax revenues and increases certainty while reducing the administrative burden on business without the framework for doing so creating complexity that swaps one set of administrative requirements for another.

The following are areas which the OECD may wish to consider in more detail as the Draft progresses.

Calculation of amounts
To ensure that safe harbours yield consistent results between territories and businesses, either the memoranda of understanding or relevant application guidelines may wish to consider what level of specification could be required to harmonise how businesses calculate key metrics. This may be affected by factors such as accounting standards, cost allocation and the functionality of management accounting systems. Rather than legislating for individual detail, a sample of a standardised approach or set of considerations might be provided.

We appreciate that there is a conflict between providing a clear and simple framework for safe harbours and the reality that being too specific to particular instances can make agreements unwieldy and too exclusive. The current emphasis on simplicity is encouraged; although that is likely to involve the acceptance of some flexibility on the part of tax authorities and the application of judgement by tax payers.

This type of environment - a framework rather than a prescription - might be enhanced by the recommendation that tax authorities entering into memoranda of understanding (which we assume will be in the public domain) include details about how key metrics are arrived at, in particular target ranges of the type proposed in paragraphs 55, 70 and 85. This should assist businesses as it will allow more informed judgement relating to the appropriateness of a safe harbour for their particular facts and circumstances.

Unilateral, bilateral and multilateral agreements
As discussed above, the more countries sign up to a particular agreement, the more likely it is to be transparent and easy for MNEs to manage. However in practice such wider regional agreements may be less likely, at least in the short term.

It is reasonable to expect a number of different agreement types to exist, varying by factors such as entity size, industry, nature of the activities and transaction size (or combinations of these). These may feature in unilateral, bilateral and multilateral agreements, however ideally such agreements will be widespread. As the Draft acknowledges in paragraph 17, to some degree these will all be inconsistent with the standard arm’s length approach.
The risk arises that MNEs will find themselves primarily ‘pricing the safe harbour’ first and considering arm’s length factors only afterwards. For example where a business uses a central principal company to bear the majority of business risk, using limited risk distributors in local territories, the return of the principal is unlikely to fall within safe harbour provisions but will in effect (quite legitimately) receive as its return only the balance of what remains once these various provisions have been met. This is likely to be challenged. This type of challenge may be widespread when it is considered that both sides of a transaction are very rarely routine.

**Substance**

While it is accepted that a functional analysis will be required to determine whether an entity is performing routine activities, the way safe harbours are set up may lead businesses to oversimplify their characterisation of an entity (for example as a contract research and development function) to access safe harbour provisions. This would be inconsistent with the Guidelines, in particular recent revisions of Chapters I-III and the current revised draft of Chapter VI. It is also likely to meet challenge from tax authorities seeking to attribute a greater level of return (which they might contend would arise from the presence of senior local personnel).

The question of substance is therefore one that could on the one hand create oversimplification of entity characterisations and, on the other, return the uncertainty and administrative requirements that the safe harbour intended to remove, for example through analysis and documentation. We suggest that this is an area the OECD might profitably expand on in the draft paragraphs to provide more explicit guidance. This might also be linked to the OECD’s ongoing work on administrative simplification.

**Flexibility**

We agree with the OECD that, while flexibility is essential, the ability to opt in and out of a safe harbour’s provisions could effectively create a ceiling in certain types of return as businesses only opt out to achieve lower levels of return, reducing the benefit for tax authorities (paragraph 19).

To remedy this, where a safe harbour is in place it could be suggested that this is the default position for the given circumstances with exceptions to be justified through normal transfer pricing procedures already set out in the Guidelines.

This could enable flexibility with a minimum of additional work on the part of the business. For example where a local entity is part of a wider group transfer pricing policy it may be reasonable to expect that the work to develop and defend this policy has already taken place. Alternatively where particular sets of conditions exist, such as the start up phase as the local business builds up volumes, these would anyway have needed to be demonstrated and this might be achieved in a proportionate way. The determination of this proportionate level is something the OECD might consider discussing in either the Draft or any corresponding work on administrative simplification.

**Interaction with APAs**

Safe harbours intend to provide comfort and certainty for businesses around low risk aspects of transfer pricing, and so are aimed at the opposite end of the spectrum from APAs which deal with complexity or potentially controversy. However, many businesses are keen to see a ‘simplified APA’ process that would give them certainty over transfer pricing issues that are not clear cut but which are not as high value or highly complex as most traditional APAs. It would be helpful to understand how the OECD view the safe harbour programme with the potential for such ‘simplified APAs’.
Interaction with double tax treaties
As set out in E.4.2, flexibility is required to ensure that double taxation is avoided or, at worst, minimised. The ideal situation where bi- or multilateral agreements prevent double taxation arising, included in paragraph 25, is of course the aim. However as shown above, a degree of subjectivity as well as potentially conflicting parameters may remain.

Where double taxation arises as a result of safe harbours, the facility for rapid resolution would be beneficial and in the spirit of what the safe harbour itself aims to achieve. While difficult to codify, through the Draft the Guidelines might provide recommendations for tax authorities (or their Competent Authorities) to endeavour to put in place such arrangements to support the safe harbour process.

Both in doing so and in implementing any bi- or multilateral agreements, consideration will need to be given regarding the interaction of these agreements with the provisions of existing double tax treaties and Article 9 to ensure they are mutually compatible and supportive. This may need to be extended to consider regional arrangements, for example the EU law regarding aspects such as market access and non-discrimination, or bilateral and multilateral trade agreements.

While both these recommendations are likely to fall primarily on tax authorities, which might deter or slow the implementation of safe harbours, the OECD can be influential in providing support for this process through the Draft and the Guidelines.

Concluding remarks
We support the OECD’s initiative to enable the simplification of transfer pricing issues through the extension of safe harbours and introduction of broad commonality between them.

As safe harbours will encompass a range of circumstances and transactions as well as differing perspectives, we appreciate that it is impossible to anticipate every eventuality. However safe harbours will only create benefit for both tax payers and tax authorities if they work in practice. It is on providing advice and guidance on how this might be achieved as simply and effectively as possible that we suggest the OECD might most profitably focus as they develop the Draft and its supporting memoranda.

We would like to thank the OECD again for this opportunity to comment and should be happy to expand on these points and contribute further to later stages of this review if required.

For clarification of any aspects of this response sent on behalf of the BDO transfer pricing network, please contact:

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<tr>
<th>Anton Hume</th>
<th>Duncan Nott</th>
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Yours sincerely

Anton Hume
Global Transfer Pricing Leader
For and on behalf of BDO LLP
BIAC Comments on the Safe Harbour Section of the OECD Transfer Pricing Guidelines and Discussion Draft on Timing Issues

September 14, 2012

BIAC appreciates the opportunity to provide comments on safe harbour and timing issues in context of the OECD Transfer Pricing Guidelines currently under review, and provides initial comments as noted below. We continue to engage in and support the comments of BIAC Members on these issues going forward.

BIAC Comments on the OECD Discussion Draft on the Revision of the Safe Harbours Section of the Transfer Pricing Guidelines

Paragraph 3, E.1

1. Paragraph 3 of E.1 states that “Despite these generally negative conclusions, a number of countries have adopted safe harbour rules. Those rules have generally been applied to smaller taxpayers and less complex transactions.” We understand that the key issue in the transfer pricing is the “Risk and Function”. Therefore, it should also be possible to apply this rule to a big company which makes less complex transaction, like a toll manufacturer or a low-risk wholesaler.

Paragraph 36, E.5

2. We suggest that the last sentence of the paragraph 36, E. 5 should be changed as follows:

Where safe harbours can be negotiated on a bilateral or multilateral basis, they may provide significant relief from compliance burdens and administrative complexity without creating problems of double taxation or double non-taxation. Therefore, the use of bilateral or multilateral safe harbours under the right circumstances should be encouraged used in principle.
BIAC Comments Regarding OECD Discussion Draft on Certain Transfer Pricing Timing Issues

[Omitted]
To:
Joseph L. Andrus
Head of Transfer Pricing Unit
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

Dear Joe,

Position Paper: BUSINESSEUROPE – Comments on the OECD Discussion Draft entitled “Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours” 6 June to 14 September 2012

BUSINESSEUROPE is pleased to provide the following comments on the OECD discussion draft on safe harbours (hereinafter referred to as “the Draft”).

The Draft suggests revisions to the current guidance on safe harbours found in Chapter IV of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“TPG”).

BUSINESSEUROPE appreciates the efforts made by the OECD to find ways to ease the administrative burden related to transfer pricing and transfer pricing analysis and documentation. For multinational enterprises this administrative burden currently seems to be ever increasing. In the end it is of course in the interest not only to multinational enterprises but also to tax administrations to be able to focus on transactions that are of a more complex nature or involve significant amounts.

The Draft starts off by acknowledging that the Transfer Pricing Guidelines (TPG) currently contain language on safe harbours which is rather negative. The use of safe harbours is generally discouraged. The Draft also adequately presents the major concerns presented in this context. As noted, safe harbours do however already exist. Various more informal and less specific “rules of thumb” do also exist in many jurisdictions. This indicates that the issue is of some relevance to multinational enterprises and tax administrations alike. Further guidance in this area is would no doubt be valuable.

It is of course true that any safe harbour to some extent works to compromise the theoretical concept of the arm’s length principle. It is also true that double taxation or double non taxation in some circumstances could follow from the use of safe harbours. The basic concerns underlying the current discouraging language in the TPG are
consequently still largely valid. The draft would probably benefit from stating these undisputable facts even more clearly.

Having clearly acknowledged these basic facts it is logical to examine whether the use of safe harbours nevertheless could be justified and whether there are ways to limit the potential negative consequences.

Transfer pricing is not an exact science. There will always be room for argument as regards what constitutes an arm’s length outcome even after the most rigorous transfer pricing analysis. Introducing a safe harbour is in fact a way of acknowledging this and the fact that such a rigorous transfer pricing analysis is in fact not warranted, reasonable or proportional in all circumstances. Although the Draft recognises that safe harbours are probably primarily to be considered for less complex transactions the Draft lacks a more substantial discussion on proportionality.

Within any multinational enterprise there are a substantial number of peripheral, low value transactions that normally cause very little controversy and are therefore regarded as low risk from a transfer pricing perspective. It is hard to justify devoting resources to a full transfer pricing analysis of each and every one of these low risk transactions and they do in fact run a significant risk of not being properly analysed at all. For an enterprise proportionality is always a key issue. Does the potential exposure represented by the transaction justify the cost of having it fully analysed?

With a safe harbour the outcome for such a transaction would of course never be exactly the same as with a full transfer pricing analysis. On the other hand, as long as the safe harbour itself is based on a reasonable analysis and constructed so as to provide enterprises with a range within which pricing will be accepted, the overall situation might in fact nevertheless improve from the current situation in terms of more general arm’s length compliance.

Strangely enough the Draft does not suggest or recommend that safe harbours - if introduced - be based on some sort of sound analysis. The aim of any safe harbour should of course be to come as close as possible to the outcome that would follow from a full analysis of transactions covered by the safe harbour. The real challenge would be to adequately target the provisions and group the transactions to be covered.

From a business perspective safe harbours in the form of rebuttable presumptions do seem attractive. On the other hand it needs to be acknowledged that a safe harbour which is repeatedly being challenged by taxpayers is probably not well designed and will probably therefore also have difficulties to achieve any sort of acceptance from other jurisdictions.

Constructing a good safe harbour would of course be a delicate challenge for any legislator. However, if the analysis underlying the safe harbour is sound and does demonstrate that in the great majority of cases the safe harbour will in fact come close or very close to what would in any event be the outcome of a full analysis this will surely be the best way to minimize cases of double taxation following the application of the safe harbour. It would improve chances of having the safe harbour accepted by
other jurisdictions, either informally or formally through actual memorandums of understanding as suggested in the draft.

BUSINESSEUROPE is happy to continue a constructive dialogue with the OECD on this topic.

On behalf of the BUSINESSEUROPE Tax Policy Group

September 13, 2012

Krister Andersson
Chairman
CBI COMMENTS ON THE OECD DISCUSSION DRAFT “PROPOSED REVISION OF THE SECTION ON SAFE HARBOURS IN CHAPTER IV OF THE OECD TRANSFER PRICING GUIDELINES AND DRAFT SAMPLE MEMORANDA OF UNDERSTANDING FOR COMPETENT AUTHORITIES TO ESTABLISH BILATERAL SAFE HARBOURS”

1 The CBI welcomes the opportunity to comment on the OECD Discussion Draft “Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours” published on 6 June 2012 (hereafter referred to as “the Draft”). The CBI has set out its comments below.

2 As the UK’s leading business organisation, the CBI speaks for some 240,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

GENERAL COMMENTS

3 Any safe harbour regime should be elective:

- The CBI believes that safe harbours should always be elective on the part of the taxpayer. To make them otherwise is likely to put taxpayers at a risk of double taxation. If the safe harbour gives a result different from the arm’s-length standard, then the taxpayer should not be required to follow the safe harbour.

- Bilateral safe harbours offer more protection against double taxation, and therefore have advantages over unilateral safe harbours. However, even bilateral safe harbours should be elective. Forcing taxpayers to abide by safe harbours that are not arm’s length is inconsistent with a long-standing OECD policy.

4 It should be possible to implement a safe harbour whereby certain transactions are exempt from the stringent requirement of preparing documentation:

- The CBI believes that there is value in considering documentation for safe harbours. The purpose of transfer pricing documentation is not always clear. Some countries apply transfer pricing documentation rules as if all potential questions and issues must be addressed within such documentation at the time of filing the tax return. Other countries see transfer pricing documentation as a tool for risk assessment and, ultimately, the decision whether to audit a taxpayer or transaction, or not. It should be possible to implement a safe harbour whereby
certain transactions below certain amounts, e.g. involving “regular” income tax rate countries, are exempt from the stringent requirement of preparing contemporaneous documentation.

5 Availability of access to the mutual agreement procedure:

- In any safe harbour regime, it is essential that access to the mutual agreement procedure is not denied.

COMMENTS ON SAMPLE MEMORANDA OF UNDERSTANDING (MOU)

6 The CBI believes that bilateral MOUs could be very helpful to business. They could be made to work where there are active competent authority relations or political/business pressure. The transparency of the process is important in reducing the perception of cosy deals and incentives. The bilateral nature under the terms of the Treaty is crucial, and removes the limitations in the European Commission’s Joint Transfer Pricing Forum approach (where further progress could not be achieved on an EU-wide basis because of different economic and legal situations between countries).

7 The Draft does not address Section F on Advance Pricing Agreements (“APAs”), but there is an interest from business in a simplified APA process. Such a process could be seen in the MOUs. To some extent, the MOUs under the Competent Authority process are a template for quicker APA agreements. The APAs the CBI’s members normally see respond to the facts and circumstances of the applicants and agree critical assumptions underpinning the pricing that fit those facts and circumstances. The MOU turns the process around and starts with critical assumptions which, if met by the parties, would determine the pricing. Although how the process is called does not matter hugely, there might be a benefit in calling it simplified APAs.

8 Some of the details in the sample MOUs appear unnecessarily strict. In particular:

a. It is unclear why taxpayers who have previously been audited should be precluded from such a safe harbour (paragraph 52(e) of the sample MOU).

b. It is also not clear why recourse to the courts should be prohibited (paragraph 62 of the sample MOU).

c. Audited financial statements may not be prepared in all cases, and may exclude smaller businesses (paragraph 74 of the sample MOU).

d. For Research & Development (“R&D”) services, the use of know-how and other intangibles excludes an applicant (paragraph 82(e) of the sample MOU). It is hard to see how any R&D services provider could provide such services without at least some know-how.
Opinion Statement of the CFE on the OECD Discussion Draft

“Proposed revision of the Safe Harbours section in Chapter IV of the OECD Transfer Pricing Guidelines”

Prepared by the CFE Fiscal Committee

Submitted to OECD Centre for Tax Policy and Administration

in September 2012
Mr. Joseph L. Andrus
Head of the Transfer Pricing Unit
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
FRANCE

Dear Mr. Andrus,

As you are aware, Transfer Pricing is one of the most topical issues for multinational enterprises. Transfer pricing rules determine how international transactions within a multinational company must be priced to ensure that each country receives its fair share of tax.

These rules should have the aim to eliminate double taxation and guarantee improved taxpayers’ compliance.

The above rules are based on the respect of the arm’s length principle, as a concept generally accepted as the best possible means to set prices in intercompany transactions and avoid double taxation on international business. The arm’s length principle is outlined in Article 9 of the OECD Model Tax Convention.

Transfer pricing compliance and transfer pricing administration have become rather complex, time consuming and costly, for both, taxpayers and tax administrations alike.

Taxpayers have to deal with numerous compliance requirements along with the uncertainty that generally surrounds tax positions involving transfer pricing, while tax administrations have limited resources to challenge transfer pricing cases, which are rather complex.

At the same time, transfer pricing has become one of the most controversial tax issues, with a growing number of disputes.

During the past few years, an increasing number of cross-border intercompany transactions could be observed as well as the entry in the international market of a large number of small and medium enterprises (hereinafter, SMEs).

SMEs face more difficulties than multinational enterprises in view of their lack of knowledge, experience on the subject, and resource availability.
In 2011, the OECD officially launched its project on the administrative aspects of transfer pricing, including a review of practices that may be implemented by countries to optimise the use of taxpayers’ and tax administrations’ resources.

The project started with a survey of the transfer pricing simplification measures in existence in OECD and non-OECD countries and led WP6 to review the current guidance on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter, OECD Transfer Pricing Guidelines).

The survey focused specifically on simplification measures adopted by countries as part of their transfer pricing regimes. These include safe harbours, less stringent documentation requirements, reduced penalties, streamlined procedures, etc.

The implementation of some transfer pricing simplification measures could result in advantages for both taxpayers and tax administrations.

From a taxpayer’s perspective, such simplification measures should facilitate transfer pricing compliance, reduce related costs as well as transfer pricing litigation cases, and guarantee certainty with regard to tax positions.

From a tax administrations perspective, such simplification measures eliminate the risk of tax base erosion, and create the opportunity to focus their limited resources on higher risk transfer pricing cases.

It is worth noting that tax authorities in several countries have developed simplification measures to alleviate the burden of taxpayers’ transfer pricing compliance requirements.

Simplification is also requested at OECD level.

The Confédération Fiscale Européenne is pleased to provide inputs on the contents of the Discussion Draft ”Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Related Provisions and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours” (hereinafter, the Discussion Draft) released by the OECD on 6 June 2012, as part of the project on administrative aspects of transfer pricing, officially launched in 2011.

The Confédération Fiscale Européenne strongly supports the OECD project on administrative aspects of transfer pricing, which should be conducted in order to:

- guarantee taxpayers’ certainty;
- facilitate transfer pricing compliance;
- reduce cost compliance; and
- avoid double taxation.

The Confédération Fiscale Européenne’s comments on the Discussion Draft are outlined below.

In commenting on the Discussion Draft, the Confédération Fiscale Européenne has been influenced by the proposed timeline. As a result, our comments are not a comprehensive list of all issues and areas of uncertainty, but a focus on the most significant issues which we believe can be addressed within the
said timeline. This does not preclude the discussion of other issues if it might be convenient to include these within the project.

We will be pleased to answer any questions you may have concerning the Confédération Fiscale Européenne’s comments, outlined below.

Sincerely yours,

Confédération Fiscale Européenne
1. **Introduction**

On 6 June 2012, the OECD published the Discussion Draft “Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Related Provisions and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours” (hereinafter, the Discussion Draft), containing two principal elements:

- a proposed revision of the provisions under Chapter IV of the Transfer Pricing Guidelines;
- associated sample memoranda of understanding for competent authorities to establish bilateral safe harbours.

The OECD released the Discussion Draft as part of its project to improve the administrative aspects of transfer pricing.

The Confédération Fiscale Européenne appreciates the work done by the OECD, the intention of which is to reduce the complexity of transfer pricing compliance procedures.

2. **The safe harbour concept**

The Discussion Draft defines a safe harbour as “a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country’s general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime. Such a provision could (...) allow taxpayers to establish transfer prices in a specific way, e.g. by applying a simplified transfer pricing approach provided by the tax administration. Alternatively, a safe harbour could exempt a defined category of taxpayers or transactions from the application of all or part of the general transfer pricing rules”.

The current Discussion Draft reflects the OECD Transfer Pricing Guidelines which have a negative outlook on transfer pricing safe harbours, discouraging their adoption.

In particular, the current provisions do not reflect the practice of OECD countries, a number of which have adopted transfer pricing safe harbours rules.

Furthermore, the current Chapter IV of the OECD Transfer Pricing Guidelines does not make any reference to the possibility of a bilateral agreement establishing a safe harbour.

The “OECD Multi-Country Analysis of Existing Transfer Pricing Simplification Measures”, released on June 10, 2011, confirmed that many countries have some form of unilateral safe harbours. In
particular, safe harbour rules have been applied to smaller taxpayers and less complex transactions.

The Confédération Fiscale Européenne welcomes the development of safe harbours, as a means to improve both, transfer pricing compliance and transfer pricing administration.

Countries with particularly limited tax administration resources or transfer pricing expertise should also find them helpful.

The Confédération Fiscale Européenne believes that safe harbors should be available to all taxpayers at least for low value-added services and other routine functions.

A clear definition of safe harbours at OECD level and the implementation of their operative guidance could reduce the risk of inconsistency in safe harbours between/among the various jurisdictions as well as taxpayers’ uncertainty.

3. Safe harbours benefits

The Discussion Draft indicates that the use of safe harbours could guarantee the following benefits:

- improved taxpayers’ compliance, simplifying the burden for taxpayers and reducing compliance costs;
- certainty that the taxpayer’s transfer prices will be accepted by the tax administration providing the safe harbour;
- greater administrative simplicity for the tax administration, which could use its limited resources and concentrate its efforts on the examination of more complex or higher risk transactions and taxpayers.

The Confédération Fiscale Européenne welcomes the development of safe harbours, especially for some types of transactions such as low-added value transactions, in order to reduce taxpayers’ compliance burden.

Furthermore, the Confédération Fiscale Européenne believes that the adoption of safe harbours could be of particular help to SMEs, for which the relative burden of compliance is more significant.

The Confédération Fiscale Européenne believes that Chapter IV should provide specific guidance for the application of safe harbours to low-added value transactions and SMEs.

4. Risk of using safe harbours

The Discussion Draft lists the possible negative consequences deriving from the availability of safe harbours:

- divergence from the arm’s length principle;
• risk of double taxation or double non-taxation;
• inappropriate tax planning;
• equity and uniformity issues.

The Confédération Fiscale Européenne emphasizes the importance of a bilateral or multilateral adoption of safe harbours, in order to reduce and/or eliminate the risks listed above.

As stated in the Discussion Draft (paragraph 25), “it is important to observe that the problems of non-arm’s length results and potential double taxation and double non-taxation arising under safe harbours could be largely eliminated if safe harbours were adopted on a bilateral or multilateral basis by means of competent authority agreements between countries. Under such a procedure, two or more countries could, by agreement, define a category of taxpayers and/or transactions to which a safe harbours provision would apply and by agreement establish pricing parameters that would be accepted by each of the contracting countries if consistently applied in each of their countries (...).”

The Confédération Fiscale Européenne appreciates the ongoing work of the OECD on developing sample Memoranda Of Understanding (MOU) for use by competent authorities in negotiating bilateral safe harbour for common categories of transfer pricing cases involving low risk distribution functions, low risk manufacturing functions, and low risk research and development functions.

The Confédération Fiscale Européenne believes that Tax Authorities should

• provide assistance to small and medium size enterprises in making comparable analysis;
• issue guidelines in the application of the cost plus method, for instance by saying that except in exceptional circumstances a cost plus 8% shall not be criticized in case of general headquarters services, cost plus 3%/5% for logistical centers, cost plus 1% for mere reinvoicing, etc.
PROPOSED REVISION OF THE SECTION ON SAFE HARBOURS IN CHAPTER IV OF THE
OECD TRANSFER PRICING GUIDELINES

AND

DRAFT SAMPLE MEMORANDA OF UNDERSTANDING (MOU) FOR COMPETENT
AUTHORITIES TO ESTABLISH BILATERAL SAFE HARBOURS

Dear Mr Andrus:

1. Introduction

We are grateful for the time and efforts which the authors have invested in this particular matter of
safe harbour in that we believe it could open the way for use by Tax Authorities in negotiating
bilateral safe harbour agreements bringing certainty to the transfer pricing policy. In particular, we
appreciate the draft samples of MOU, which are destined to become a model for Tax Authorities.

We are pleased to submit our comments on the discussion draft, which are presented according to
the number of the paragraph at point.

2. Exhibit 1: Draft sample of MOU on low risk manufacturing services

52. (a) According to this paragraph, the Qualifying Enterprise shall conduct business operations
exclusively in the State where it is resident.

According to our understanding the presence of small business operations in other countries, would cause the Qualifying Enterprise not to avail itself of the safe harbour. In order to add certainty to the MOU, it would be interesting to allow the Qualifying Enterprise to conduct business operations predominantly in the State where it is resident, as correctly specified in paragraph 52 (b), namely, that the Qualifying Enterprise is not requested to exclusively perform manufacturing services in its State of residence, it being sufficient that it performs manufacturing services as its predominant business activity.

In any case, minor activities different from those forming the object of the MOU should always be allowed abroad.

52. (e) The Qualifying Enterprise shall not engage in advertising, marketing, distribution function, credit, collection functions or warranty administration functions with regard to the products it manufactures.

We understand that combinations of the said functions may characterize the Qualifying Enterprise as something more than a low risk manufacturing servicer. However, since in complex organizations, it could happen that certain functions are occasionally performed by the provider of manufacturing services, it might be helpful to provide for a certain percentage (low) representing the threshold above which the safe harbour would not be applicable. In such case, the sporadical performance of the aforesaid functions would not immediately exclude the Qualifying Enterprise from the safe harbour, if the functions were related to activities different from those forming the object of the MOU.

52. (f) The Qualifying Enterprise shall not bear any transportation or freight expenses with respect to such finished products it manufactures.

We agree that the Qualifying Enterprise should not bear any risk for the products, however it should be made it clear that the freight costs may be incurred by the Qualifying Enterprise and charged to the associated buyer enterprise.

53. (c) A Qualifying Enterprise should not have total assets in excess of a certain amount.

It could be argued that the amount of assets involved is very much dependent on the type of operations performed, and, therefore, very difficult to estimate. It does not seem that a certain investment in assets could lead to the invalidation of the use of the safe harbour. In order to add certainty to the MOU, it might be helpful to expunge such limit. According to this line of reasoning, the threshold provided by paragraph 53 (b) could be sufficient.

53. (d) A Qualifying Enterprise may not derive more than a \( x \) percent of its net revenues from transactions other than Qualifying Transactions.

The presence of other revenues \textit{sic et simpliciter} should not disqualify the Qualifying Enterprise from availing itself of the MOU, upon the condition that the predominant activity is towards other companies of the same group.

55. (a) and (b) We endorse the sample of remuneration of the Qualifying Enterprise; however, we would consider it proper to include the currency gain or loss not related to items of a financial
nature within the costs. Such items should be considered necessarily related to the business, and, therefore, included.

57. Permanent establishment

It is not clear to us whether the wording of this paragraph serves to disallow the Tax Authorities the possibility to challenge the presence of a permanent establishment whatever the circumstances. If such is the case, it should be made clear in the guidelines that the possibility to assess the Permanent establishment is excluded when the behaviour adopted by the Qualifying Enterprise and by the associated enterprise is substantially respectful of the MOU. This exclusion is the _reward_ for the taxpayers who adhere to the MOU.

3. Exhibit 2: Draft sample of MOU on low risk distribution services

We intend to draft comments similar to those presented for manufacturing services.

In particular:

67. (a) See comments of paragraph 52. (a)

67. (e) The Qualifying Enterprise shall not engage in manufacturing or assembly functions with regards to the products it markets and distributes. See same comments of paragraph 52. (e) where manufacturing or assembly functions could be allowed if not predominant over the distribution services.

68. (c) See comments of paragraph 53. (c)

68. (d) See comments of paragraph 53. (d)

72. See comments of paragraph 57.

4. Exhibit 3: Draft sample of MOU on low risk research and development services

We intend to draft comments similar to those presented for manufacturing services.

In particular:

82. (a) See comments of paragraph 52. (a)

82. (d) The Qualifying Enterprise shall not engage in product manufacturing and assembly functions, advertising, marketing and distribution functions, credit and collection functions, or warranty administration functions.

The presence of other operations _sic et simpliciter_ should not disqualify the Qualifying Enterprise from availing itself of the MOU, upon the condition that separate accounting records are kept in order to allow Tax Authorities to audit the Qualifying Transactions and related costs.
83. (c) See comments of paragraph 53. (c)

83. (d) See same comments of paragraph 53. (d)

85. (a) See same comments of paragraph 55. (a)

87. See same comments of paragraph 57.

Please feel free to contact us if you have any queries about this letter.

Marco Melisse and Sebastiano Sciliberto
Partners of CM & Partners Studio Associato

CM & Partners Studio Associato is a tax firm, which has advised multinational companies for more than twenty years.
Comments on the OECD Safe Harbours Draft of June 6, 2012

Dear Mr. Andrus,

We are pleased for the opportunity to submit our comments on the Safe Harbours Draft. We have also had the opportunity to read through the letter of comments submitted by USCIB dated August 28, 2012, as published on their web home page. As we share all comments therein, including the praise for the positive shift in the Draft about safe harbours, we will focus our comments below on unilater safe harbours, which the Draft discusses somehow in a negative tone.

Bilateral (or multilateral) agreements clearly allow for the optimal compromise between certainty, compliance simplicity, risk management and fair allocation of taxing rights. The sample MOUs attached to the Draft do illustrate all significant benefits of bilateral approaches.

Statistics and professional experience show, however, that unilateral rulings, agreements and APAs, if compared to bilateral ones, do provide benefits in that they are less time-consuming and simpler to manage.

MNEs face different level of risks depending on each Country’s tax policy on business investments, inbound or outbound. Same Countries do have a stable tax environment, others face continuous reforms and amendments affecting stability and certainty on investments. Revenue authorities and auditors have different attitudes or even different budgetary objectives and constraints from time to time. Tax laws of certain Countries allow the Revenue to collect taxes provisionally, wholly or partially, on the basis of tax assessments before any judicial review by exposing MNEs to major cash flow constraints. Other Countries do not provide for that.

MNEs may also have developed different relationships with the tax authorities’ of a given Country with a business-friendly approach or focusing on capital import objectives compared to others. Some MNEs may also have transactions suitable for safe harbours between subsidiaries of Countries with comparable levels of effective tax rates, others between a low-tax company and a high-tax one. Tax life in the daily practice gives a whole range of experiences.
In some of the above scenarios, particularly if the relevant Countries have different attitudes, different effective tax rates and/or unbalanced taxing powers in the relationship with taxpayers, a unilateral safe harbour may be the most practical and beneficial instrument both to MNEs and tax authorities to achieve certainty, respectively, on tax burden and collections.

We will therefore hope that the WP6 discussions on the Draft will lead to a revision that will highlight the benefits of bilateral and multilateral safe harbours without negative emphasis on the unilateral ones, which may prove beneficial to MNEs and tax authorities equally in quite a range of scenarios.

As transfer pricing is not an exact science, any unilateral safe harbour, if based on arm’s length principles and ranges, should not lead to major exposure of double taxation or non-taxation by, thus, achieving an effective balance between certainty, compliance simplicity, risk management, and tax revenues collection.

We trust that any resolution that WP6 will be making on the revision of the safe harbours Draft will be guided by consensus on the overarching goal of simplification for all stakeholders. Safe harbours would be an instrument of simplification at times in which legitimate requests of many Countries to get a thorough understanding of the transfer pricing policy applied by MNEs have caused an increasingly burdensome level of transfer pricing documentation compliance in most Countries on top of all further reporting compliance about intragroup transactions (as requested for accounting purposes, FIN 48-type documentation, etc., as generally applicable to all MNEs.)

*   *  *

Thank you again for the opportunity to participate in the discussion on the subject matter.

Sincerely,

Gaetano Pizzitola
Head of Cross-Border Tax Services
Crowe Horwath Italy

Fabio Zampini
Cross-Border Tax Manager
Crowe Horwath Italy
14 September 2012

Dear Mr. Andrus,

**RE: Comments on the proposed revision of the section on safe harbours in Chapter IV of the TPG**

De Witte-Viselé Associates ("DWVA") thanks you for the opportunity given to comment on this revision of the section on safe harbours in Chapter IV of the Transfer Pricing Guidelines ("TPG") issued on 6 June 2012.

We are pleased to provide you hereby with our comments on this topic for which benefits can hardly be perceived without a firm consensus of the international community and tax authorities on this topic.

Below, you will find our comments related to the update of the TPG regarding the use of the safe harbours and our comments regarding the draft Memoranda Of Understanding for the application of certain safe harbours.

We respectfully hope that these comments will help the OECD to improve its TPG and permit to both tax payers and tax authorities to ease the compliance with transfer pricing regulations.

In the meantime we remain at your disposal for any further explanation regarding the comments we made.

Sincerely,

Leslie Van den Branden  
Partner  
De Witte-Viselé Associates

Aleksandr Natanelov  
Manager  
De Witte-Viselé Associates

Benoît Desirrotte  
Manager  
De Witte-Viselé Associates
Following the request for comments regarding the “Administrative aspects of transfer pricing” on 9 March 2011, we would like to congratulate the OECD for its prompt reaction and the recent release of the “Proposed revision of the section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines” (hereafter the “Safe Harbour Revision”).

Responding to different echo’s coming from the business community, the use of the safe harbours in the transfer pricing context could, despite of its theoretical limitations, be a way of improving and easing the compliance of targeted taxpayers or transactions.

The following sections of the present document present our comments relative to the Safe Harbour Revision. Starting by observing that the recommendations did not change substantially as such (section I), we will then highlight (and welcome) the distinction made by the OECD between the safe harbour rules and the compliance with the arm’s length principle (section II). In the last (third) section, we will provide the OECD with specific comments regarding the draft MOU and their scope.
I – SAFE HARBOUR REVISION ARE RELATIVELY SIMILAR TO THE PREVIOUS RECOMMENDATIONS

First of all, we generally observed that the benefits of safe harbour regimes highlighted in the Safe Harbour Revision are similar to the ones contained in the original recommendations of the TPG. Furthermore, we also observed that the concerns remained in general unchanged (or even toughened) and therefore don’t seem to be tempered in light of today’s general need to find easier ways to comply with transfer pricing dispositions.

The Safe Harbour Revision is drafted in a careful way, embedding all the conditions to avoid any generalisation regarding the position taken by the OECD in this respect. The mere definition of safe harbour measures has indeed slightly been restricted. The former drafting of the OECD recommendations was including administrative simplification measures in favour of certain categories of taxpayers/transactions. However, the current Safe Harbour Revision restricts its recommendations only to the determination of acceptable transfer prices. More clarifications regarding the use of different types of administrative simplification measures, as envisaged by the business community (full documentation relief, partial documentation relief), are still welcomed in order to ensure consistency in their use.

On a different note, we welcome the designation of the safe harbour as a “rebuttable presumption (...) under which a mandatory pricing target would be established by a tax authority, subject to a taxpayer’s right to demonstrate that the target price is inconsistent with the arm’s length principle when applied in the taxpayer’s case.” This formulation gives the taxpayer the possibility to choose the most convenient way of complying with transfer pricing rules, either by using a safe harbour, or documenting its intercompany transactions by means of an arm’s length compliant transfer pricing documentation.

When dealing with the concerns over safe harbours, the OECD reported certain risks that were not identified in the previous recommendations (e.g. possibilities of “safe harbour shopping”, adverse selection in case of optional regime), maintaining that the use of safe harbour should be done at the sole discretion of the different tax authorities and that their application should follow well defined criteria. One may also note that safe harbour shopping would in principle be more likely to happen within larger international groups having transactions in a large number of jurisdictions. Appropriate anti-abuse rules will need to be enforced to avoid such use of safe harbour provisions.

We also welcome the position taken by the OECD acknowledging that the safe harbours might diverge from the arm’s length principle (section E.4.1.), representing a trade-off between a strict compliance with the arm’s length principle (Article 9 of the OECD Model Tax Convention (MTC)) and a simplification of the administrative measures aiming at resolving any “difficulties or doubts arising as to the interpretation or application of the Convention” (Article 25(3) of the OECD MTC).

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1 Articles of the OECD Model Tax Convention On Income and Capital.
The OECD may still put forward some concerns against the use of safe harbours, however it also opens a door to mitigate those risks through international cooperation and in particular the conclusion of bilateral or multilateral international dialogue regarding safe harbours. We welcome the conclusions of the OECD on the safe harbours which are generally more positive than the former TPG. The new provisions on safe harbours acknowledge that it might be more beneficial for “smaller” taxpayers, for which the cost of compliance with the arm’s length principle sometimes outweigh the risk of adjustment they are bearing.

II – THE SAFE HARBOUR REVISION AVOIDS THE DEBATE REGARDING THE ARM’S LENGTH NATURE OF SAFE HARBOURS

The Safe Harbour Revision acknowledges that the use of safe harbours “(...) may not correspond in all cases to the most appropriate method applicable to the facts and circumstances of the taxpayer under the general transfer pricing provisions”\(^2\). It also states that “(...) such efforts to set safe harbour parameters accurately enough to satisfy the arm’s length principle could erode the administrative simplicity of the safe harbour”\(^3\) – read – it would become neither a transfer pricing analysis in line with the arm’s length principle, nor a safe harbour.

The TPG are aimed at guiding taxpayers and tax authorities regarding the interpretation of Article 9 of the Convention (i.e. the determination of arm’s length transactions) and we agree on the approach of the OECD to link the safe harbours concept to Article 25(3)\(^4\) of the Convention, to avoid any confusion between the use of safe harbours and the application of the arm’s length principle\(^5\).

We agree with the position taken by the OECD, considering that we should move away from the intention to make “arm’s length safe harbours”. Safe harbours are administrative simplifications aimed at improving transfer pricing compliance and not “once for all” interpretations of the arm’s length principle, requiring, by definition, a case-by-case analysis.

\(^2\) Safe Harbour Revision, §17, p.6.
\(^3\) Safe Harbour Revision, §18, p.6.
\(^4\) Administrative measures adopted by Competent Authorities, in order to simplify the interpretation and application of the Conventions under certain conditions (ruled by Article 25 of the Convention).
\(^5\) General Arm’s Length principle ruling the allocation of profit between related enterprises (Article 9 of the Convention).
III – MOU FOR COMPETENT AUTHORITIES TO ESTABLISH BILATERAL SAFE HARBOURS

The OECD proposed, attached to the Safe Harbour Revision, three drafts of MOU setting the remuneration for intercompany transactions relative to given Qualifying Enterprises, involved respectively in “low risk manufacturing services”, “low risk distribution services” and “low risk research and development services”.

We made below our comments regarding all three MOU; please note that our comments are, unless specified otherwise, common to all MOU as they remain conceptual.

- **A – Qualifying Enterprise**

The MOU foresees the application of the safe harbour to Qualifying Enterprises meeting certain criteria.

Generally speaking, we would recommend focusing the application of the safe harbour based on the characteristic of intercompany transactions instead of the characteristics of Qualifying Enterprises. Limiting the application of the safe harbours to taxpayers presenting certain financial characteristics is susceptible to create distortions in the competitive environment. Indeed, the intercompany activities of a taxpayer are not always reflected by its financial statements (covering sometimes other activities with third parties or other non-related intercompany transactions).

In order to avoid having “biased” financial statements, the Qualifying Enterprise would be granted the benefit of the safe harbour only if it is involved in a single type of activity. Paragraph 52 (b), (d), (e), (g) of the various MOU’s insists indeed on the limited number of activities that the Qualifying Enterprises should be carrying out to permit the application of the safe harbour.

Although we understand the logic behind these criteria, we estimate that companies involved in one single type of activities are mostly met within highly integrated (and centralized) group structures (e.g. such as principal structures), mainly implemented within sizeable international groups, which are not directly targeted by this type of measures. In line with the transactional approach of the TPG, applied in the context of transfer pricing analyses, the eligibility criteria could instead be articulated on a transactional basis; any taxpayer demonstrating its intercompany transactions meet the selection criteria set for the safe harbour would therefore be able to benefit from it. Such demonstration would obviously be easier for companies involved in one single type of activity but would give the opportunity to companies involved in more than one type of intercompany transaction to benefit from the safe harbour regime in case they have the analytical tool to demonstrate the “routine” nature of their intercompany transactions.

In this respect, we would also like to refer to the practical experience we had in Belgium in the past with our well-known Belgian Service Centre Regime and Belgian Distribution Centre Regime which were meant to constitute safe harbours for selected taxpayers.
In order to be able to benefit from the abovementioned regimes, it was sufficient to demonstrate that the taxpayer complied with the qualifying criteria on a divisional basis rather than on a legal entity basis in order to have sufficient flexibility to integrate qualifying safe harbour activities in existing legal entities. The taxpayers were required to keep separate (management) accounts in order to identify the financials for the application of the safe harbour rules. This approach worked very well in practice and adhered to the needs of the international business community.

We detailed below our comments on each selection criterion, unless explicitly mentioned otherwise, our comments may also be valid for all MOU.

(a) No comments;

(b) As explained above, we would favour a transactional approach for the application of the safe harbour;

(c) No comments;

(d) This criteria, which, in fine, aims at ensuring the PnL of the enterprise is not influenced by non-related activities is only relevant if those activities are directly related to the intercompany transaction at stake. On the contrary, a simple isolation of those non-related costs should suffice to carve out their impact on the intercompany results (see § 54);

(e) Similarly, the application of the safe harbour may be jeopardised if those revenues are directly related to the intercompany transaction at stake. On the contrary, should those revenues be related to third party transactions, the taxpayer who is capable to exclude those revenues from its intercompany results could still be able to benefit from the safe harbour regime;

(f) No comments;

(g) In the case of “low risk manufacturing services” and “low risk distribution services”, nothing should refrain a company involved in general managerial, legal, accounting or personnel management functions to benefit from the dispositions of the safe harbour, when it demonstrates the “routine” nature of its intercompany transactions. It will, however, be important for the taxpayer to isolate the “routine” transactional results attached to such activities (i.e. not influenced by its managerial, legal, accounting or personnel management functions);

(h) In the case of “low risk manufacturing services” and “low risk distribution services”, following the same reasoning as for the other comments, the importance of the certain assets should be limited to the analysis of the intercompany transaction at stake and not to the whole company;
(i) In the case of “low risk manufacturing services”, the limitation relative to the finished product inventory should only concern products to be sold intercompany within the scope of the safe harbour.

- **B – Determination of the Taxable Income of the Qualifying Enterprise**

In the determination of the taxation income relative to “low risk manufacturing services” and “low risk research & development services”, we noticed that one only refers to the mark-up that should be applied on all costs of the Qualifying Enterprise, excluding net interest expenses, currency gain or loss and any non-recurring costs.

Due to the ‘single-activity’ approach taken in the MOU, no definition or identification criteria of the cost base is included in the respective MOU. We highly recommend to reconsider this in order to enable to apply safe harbour regimes on a transactional basis rather than on a legal entity basis.

- **C – Other clauses (PE, Election and Reporting Requirements, Termination of the Agreement)**

No specific comments.

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13 September 2012
Our ref: JH/AL/MS AP-8

Dear Mr Andrus

Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines

We welcome the OECD’s project to improve the administrative aspects of transfer pricing, and the review of the guidance on safe harbours in particular, and appreciate the opportunity to comment on the proposals.

We agree with the comments in the discussion document that the current section in Chapter IV of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (‘the OECD guidelines’) on safe harbours is unduly negative, and that in certain circumstances safe harbours can provide a useful means of reducing the administration burden for taxpayers and tax authorities.

Complying with transfer pricing requirements is a time-consuming and expensive consideration for multinational groups. The availability of safe harbours, either qualitative or quantitative as discussed below, may provide an opportunity to reduce the compliance cost for taxpayers, as well as permitting tax authorities to focus their limited resources on areas with the most significant transfer pricing risk. Used appropriately, safe harbours may enable tax authorities to increase the efficiency of their yield from transfer pricing enquiries and provide taxpayers with much-desired certainty.

Comments on the proposed changes to Chapter IV of the OECD guidelines.

We are broadly in agreement with the proposed changes to Chapter IV of the OECD guidelines as recommended in the discussion draft.

We agree that there is a risk that poorly designed unilateral safe harbours could initially distort taxpayer behaviour in favour of the tax authority offering the safe harbour. However, we agree that there is a question whether this would be of ultimate benefit to taxpayers, because of the likelihood of audit and adjustment by the tax authority in the counterparty country under the arm’s length principle and the issue
of whether the country offering the safe harbour would be prepared to allow mutual agreement adjustments in consequence. In such circumstances there would be at best no administrative advantage in having safe harbours and at worst be unrelieved double taxation. Well-designed, appropriate safe harbours should not distort taxpayer behaviour, but should provide administrative certainty.

We agree that the OECD’s proposal for bilateral safe harbours removes many of the issues that could arise in relation to unilateral safe harbours. Assuming parity of transaction flows, there will not be incentives for one country to offer a safe harbour with the intention of attracting taxable profits. In addition, the bilateral nature of the agreement should negate the audit challenges and subsequent MAP discussions which add to transfer pricing compliance costs.

The two key benefits that we see for taxpayers in having bilateral safe harbours offered by tax authorities are: lower compliance costs (including a reduction in tax authority audits) and certainty. These benefits are of great value to businesses, including in areas of low transfer pricing risk where compliance costs are perhaps disproportionately high and there remains no certainty that transfer prices will not be subjected to tax authority audit in one or more countries. There is perhaps significant benefit for taxpayers in having safe harbours offered for such low risk transactions, because these may not be eligible for advance pricing agreements (APAs) where tax authorities have had to limit an APA programme to complex or high value transactions in order to be able to adequately resource them. In addition, the costs of obtaining an APA by an individual taxpayer may be prohibitive where the volume of transactions is low. The bilateral safe harbours proposed by Working Party 6 in the discussion draft seem to us to offer an alternative form of APA: an APA available to many taxpayers, covering specified transactions and subject to parameters.

For cross-border transactions between two countries that have agreed a suitable safe harbour compliance costs are likely to be much reduced, although businesses (and tax authorities) will need to ensure that the transactions fall within the requirements specified for the safe harbour to apply. Once satisfied on this point, businesses will have greater certainty as to their tax liabilities in the countries concerned, which has additional benefits including more accurate forecasting and tax provisioning in statutory accounts and known cash and currency requirements.

Optional use of the arm’s length principle

We agree that it is appropriate and important for taxpayers to always have the option to apply the arm’s length principle instead of any safe harbour. This would maintain the cohesion of existing double tax treaties and mean that safe harbours could be offered as an administrative simplification rather than a move away from the arm’s length principle.

Competent authority resources required to agree safe harbours

We recognise that there will be an up-front resourcing cost for tax authorities in agreeing bilateral safe harbours as proposed in the discussion draft, but long-term such safe harbours should be efficient for tax authorities in allowing a focus of resources on complex and high risk transfer pricing matters, and a reduction in audit and MAP cases. As such, we would welcome encouragement in the OECD guidelines for tax authorities to agree bilateral safe harbours.

The most significant challenge for taxpayers that we foresee with bilateral safe harbours is that they cannot influence countries agreeing them, and it may take many years before sufficient bilateral safe harbours exist to reduce significantly an organisation’s compliance costs in respect of low risk
transactions. There is also a concern that the time required in negotiating bilateral safe harbours may require a diversion of competent authority resources away from existing APA and MAP work.

Potential areas for safe harbour negotiation and the draft memoranda of understanding (‘MOUs’)

The example MOUs offered by the discussion draft suggest a useful framework for competent authorities in approaching safe harbours. Whilst low risk manufacturing and low risk distribution activities might fit within such a framework, we question whether contract research and development is a good example of low risk activity, as in our experience tax authorities seldom agree that it is. We would not want this example to unduly delay the agreement of bilateral safe harbours in other circumstances.

Safe harbours could provide benefits for other types of transactions that are relatively straightforward to price. For example, head office and shared service centre (back office) services are commonplace. There is work in this area that taxpayers would have to undertake on a facts and circumstances basis – such as allocating costs according to an appropriate allocation key, excluding shareholder costs and identifying pass-through costs on which no mark-up should be applied. However, the level of mark-up applied to such services is typically in a narrow range and the time spent benchmarking such a mark-up can be onerous. We would welcome a further MOU that considers safe harbour for the mark-up to be applied to such low-value adding services.

Quantitative and qualitative safe harbours

Safe harbours can be either qualitative, excluding certain types of transaction as discussed in the discussion draft, or quantitative, setting margins or de minimus thresholds below which a country’s transfer pricing regulations would not apply. Whilst the discussion draft does not consider quantitative safe harbours, we consider that a good example that works effectively is the UK’s unilateral regime to exempt small and medium-sized enterprises from UK transfer pricing requirements. The small and medium-sized enterprise thresholds are set by the European Commission, and therefore have international understanding. The UK Exchequer is protected by exceptions from the exemption in two circumstances: firstly, where the other party to the transaction is in a country which does not have a double tax treaty with the UK that contains a non-discrimination article (to prevent against abusive transactions with tax havens being outside of the scope of UK transfer pricing) and secondly, for medium-sized companies only, where the UK tax authorities issue a notice that UK transfer pricing rules should be applied. In practice, such notices are very rare but this exception provides a sensible deterrent against transfer mispricing to achieve deliberate UK tax avoidance. We should be grateful if Working Party 6 would consider whether some amendments could be made to the guidance in chapter IV of the OECD guidelines to encourage countries to consider, on a unilateral or if necessary bilateral basis, exempting small and medium-sized enterprises from transfer pricing requirements. This is of particular benefit because transfer pricing compliance costs have a disproportionate effect on small and medium-sized enterprises relative to the size of transactions, and can be a barrier to international expansion for such businesses.

Quantum of debt (thin capitalisation)

We note that the current discussion draft specifically excludes any consideration of safe harbours in relation to quantum of debt (thin capitalisation). We recognise that this can be a difficult area in which to obtain international consensus, but for taxpayers this is a key issue and one where safe harbours would be welcomed. Countries such as New Zealand already have unilateral quantum of debt safe harbours and use them to great effect.
We would be happy to discuss our thoughts in this area further with you.

Yours sincerely

John Henshall
Deloitte LLP
Dear Mr. Joe Andrus:

Thank you for the continued opportunity to work with the OECD and its Working Party No. 6 on Transfer Pricing and attendant International Tax Issues and most specifically the “Proposed Revisions of the Section on Safe Harbours” dated June 6, 2012. I welcome the opportunity to continue this dialogue with the OECD and its Working Party in light of our earlier recommendations outlined in our related and attendant submission dated June 29, 2011. I believe that the progress that the OECD has made since June 29, 2011 has been thoughtful and measured and brings practical and implementable alternatives and approaches that are mutually beneficial to both taxpayers and tax authorities under certain defined circumstances.

Introduction

I agree that there is a correct time and place for tax simplification and easing the administrative burden as identified in our recommendations dated Jun 14, 2012. I continue to recommend that the practicality of Safe Harbours (Now Herein “SH”) should not be considered in a vacuum in that I believe that an equitable approach for Safe Harbours be congruent with the interests of tax authorities, taxpayers, and the interests of applicable tax treaties and their respective Competent Authorities or MAP. I believe Safe Harbours should be negotiated bilaterally and multilaterally for practicality.

New Informational Return Model - For Safe Harbour Elections

While the Discussion Draft raises many potential nuances and intricacies of a Safe Harbour, I choose one of the issues that we believe will be the most difficult to deal with simply because the OECD cannot control other country’s promulgation of tax laws, regulations, and country-specific statutes. Providing testimony to IRS and Treasury on
the most current version of Low-Margin Service Regulations, I have first hand experience in dealing with the initiatives of IRS and the U.S. Treasury Department in their most recent efforts at Safe Harbours for services. Collective insights lead us to the conclusion that the biggest obstacle that the OECD will face in potentially moving forward is the risk of double taxation or lack of deductibility of service costs when a lack of symmetry exists among various taxpayers in countries that do not conform to a potential universal standard set out by the OECD for its member countries. For this reason, I believe that a requirement of any potential Safe Harbour would require the taxpayer to affirmatively elected the Safe Harbour by filing an information return with its tax return indicating which countries may potentially be impacted by the Safe Harbour Provision. This informational filing would accomplish two objectives as well as providing more and much needed taxpayer transparency to the tax authorities. It would allow thorough examination of the cross border participants and whether a tax treaty would prevent the threat of double taxation. Moreover, the informational filing would “notice” the relevant tax authorities of the participating countries that a Safe Harbour provision has been “elected” into amongst the member countries or that a tax treaty otherwise exists that eliminates the need for the respective tax authorities to spend time on smaller and limited scope routine transactions allowing an easing of administrative burden and freeing up time for larger and higher dollar volume transactions.

This author does believe that a subset of transactions needs to be limited in scope and nature. I do not believe that the safe harbour, however, should be limited only to smaller MNE’s as advanced by the OECD’s Discussion Draft. Smaller transactions, as to be set by the OECD in consultation with Working Party No. 6 and the Practitioner Community, should be electable by the taxpayer. In other words, larger MNE’s with smaller margin and more routine transactions should be eligible at the election of the taxpayer for the Safe Harbour Provision. I believe that transactions that categorically yield low margins at or below shareholder or stewardship activity already covered by the OECD Guidelines such as low margin services or alternatively the transfer of various soft forms of intangible property whose value is easily benchmarked, or loans (as defined by the OECD in consultation of OECD, its Working Party No. 6, and the Practitioner Community should be) should be eligible for Safe Harbour Election. Various forms of “Soft Intangible Property” (Now Herein “IP”) that typically yield returns of 3% of Net Sales or less such as processes, procedures, systems, methods, et al should be considered for aforesaid Safe Harbour Treatment. I believe that these “Covered Safe Harbour” forms of IP will require further consideration and enumeration to be determined by the OECD and its relevant Working Party No. 6 in consultation with the Practitioner Community.

I believe that the same opportunity exists for low margin services outside the scope of shareholder and stewardship services already covered. The Discussion Draft raises as one of the weaknesses of the Safe Harbour the lack of parity from tax jurisdiction to tax jurisdiction. This author believes that with IRS and Treasury’s Services Project and
attendant OECD Safe Harbour Guidelines Initiative, the stage is now properly set for the OECD to consider a “unified approach” that would bring parity within the two leading Promulgators of Transfer Pricing Guidance and leadership. One of the main challenges that the OECD’s Discussion Draft points out is that the lack of parity can result in double taxation or uncertain deductibility treatment by the associated enterprises. In fact, this author testified before IRS and Treasury twice before and asked that they seek guidance and input from the OECD to better understand the implication of their efforts in the context of double taxation exposure for MNE’s. The OECD is correct in its characterization that as the United States went to implement its Covered Low-Margin services that did not always require documentation, other countries began to deny deductions for services that would otherwise have been contemporaneously documented and subject to the proofs required by foreign jurisdictions to obtain deductibility criteria.

This author also agrees that a potential Safe Harbour may be subject to abuse if potential CUP’s exist. One limiting criteria for the potential application of a Safe Harbour would be that the transaction be benign and routine in nature in that it does not possess any special attributes that a potential CUP comparison would produce a different answer than the Safe Harbour Election would produce. The risk for the proper characterization of the covered Soft Forms of IP, loans, or low-margin services would reside with the taxpayer, but be duly noted and subject to regulatory review and oversight by its disclosure on an Informational Return similar in nature to the Canada Revenue Agency Form T-106 Information Return that requests information of the related parties to the transaction, the quantum of the transaction, the countries involved in the intercompany transaction, and most importantly the characterization of the intercompany transaction which would indicate service, intangible property, tangible property, or financing.

Once again, I appreciate the opportunity to provide testimony on these all-important issues of Safe Harbours as they relate to Transfer Pricing and look forward to our continued work with the OECD and its attendant Working Party No. 6 on Transfer Pricing and International Tax Issues. If you have any comments or questions, please do not hesitate to contact me directly.

Kindest Regards,
John K. Drewno, B.A., M.A., J.D.

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The OECD Discussion Draft on Safe Harbors -- and Next Steps

by Michael C. Durst
August 6, 2012
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Michael C. Durst is a columnist for Tax Analysts. From 1994 to 1997, he served as director of the IRS advance pricing agreement program. This is the second in a series of three articles addressing recent OECD discussion papers. The first article, on the OECD's discussion draft on intangibles, appeared in Tax Notes on July 16, 2012; a third article, on the relationship between the discussion drafts and risk-shifting under transfer pricing rules, is coming.

In this article, Durst argues that the OECD discussion draft on safe harbors represents a useful step toward a workable system of transfer pricing rules. More steps must be taken, however, if the OECD is to achieve its apparent goal of removing impediments to effective transfer pricing administration around the world. The article concludes with reflections on the challenges facing the OECD and on the potential role of non-OECD countries in developing transfer pricing rules for global application.

The views expressed in this article are solely those of the author.

Overview

On June 6 Working Party 6 of the OECD's Centre for Tax Policy and Administration issued a discussion draft recommending that the OECD adopt changes to its transfer pricing guidelines relating to the use of safe harbors in simplifying transfer pricing administration. The discussion draft envisions that tax administrations will develop safe harbor ranges of arm's-length margins and markups for use in benchmarking the incomes of relatively uncomplicated business operations conducted by members of multinational groups. The authors append to the discussion draft detailed templates that competent authorities might use in establishing bilateral safe harbors governing three common types of situations: low-risk distribution operations, low-risk manufacturing operations, and the provision of low-risk research and development services. In recommending the use of safe harbors, the discussion draft would reverse the strongly negative assessment of safe harbors contained in the OECD transfer pricing guidelines as issued in 1995.

The discussion draft, in my view, responds in a sensible manner to some of the most common and serious practical difficulties that have arisen in transfer pricing practice over the past several decades. Attempting, over the years, to perform "from the ground up" factual and comparables analyses for each individual business operation, regardless of its uniqueness or complexity, has led to very large and in a great many cases prohibitive compliance costs. Despite the high costs incurred, however, the relative paucity of available comparables has caused comparable analyses to yield results that are too approximate and uncertain to be used by tax authorities in enforcement. As a
result, transfer pricing enforcement efforts around the world, even in relatively straightforward factual situations, have proven difficult and, in far too many instances, ineffectual. In many cases, transfer pricing rules are effectively unenforced because national tax administrations have no practical means of identifying clear benchmarks for acceptable arm's-length levels of income.3

The need for a more cost-effective and workable approach has become more acute as developing countries, which typically are not OECD members, have become increasingly involved in the global economy. These countries need access to simplified enforcement tools to have any realistic chance of enforcing transfer pricing rules and generating badly needed tax revenues. The perceived complexity of OECD transfer pricing methods, in the absence of safe harbors, has contributed in recent years to tension between the OECD and the tax authorities of some developing countries. It is fair to interpret Working Party 6’s discussion draft on safe harbors as a step toward meeting the expressed needs not only of OECD member countries but also of developing countries that are not OECD members.

Presumptions

Some taxpayers might not like paragraph 9 of the discussion draft, which states that countries might want to place some presumptive weight behind safe harbor ranges to facilitate enforcement.4 Although this paragraph may seem discordant to some commentators, it must be remembered that transfer pricing rules are intended to constitute antiavoidance tools for use in tax enforcement, and for antiavoidance tools to be effective in practical application they must have some teeth. Long-standing experience has now made clear that requiring tax administrations to engage with taxpayers in case-by-case donnybrooks of detailed factual analysis, without the guidance of clear presumptions of some kind, simply is not realistic; requiring this approach has proven to be a recipe for tax anarchy rather than tax enforcement. The authors of the OECD discussion draft appear to recognize that an enforceable transfer pricing system that sensibly balances taxpayer and government interests will need to contain a presumptive element.

The discussion draft observes correctly that to prevent overreaching in enforcement, a taxpayer should be afforded opportunities to obtain relief from safe harbors when the safe harbors are plainly inappropriate to the taxpayer’s facts. To permit reasonably cost-effective enforcement, however, this relief should be available only if the potential overtaxation of the taxpayer is substantial relative to the size of the taxpayer’s related-party transactions. The unavoidable fact is that tax enforcement in many areas -- not only transfer pricing -- requires a trade-off between (i) precision in differentiating among the factual situations of different taxpayers and (ii) the practical demands of real-world enforcement. For example, tax laws typically allow for depreciation according to relatively rough schedules, rather than trying to estimate "economic depreciation" in every instance; and the tax laws establish an arbitrary percentage of the cost of business meals that is to be considered incurred for business, as opposed to personal, purposes. Neither kind of presumption is likely to be truly "correct" against a standard of perfect measurement of the taxpayer's net income, but perfection in income measurement is an impossible standard, and the tax laws wisely allow for reasonable presumptions in appropriate cases.
No extreme resolution, in favor of either taxpayers or governments, of the necessary trade-off between precision of income measurement and the practical administrability of tax laws is likely to be sensible. Instead, a balance is necessary. The kind of rebuttable presumption envisioned by the authors of the OECD discussion draft appears to represent such a balance, even though maintaining the appropriate balance in practice is likely to require continuing care and effort on the part of tax administrations. The approach to presumptions in the discussion draft seems the best approach that's reasonably available, and it should be maintained.

**Double Taxation**

In the past, probably the most common argument against safe harbors has been that by permitting deviations from the "correct" margin or markup in a particular case, a safe harbor could subject taxpayers to some level of double taxation. Indeed, in transfer pricing policy discussions over the past several decades, some have seemed to argue that any possible exposure of any taxpayer to double taxation, under a particular set of transfer pricing rules, renders those rules unacceptable. The discussion draft on safe harbors takes a more sophisticated view of the problem of double taxation. It acknowledges that exposure to double taxation is inherently undesirable, but it also recognizes that in practical tax administration there must be some degree of trade-off between protection of taxpayers against double taxation and other important goals. One of those goals is the need for enforceability -- or, as we transfer pricing specialists have taken somewhat awkwardly to saying, a need to avoid double nontaxation. Importantly, the discussion draft generally appears to treat the avoidance of double nontaxation as equivalent in importance to the avoidance of double taxation.

The discussion draft also acknowledges another important goal, which historically has not been given sufficient emphasis in transfer pricing policymaking: namely, the goal of certainty in tax administration and enforcement. Just as the possibility of double taxation might inhibit international trade and investment, so might uncertainty in the effective tax rates that multinational businesses are likely to face. By reducing uncertainty, even at the cost of some additional exposure to double taxation, safe harbor rules may well result in an overall enhancement of the climate for international trade and investment. Further, safe harbors provide certainty not only to taxpayers but also to governments, thereby affording governments greater confidence in their fiscal planning. Overall, the reduction of uncertainty for both governments and taxpayers might be among the most important contributions of greater use of safe harbors in transfer pricing administration.

As a general matter, the discussion draft displays a preference for bilateral and multilateral, as opposed to unilateral, safe harbors. As long as that preference is not interpreted as precluding unilateral safe harbors when mutual agreement mechanisms are not available, I would agree that the draft's preference rests on firm ground. After all, as the discussion draft points out, when countries on both sides of a related-party transaction have agreed in advance to a particular safe harbor, the likelihood of both double taxation and double nontaxation can be greatly reduced or even eliminated. Moreover, as the discussion draft points out, there is precedent for successful bilateral implementation in the 1990s of a safe harbor regime for maquiladora manufacturing operations near the U.S.-Mexico border. When countries have in place experienced and well-staffed competent authority functions, it would seem sensible for the countries to
seek a high level of involvement of the competent authority process in the design and implementation of safe harbors.

Especially from the standpoint of the least-resourced developing countries, however, it is important to encourage the development of safe harbor rules even when they are implemented unilaterally. Bilateral and multilateral safe harbors require both extensive treaty networks and well-resourced competent authority staffs, and some developing countries have neither. Moreover, the effective negotiation of tax treaties by developing countries requires difficult policy choices and a high level of international tax experience, and the development of extensive treaty networks and competent authority staffs is likely to remain a long-term project for many countries. The less-resourced developing countries will be among those that can gain the greatest benefits from safe harbors in terms of efficient enforcement and greater certainty of tax revenues, and those countries should be encouraged to adopt them, even recognizing that in most cases developing countries will need to adopt safe harbors on a unilateral basis.

Next Steps for Simplification

The discussion draft on safe harbors, along with the OECD's similarly promising discussion draft on transfer pricing for intangibles, together represent only an early stage of the OECD's ongoing project to bring much-needed simplification to international transfer pricing law. To achieve the dual goals of (1) enabling transfer pricing rules to curtail large-scale tax avoidance and (2) enabling governments to administer and enforce the rules at a reasonable cost and with reasonable predictability, the OECD will need to follow up its initial efforts with additional analyses and proposed guidelines. OECD's further efforts should include the following:

The first article in this three-part series suggested further steps to be taken in the area of transfer pricing for intangibles, and a forthcoming article will suggest steps related to the handling of taxpayers' business risks in transfer pricing rules. With respect to the topic of safe harbors, an important further step -- and it will be a challenging one -- will be to devise simpler and more uniform profit split methods for use where the kinds of safe harbors addressed in the OECD discussion draft cannot be applied. The discussion draft promotes safe harbors for use only with "one-sided" transfer pricing methods that can be applied with reference to financial data from only a single member of a multinational group. These methods -- the most commonly used of which is the transactional net margin method, or in U.S. terminology, the comparable profits method -- often are useful in benchmarking the arm's-length incomes of relatively subordinate operations within multinational groups, such as limited-risk distributors, manufacturers, and service providers, which usually are not seen as developing valuable intangible assets for their own account.

For intangibles-creating business operations, more complex transfer pricing methods, often involving profit splits, must be used. Currently, the guidelines envision that taxpayers and tax administrations will draft profit splits for multinational groups on a case-by-case basis, based on extensive analyses of the facts and economics of each taxpayer's business operations. This always has been an impossible expectation, and as a result transfer pricing enforcement for complex, high-income business operations has in many instances ground to a costly halt. For the transfer pricing system to work, substantial simplification of profit-split methods will be required, similar to the
simplification envisioned in the OECD safe harbor draft for one-sided methods. This simplification will be very difficult because of the complexity and high-income levels typically associated with business operations for which profit-split methods are appropriate. Nevertheless, the simplification of profit-split methods is a nut that must be cracked if transfer pricing rules under the paradigms of the current OECD guidelines are to prove administrable and enforceable.

Two Concluding Comments

As evidenced by the two pending discussion drafts, the OECD appears to be trying to address, through meaningful but still-incremental reforms, the two major problems that have to date proven intractable under the OECD transfer pricing guidelines: (1) vulnerability of the transfer pricing rules to large-scale shifting of income to low- and zero-tax jurisdictions; and (2) undue complexity in the rules, which has often interfered with enforcement and has given rise to unacceptably high compliance costs. I have, in recent years, expressed the view that these two difficulties reflect deficiencies in the basic reasoning on which the guidelines are constructed. In particular, I have argued that (1) reliance on searches for comparables cannot realistically be expected to generate data of sufficient quality to be useful in day-to-day tax administration; and (2) attempting to fashion transfer pricing methods on a case-by-case basis for all of the millions of transactions in which members of common groups engage around the world is an impossible, self-defeating, and damaging task. Some of my criticisms have suggested that a program of incremental reform, like the one on which the OECD has embarked, however thoughtful and well intentioned, cannot in the final analysis succeed. Instead, I and others have argued, it will be necessary to go back to the basics and to implement an essentially new system of greatly simplified profit splits, to achieve a reasonable balance between the accurate measurement of taxpayers' net incomes on one hand, and enforceability and administrability on the other.

The only way that I can reconcile, for the time being, my skepticism of the feasibility of incremental reform, and the OECD's apparent determination to seriously pursue that reform, is to hope that my skepticism has been unwarranted and that the OECD's current efforts prove successful. Certainly, there is much in the new discussion drafts to warrant an increased level of optimism. Also, even if the OECD's reform efforts ultimately fall short of their intended goals, (1) some elements of the current OECD efforts, including the revision of guidelines related to safe harbors, are likely in themselves to provide valuable benefits, particularly for developing country tax administrations; and (2) even if attempts at reform prove less than fully successful, the process of seriously seeking reform should develop knowledge, including empirical understanding of multinational business transactions, that could ultimately contribute to the realization of a better functioning international tax system. I therefore believe that the OECD's reform efforts deserve the vigorous support of tax administrations around the world. The OECD's efforts also deserve the serious attention, both encouraging and, where warranted, critical, of all who desire the improvement of international tax methods, particularly in a time of global economic constraints when that improvement is needed especially urgently.

A final comment relates to the role in the reexamination of transfer pricing rules of countries that are not members of the OECD. The OECD comprises only a minority of countries, and it is natural for nonmember countries to desire a forum in which all
countries, including developing countries, have a political voice in deciding on guidelines that are to be recommended for global application. This is not to deny the value of the high degree of technical expertise and experienced judgment that has been gathered among the OECD's personnel, nor is it to deny -- as illustrated by the recent Working Party 6 discussion drafts -- that despite the limitations of its membership base, the OECD is capable of articulating rules that should be useful to both member and nonmember countries. Nevertheless, the eagerness of the OECD to work cooperatively with developing countries, although surely beneficial, cannot substitute for an independent voice for those countries in policymaking.

A sensible approach, I believe, would be to encourage and support the continuation and expansion of the OECD's efforts to revise its guidelines, but concurrently to promote the development of a forum of broad international membership, perhaps built around the current U.N. tax committee, as a center for developing and evaluating guidelines for transfer pricing administration. This forum would operate in cooperation and coordination with the OECD and other multinational organizations but would also maintain its institutional independence. The forum would be supported financially at a level that can support a staff of high qualifications and reasonable size, similar to that of the OECD.

This approach, toward which the U.N. committee already has made some progress, should not be seen as undesirable duplication of effort. Views on transfer pricing quite legitimately differ around the world, sometimes because of the different economic and political situations of different countries, and a stable and effective global network of transfer pricing rules will require some tolerance for differences of approaches among countries that face different economic and political circumstances. Ensuring that countries in many different situations are politically enabled and have adequate supporting resources to articulate diverse approaches to resolving problems in international taxation seems essential to the development of a system that will be seen as operating fairly, effectively, and stably over the long term.

**FOOTNOTES**


2 These problems are demonstrated vividly by the deficient state of the contemporaneous documentation that taxpayers around the world are supposed to prepare to explain the detailed analyses that they are conducting. The head of transfer pricing at the OECD has observed that "transfer pricing documentation is some of the least informative literature that you will ever read." See "Andrus Favors Multilateral Approach to Safe Harbors, Simplified Documentation," *Tax Mgmt. Transfer Pricing Rep.* (Feb. 9, 2012). In response to these concerns, the OECD has expressed an intention to make wider recommendations for reforming the practice of transfer pricing documentation, in addition to addressing documentation problems to some extent in the discussion draft on safe harbors.
3 See the discussion of this point in Durst, "Pragmatic Transfer Pricing for Developing Countries," Tax Notes Int'l, Jan. 23, 2012, p. 279, Doc 2011-25096, or 2012 WTD 7-11.

4 Paragraph 9 states:

[A] rebuttable presumption could be established under which a mandatory pricing target would be established by a tax authority, subject to a taxpayer's right to demonstrate that the target price is inconsistent with the arm's length principle when applied in the taxpayer’s case. It would be essential in such a system to permit resolution of cases of double taxation arising from application of the mandatory pricing target through the mutual agreement process.

5 See, e.g., paragraph 11(2) of the discussion draft.

6 See discussion draft paragraph 46.


END OF FOOTNOTES

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Joseph L. Andrus  
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via mail - joe.andrus@oecd.org

Ernst & Young comments Safe Harbours and Timing Issues

Dear Mr. Andrus,

Ernst & Young wishes to thank you for the opportunity to submit comments regarding the Discussion Draft of the OECD project on the “Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours” (the “OECD Safe Harbours Discussion Draft”) as well as on the OECD’s Draft on “Timing Issues Relating to Transfer Pricing” (the “OECD Timing Issues Draft”).

Ernst & Young commends the work of Working Party No. 6 of the OECD Committee on Fiscal Affairs in its effort to improve the administrative aspects of transfer pricing and to provide practical guidance on the topics of safe harbours and timing issues. We are particularly pleased at the willingness of OECD to reconsider its position on safe harbours since this offers an opportunity to focus resources on more significant issues and we are sure that all countries and particularly the non-OECD countries will appreciate this move towards greater simplification.

This letter presents the collective view of Ernst & Young’s global transfer pricing network. We agree to have our comments posted on the OECD website.

If you have any comments or questions, please feel free to contact any of the following:

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Yours sincerely,

On behalf of Ernst & Young,  
Prof. Dr. Thomas Borstell  
Global Director - Transfer Pricing Services
1  OECD Safe Harbours Discussion Draft

Ernst & Young has already on several occasions concurred with the OECD’s intention to address practical and administrative aspects of implementation of the Transfer Pricing Guidelines (“TPG”). With the proposed revision of the section on Safe Harbours in Chapter IV of the TPG the OECD has made an important step forward in this respect.

Ernst & Young agrees with a widely stated position that the replacement of the generally negative view regarding the use of safe harbours in the present TPG by a position that the benefits of safe harbours may outweigh the related concerns may seem a small step, but can potentially be one with a major impact. The change in position on the use of safe harbours and not least the guidance on the use of bilateral or even multilateral agreements in this respect has the potential to significantly decrease the number of transfer pricing disputes, and is therefore endorsed by Ernst & Young.

In this respect, Ernst & Young welcomes the suggested sample memoranda of understanding that country competent authorities may use to establish such bi- or multilateral safe harbours, which are suggested as additions to an Annex to Chapter IV of the TPG. Not least because of the notion in paragraphs 60, 75 and 90 that the qualifying enterprise and its relevant associated enterprise are relieved from the obligation to comply with otherwise applicable transfer pricing documentation requirements in State A (respectively State B) with respect to the qualifying transaction if the election and reporting requirements of this memorandum of understanding are satisfied and reporting income is calculated in accordance with its terms in a timely filed tax return for the respective year. Given the potential for disputes whether such requirements are met, the OECD may consider to provide more guidance on when the requirement of “a detailed calculation of the income of the Qualifying Enterprise from Qualifying Transactions applying the principles of this memorandum of understanding” would be met.

Although the OECD’s report on allocation of profits to permanent establishments contains the notion that the guidance provided by the TPG should be applied by analogy, the OECD may consider to express that this also includes the amended section on safe harbours including the suggested use of memoranda of understanding.

Paragraph 19
Appreciating the issue raised in paragraph 19 that “[C]ountries may also be concerned over the ability of taxpayers to opt in and out of a safe harbour” the OECD also may consider implementing the notion that the fact that a taxpayer would not opt for the safe harbour approach should not be taken into account by the tax administration in determining whether to commence an examination of that taxpayer (analogous to paragraph 4.156 TPG).

Ernst & Young supports the development and deployment of multilateral Safe Harbour negotiations as substitutes or complements to bilateral negotiations. Such practices would be especially feasible under the aegis of existing and functional supranational bodies such as the European Union. These practices would serve to synchronize and simplify Safe Harbour rules across jurisdictions, thereby aiding business competitiveness on regional and global scales.

Paragraphs 29 and 30:
Finally, Ernst & Young would like to note that paragraphs 29 and 30 of the draft both appear to imply that it is easy to shift profits to a tax haven. This creates a tension with the notion of the guidelines that “[T]ax administrations should not automatically assume that associated enterprises have sought to
manipulate their profits”. The OECD should consider amending these paragraphs to prevent any misleading and unintended impression.
2 Comments on OECD Timing Issues Draft

[Omitted]
Mr. Joe Andrus  
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14 September 2012  

Dear Joe  

Draft on safe harbours  

Grant Thornton UK LLP together with Members and Correspondent firms of the Grant Thornton International organisation, welcome the opportunity to comment on the paper issued on 6 June 2012 by the Secretariat of Working Party No 6, regarding safe harbours.  

Overview  

We welcome the discussion of the suitability of safe harbours. We consider that in some circumstances safe harbours can provide a welcome relief for taxpayers from the burden of transfer pricing compliance. Furthermore, bilateral safe harbours may reduce the pressure on demand for APA programmes and speed up APAs being negotiated. However, our view remains that safe harbours could lead to the over-simplification of many transfer pricing issues and that this will ultimately reduce compatibility with the arm’s length principle. This document sets out our views on which situations may be appropriate for safe-harbours to be introduced, and where we would be opposed to their introduction.  

Exemptions for small and medium enterprises  

Paragraph 3 of section E.1 of the proposed revision to the Transfer Pricing Guidelines (TPG) notes that some countries have adopted safe harbour rules for small and medium enterprises (SMEs).  

We consider that unless they are exempt from transfer pricing rules, SMEs bear a compliance burden that is disproportionate to the quantum of the potential underpaid tax at stake. As such, we support the OECD in promoting a safe harbour for SMEs.  

An OECD-wide SME exemption should build a uniform approach across all countries. Presently, where transactions are conducted between two entities, one with a local SME exemption and one without, documentation should be required to satisfy the requirements of one territory. This limits the value of the exemption.  

We would therefore welcome the introduction of an SME exemption to all OECD countries. Ideally, the criteria for an enterprise to be treated as an SME should be consistent across all territories to maximise the value of this exemption.  

Paragraph 3 of section E.1 of the document notes that such exemptions are generally valued by taxpayers and tax administrations, and we would like to see the OECD provide further encouragement for their wider adoption.
Introduction of a transaction level exemption

In addition to an SME exemption, we would encourage the introduction of a threshold for inter-company transactions, beneath which there would be no requirement to comply with transfer pricing requirements.

Under existing guidance, multinational companies are required to test an arm’s length basis for pricing each transaction, regardless of quantum. Even for large groups this can represent a significant burden on resources, which may be better utilised focusing on ‘core’ transactions.

A transaction level exemption would reduce the administrative burden for large numbers of taxpayers, and would give the taxpayer welcome opportunity to concentrate resources on higher risk areas.

It would be a necessary prerequisite for a taxpayer to perform some work to ensure that the transaction is quantified properly so that it can accurately be compared with the threshold.

Concerns over safe harbours

Section E.4 of the consultation document discusses various concerns over safe harbours.

In our view, the adoption of safe harbours for ‘core’ transactions could lead to an oversimplification of the transfer pricing methodology. For example, a safe harbour for remunerating low value added services could be applied broadly by large numbers of taxpayers, but in some cases further examination may identify that the service adds more value than previously thought and hence the transaction is not a low value added service after all. We do not believe that there is a short cut or substitute for preparing a functional analysis to identify the nature of the transaction in the first instance. Notwithstanding, if a safe harbour is adopted it should not require tax payers to prepare large amounts of supporting documentation as this would erode the administrative benefits of such provisions.

Despite our reservations, we would view the introductions of multilateral or bilateral safe harbours as being preferable to unilateral safe harbours, even though it may prove difficult to agree multilateral safe harbours. Both parties to a transaction need to be aligned with the same safe harbour rules in order to gain a benefit, and if the safe harbour does not exist under similar rules in the other jurisdiction, then the potential for double-taxation remains.

Examples of appropriate safe harbours

We consider that there are two specific types of transaction where safe harbours could be of considerable value to the taxpayer.

Debt funding

Paragraph 10 of section E.2 of the discussion draft notes that the scope of the document does not include tax provisions designed to prevent "excessive" levels of debt in foreign subsidiaries.

We consider that there should be wider use of safe harbours to indicate an appropriate level of intra-group debt funding for a company. In some jurisdictions, it is possible to agree with tax authorities whether intra-group debt levels are appropriate, but this negotiation is complex, costly and time-consuming. The introduction of safe harbours for debt levels could provide considerable clarity for taxpayers and significantly reduce the administrative burden that is faced by companies that are heavily reliant on debt finance.

The discussion draft on safe harbours specifically excludes debt funding and capitalisation levels, and we would welcome further comment and discussion in this area.
Shared administrative services

From our experience, many large multinational companies have a central company that provides shared administrative (sometimes described as ‘low value’ or ‘back office’ services) services to other group companies in a number of different jurisdictions. We consider that a safe harbour for these services may be more appropriate than it would be for other transactions, as the nature of these services are often similar, and potentially they are less susceptible to variation across industry.

If the OECD could identify an appropriate arm’s length mark-up for such services, taxpayers could gain certainty and minimise the need to use resources in documenting and benchmarking these transactions. The OECD consultation document does not specifically mention appropriate safe harbours for such services but this would be an area where we would specifically welcome their broader adoption.

Memorandum of Understanding

The discussion also includes a draft sample Memorandum of Understanding that could be used by two tax authorities to agree a range of acceptable margins that should be earned upon the provision of a given service, for example low risk manufacturing distribution or contract R&D.

While we acknowledge the benefits of such agreements, as discussed earlier we do not always believe that safe harbours are appropriate for core transactions. We believe that adopting safe harbours for different classes of intercompany transaction could encourage a one-size-fits-all treatment that would be inconsistent with the arms’ length principle. However, where they are used, we prefer multilateral or bilateral safe harbours to unilateral safe harbours, and the MOU proposal is helpful here.

Conclusion

As discussed above, we do not consider that safe harbours necessarily give outcomes that are aligned with the arms’ length principle. However, we acknowledge that they can help relieve the administrative burden for taxpayers and tax authorities alike. With that in mind, we consider that there are some circumstances where they would be welcomed, particularly for SME or certain transaction-level exemptions. The target transactions should be low value-added, low risk and non-core transactions. If carefully defined, there should then not be a significant impact on the tax base of any jurisdictions.

To minimise the costs of applying a safe harbour, the required supporting documentation should be kept to a minimum. We also consider that there is a requirement for consistency across the OECD countries. Where safe harbours are adopted, we welcome the use of bilateral or multilateral agreements as we consider that unilateral safe harbours have limited value to many groups, and we welcome the publication of the draft MOU.

We wish to thank Member and Correspondent Firms of the Grant Thornton International organisation for their support and input into this response.

Yours sincerely

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October 23, 2012

Via mail and email

Re: Comments on the Proposed Revision of the Section on Safe Harbors in Chapter IV of the OECD Transfer Pricing Guidelines

Dear Mr. Andrus,

We welcome the opportunity to respond to the PROPOSED REVISION OF THE SECTION ON SAFE HARBOURS IN CHAPTER IV OF THE OECD TRANSFER PRICING GUIDELINES AND DRAFT SAMPLE MEMORANDA OF UNDERSTANDING FOR COMPETENT AUTHORITIES TO ESTABLISH BILATERAL SAFE HARBOURS (“Discussion Draft”) issued on June 6, 2012.

We agree that simplification measures to the current transfer pricing regime would be beneficial to both taxpayers and tax authorities in certain situations, and we applaud the efforts of Working Party No. 6 in its preparation of the Discussion Draft. This letter provides several recommendations that may help to advance the principal objectives of the Discussion Draft. Our response draws upon our experience in providing advice and analysis for both taxpayers and tax authorities in transfer pricing matters.

I. Initially Restricting Safe Harbors to Smaller Taxpayers and Subsequently Relaxing the Restriction

We believe that measured steps should be taken to test the efficacy of the proposed safe harbors so that the “law of unintended consequences” does not adversely impact taxpayers or tax authorities in
any significant way. Such measured steps are implicit in Para 35, E5 of the Discussion Draft,\textsuperscript{1} and we would suggest limiting the safe harbors, at first, to companies that report a maximum annual consolidated exchange-rate equivalent net turnover of less than 250 million Euros. Cursory research indicates that there are in excess of 17,000 companies with operations in multiple jurisdictions that report net turnover between 50 million and 250 million Euros.\textsuperscript{2}

It is our experience as transfer pricing practitioners that the cost to document a relatively simple transfer pricing transaction does not vary significantly with the tax burden associated with the transaction, so small companies will greatly benefit from the certainty associated with a safe harbor. It is also our experience that small companies frequently operate in a limited number of tax jurisdictions and have relatively straight-forward transfer pricing transactions. These factors should lead to less concern among tax authorities that safe harbors will invite perceived abuse. At the same time, there should be enough companies within this size limitation for tax authorities to evaluate and react to any systemic adverse consequences of the safe harbors before widening the application of safe harbors to a broader set of participants.

We would also emphasize that this size limitation should not be permanent. The size restrictions should allow tax authorities to more easily embrace safe harbors at their onset. Assuming that the safe harbors are well-designed, the benefits to tax authorities and taxpayers should quickly become apparent. Thus, we would recommend that any guidelines issued by the OECD include a timeline to relax or eliminate our proposed size limitations in future years.

II. Industry Exclusions are not a Reliable Guideline for an MOU

The individual draft Sample MOUs found in the Discussion Draft (Para 53 (a) for Low Risk Manufacturing Services, Para 68 (a) for Low Risk Distribution Services, and Para 83 (a) for Low Risk Research and Development Services) allow for a Qualifying Enterprise to be excluded from a safe harbor if it conducts its principal operations in a specified industry. In theory this is a smart division, because firms within an industry should operate similarly and have similar financial

\textsuperscript{1} “...in cases involving smaller taxpayers or less complex transactions, the benefits of safe harbours may outweigh the problems raised by such provisions.”

\textsuperscript{2} We relied the Oriana and Amadeus databases of Bureau van Dijk and the S&P Capital IQ database to form our estimates. We have eliminated companies operating in multiple jurisdictions and reporting net turnover of less than $50 million Euros to avoid any bias of very small companies that may not be subject to transfer pricing rules. Our research indicates there are in excess of 168,000 such companies.
results. In reality, industry definitions are imprecise and the financial results of firms classified within an industry can widely vary. When divergent financial results are due to structural economic differences across firms, versus short-term idiosyncratic factors, the safe harbors as proposed in the Discussion Draft run the risk of creating highly variable financial results across associated enterprises of different firms in any country.

This concept is closely related to the discussion in Para 3.31 of the OECD Transfer Pricing Guidelines, since the safe harbors in the Sample MOUs of the Discussion Draft are cast as one-sided analyses:

… A one-sided analysis may not take into account the overall profitability of the MNE group from the controlled transactions for purposes of comparability. A one-sided analysis potentially can attribute to one member of an MNE group a level of profit that implicitly leaves other members of the group with implausibly low or high profit levels. While the impact on the profits of the other parties to a transaction is not always a conclusive factor in determining the pricing of a transaction, it may act as a counter-check of the conclusions reached.

Thus, to minimize the variance of financial results across associated enterprises of different companies, we would suggest that some consolidated financial metric(s) should be satisfied by a taxpayer electing a safe harbor, and perhaps in lieu of an industry restriction. Strictly as an example that should not to be construed as a numerical recommendation, if a safe harbor allowed a Qualifying Enterprise a margin of 3% of net sales for its Low Risk Distribution Services, then one might require that the consolidated margin of the transactional chain for the Qualifying Enterprise and its associated enterprises must exceed an average of 8% of net sales over a three year period. We believe this restriction will enhance the robustness of long-term acceptance of safe harbors among treaty partners. We also believe that because financial results may be overly variable in a one year period, such consolidated financial metrics should be employed over a longer time period, such as a three- or five-year average.

III. Care must be Taken so the Safe Harbor does not to merely Shift the burden from a Comparables Analysis to the Burden of Defining an Entity
The Sample MOUs address safe harbors for three different types of entities: Low Risk Manufacturing Services, Low Risk Distribution Services, and Low Risk Research and Development Services. In practice, such entity definitions are useful labels to generally describe the activities of an entity when performing a transfer pricing analysis. Frequently practitioners rely upon these definitions as a starting point to frame a search for comparables that match the risk profiles of an entity that is part of a transactional value chain.

However, if the descriptions of the activities a Qualifying Enterprise can provide are not well-defined, and if financial tests are not appropriate for the type of activities rendered, then the safe harbors may merely shift the focus of contention in the transfer pricing arena from comparable selection to entity definition. We can envisage scenarios where the definitions will become a significant point of contention between a taxpayer and a tax authority. (For example, the MOU on Low Risk Distribution Services envisages that the Qualifying Enterprise may engage in marketing activities. Yet, it is our experience that “marketing activities” can be construed quite differently across firms.) If tax authorities perceive that the misclassification of activities is a prevalent fact pattern, then it is quite possible that the cost to determine a transfer price for a company is not truly reduced under a safe harbor – the cost is simply shifted to another transfer pricing playing field.

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We thank you for the opportunity to provide comments to the Safe Harbor, and commend the OECD on its activities. We would be happy to provide additional clarification on our comments or respond to any further questions, at your request.

Sincerely,

Michael Heimert, Phd
President
Ceteris

Nelly Korsun
Director
Ceteris

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3 The opinions expressed in this letter are those of the authors and do not necessarily reflect the views of Ceteris or its clients.
September 14, 2012

Mr. Joseph L. Andrus
Head of Transfer Pricing Unit, Centre for Tax Policy and Administration
Organization for Economic Co-operation and Development (OECD)

Subject: Comments on the Discussion Draft on the revision of the section on safe harbours in chapter IV of the OECD transfer pricing guidelines.

IFA Mexican Branch (IFA Grupo Mexicano, A.C. and hereinafter referred to as IFA MX) is pleased to comment on the discussion draft of the above mentioned subject. Our comments on the interim draft are as follows:

IFA MX believes that under the current wording, given the different nature of the arm’s length principle and the safe harbor (SH), if a taxpayer chooses a unilateral SH approach, it is not clear if they resign to their right to invoke a MAP or not. We would welcome further guidance on this issue.

Furthermore, we would like to suggest stressing throughout the document that, in general, safe harbors should be considered as an option for the taxpayer rather than an obligation, since by nature the safe harbor should not be considered as arm’s length.

Finally, we would welcome the inclusion of materiality rules to transactions of small amount.

* * * * *

The members of IFA MX are pleased to provide these comments to contribute to the further development of the OECD Transfer Pricing Guidelines.

Yours sincerely,
Mr. Joe Andrus,
Head, Transfer Pricing Unit
OECD

Comments on OECD “Discussion Draft: Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbour”

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. in response to the invitation to public comments by OECD regarding “Discussion Draft: Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbour.” The Japan Foreign Trade Council is a trade-industry association with trading companies and trading organizations as its core members, while one of the main activities of its Accounting & Tax Committee is to develop the trade environment by submitting specific policy proposals and requests to government authorities concerning tax matters. (Member companies of the Accounting & Tax Committee of JFTC are listed at the end of this document.)
The Sample MOU (Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours) contained in the Discussion Draft presents a series of drafts pertaining to low risk manufacturing services (Exhibit 1), low risk distribution services (Exhibit 2), and low risk research and development services (Exhibit 3).

Among these, the Draft Sample MOU on Low Risk Distribution Services (Exhibit 2) presents the range of the ratio of net income before tax to total net sales as a safe harbour standard under the chapter entitled “Determination of the Taxable Income of the Qualifying Enterprise.”

However, assuming that a low risk distributor acting as an intermediary especially without any physical possession of the products provides functions corresponding to operating expenses and does not provide other significant functions, we believe it is reasonable to set as a safe harbour range the Berry’s Ratio or the ratio of net income before tax to total cost as in the case of Exhibits 1 and 3.
Japan Foreign Trade Council, Inc.

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Sumitomo Corporation
Toyota Tsusho Corporation
Yuasa Trading Co., Ltd.
To    Joseph L. Andrus, Head of Transfer Pricing Unit,  
OECD’s Centre for Tax Policy and Administration

From    KPMG’s Global Transfer Pricing Services Practice  
(Clark Chandler and Francois Vincent)

Cc    Stephen Blough, Sean Foley, Loek Helderman, Andrew Hickman, Matthias Kaut, John Neighbour, 
Kari Pahlman, Rema Serafi, Prita Subramanian,Montserrat Trape, Brian Trauman, Matthew Whipp

OECD Invitation to Comment on the Discussion Draft “Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours”

Professionals in the Global Transfer Pricing Services practice of KPMG welcome the opportunity to comment on the OECD’s Discussion Draft titled “Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours: 6 June to 14 September 2012” (“Discussion Draft”).

KPMG congratulates the OECD for drafting and circulating the Discussion Draft as quickly as it did given all the energy that must also have gone into the intangibles project. Releasing the Discussion Draft early shows clear commitment on the part of the OECD to engage the business community in a dialogue during the drafting process.

KPMG’s specific comments on the Discussion Draft are as follows:

Safe harbours should be elective:

Safe harbours should always be elective on the part of the taxpayer. To make them otherwise is likely to put taxpayers at risk of double taxation. As the Discussion Draft notes, unilateral safe harbours only protect taxpayers from adjustments by one of the two or more tax authorities with an interest in a transfer pricing transaction, and KPMG’s experience is that many tax authorities will simply not respect or give any weight to the safe harbours offered by other tax authorities.

Under such circumstances, mandatory unilateral safe harbours may lead to a high risk of double taxation and/or the need to seek resolution in Competent Authority. For example, if the tax authority of a taxpayer providing administrative services to its affiliates imposes a mandatory safe harbour of cost plus 10 percent, and the tax authorities of the counties that are paying for these services conclude that the right arm’s length amount is cost plus 5 percent, the taxpayer is put in a position where it cannot comply with the mandatory safe harbour and the arm’s length standard as
interpreted by the other tax authorities without incurring double taxation. If the safe harbour gives a
result different from the arm’s-length standard, then the taxpayer should not be required to follow
the safe harbour.

Bilateral safe harbours offer more protection against double taxation, and therefore have advantages
over unilateral safe harbours. However, while concern over double taxation is reduced (and
possibly eliminated) if two tax authorities agree on a safe harbour, there is no guarantee that the safe
harbour agreed to by the tax authorities will either (i) respect the transaction as set up by the
taxpayer (e.g., a tax authority may require single function manufacturing entities to not report a loss,
even though the taxpayer may have set up the manufacturer as a risk taker) or (ii) be consistent with
the internal administrative constraints faced by the taxpayer (e.g., the safe harbour may require a
controlled distributor to fall within an operating margin range of 2 percent to 4 percent, but the
taxpayer’s accounting system may not have the capability of complying with that requirement).
Therefore, even bilateral safe harbours should be elective – forcing taxpayers to abide by safe
harbours that are not arm’s length in inconsistent with long standing OECD policy.

Safe harbour simplification of documentation:
A discussion of safe harbours from the obligation of documentation is absent from the Discussion
Draft. We believe that it would be useful to revisit the purpose of transfer pricing documentation.
More specifically, some countries currently apply transfer pricing documentation rules as if all
potential questions and issues must be addressed within such documentation which must be
prepared by the time the relevant tax return is filed. Other countries see transfer pricing
documentation as a tool for risk assessment (and, ultimately, the decision whether to audit a
taxpayer or transaction, or not). In our view, it should be possible to implement a safe harbour
whereby certain transactions below certain amounts, involving “regular” income tax rate countries,
etc., are exempt from the stringent requirement of preparing contemporaneous documentation.
However, in such circumstances, taxpayers would still have the burden of answering any question
or issue raised during an audit of such transaction, if such an audit nonetheless occurred.

Determining optimal use of resources:
As safe harbours are meant to optimize the use of transfer pricing resources both for taxpayers and
tax administrations, it would be useful for tax authorities to understand how effectively their
transfer pricing administrative resources (i.e., audit, examination and dispute resolution resources)
are spent. In turn, this would indicate where such resources are “wasted” because of low or no
return on the investment of these resources resulting arguably from the lack of abuse in the system.

KPMG suggests the approach described below to assist tax authorities in establishing parameters
around safe harbours. Each tax jurisdiction could undertake to analyze its administration of transfer
pricing transactions along the following lines:
• Number of transfer pricing audits undertaken in a year (including audits resulting in no adjustments);
• Number of hours spent by auditors, appeals officers, competent authority staff (where applicable) and attorneys (where applicable) in finalizing transfer pricing audits, and related costs (including external costs);
• Type of transaction and transfer pricing methodology used by the taxpayer; and
• Taxpayer’s filing position vs. final resolution of case.

If the above information is broken down into various categories such as size of taxpayer, size of transaction and type of transaction, then a matrix should emerge indicating where most of the risk lies and, conversely, which areas are not worth the tax authorities’ time. Thus, it should indicate where gains could be made in better investing both the tax authorities’ and taxpayers’ resources by implementing safe harbour rules.

For instance, such an analysis might indicate that a safe harbour of cost-plus x percent to y percent for low-risk manufacturing could easily be applied to all such transactions between, purely for the purpose of an example, Germany and France as data would show that adjustments above or below that range are generally not sustainable (in court and via the mutual agreement procedure) and thus constitute a waste of tax authorities’ time and resources.

**Permission for mutual agreement procedure:**

We recommend that safe harbour regulations include a provision permitting the mutual agreement procedure. With unilateral safe harbours, unless the unilateral safe harbour is de facto below an arm’s length charge (like the Services Cost Method in the US), there is a reasonable risk of double taxation and hence the need for further mutual agreements procedures. It is essential to state that in case a safe harbour is applied by the taxpayer, the opportunity to apply for mutual agreement procedure is not reduced.

**Addressing non-taxation of income:**

In Paragraph 19, the Discussion Draft indicates that one concern with an elective safe harbour is that taxpayers may abuse it by reporting the safe harbour pricing to one tax authority and arm’s length pricing to the other tax authority, with the result that any income arising because of the difference in these two prices essentially disappears and is not subject to taxation by either tax authority. KPMG believes that this issue can be addressed easily through the wording of the safe harbour; e.g., that there is a safe harbour of cost plus x percent provided that the same price is reported to all interested tax authorities.
Authority to challenge abusive or inconsistent use of safe harbours:

The Discussion Draft notes that one of the concerns with allowing safe harbours is that they may allow taxpayers to engage in abusive tax planning and/or may be misused to lower taxable income. While KPMG believes that such concerns are exaggerated in the case of well-crafted safe harbours, it also recognizes that the concern exists and that tax authorities have a legitimate interest in preventing such abuse. Because of this, and in the spirit of trying to get much of the benefit of safe harbours without exposing tax authorities to undue risk, KPMG suggests that many tax authorities may be more comfortable with having a safe harbour that gives a taxpayer a strong presumption of correctness, but which nevertheless allows the tax authority to challenge a taxpayer’s use of the safe harbour if that use is abusive or inconsistent with the purpose of the safe harbour. While allowing tax authorities to rebut a taxpayer’s use of a safe harbour has the clear disadvantage of lowering certainty, this cost may be worth it if it makes tax authorities more willing to use safe harbours.

In this regard, KPMG believes that the position taken in the Discussion Draft in Paragraph 9, which would set up a transfer pricing rule that is initially mandatory for taxpayers, but which would allow the taxpayers to rebut this mandatory pricing standard, is backward. As noted above, KPMG strongly believes that safe harbours should be elective on the part of taxpayers.

Encouraging experimentation with safe harbours:

Given tax authority concerns over taxpayer abuse of safe harbours, it is important to note that safe harbours can be put in place for a period of time, and then withdrawn or amended if taxpayers are found to be abusing them. The Discussion Draft should encourage tax authorities to experiment with safe harbours, secure in the knowledge that they can discontinue or change safe harbours that are not meeting their policy interests.

Creative ways of setting up safe harbours:

The Discussion Draft should encourage tax authorities to set up safe harbours in creative ways that achieve an appropriate balance between the risk of lost income due to the safe harbour and the cost of complying with the arm’s length standard. For example, a tax authority could set up an elective safe harbour operating margin range of 3 percent to 5 percent for a low risk distributor, with the provision that no adjustment would be made unless that adjustment led to a change of at least xx (the table below sets this threshold at 100,000 for illustrative purposes) in taxable income or deduction. This would provide an effective range of protection that is very high for small transactions, but which declines as transaction volume increases. (See table below.)
Thus, as long as the taxpayer initially reports income that is consistent with the safe harbour, it is very unlikely that the tax authority will propose an adjustment on a small transaction unless it thinks that the taxpayer has substantially mischaracterized the transaction – with a transaction volume of 1,000,000, no adjustment could be made unless the tax authority thought that the right arm’s length operating margin should either be less than -6 percent or more than 140 percent, which is unlikely in the case of a low risk distributor. As the transaction volume increases, the level of protection falls, and it essentially disappears when the transaction volume reaches 10,000,000.

This is not the only way of constructing a safe harbour that links the magnitude of revenue at risk with compliance cost, and KPMG is not recommending it as the best way. In fact, we note that the system described above potentially leads to unequal treatment of taxpayers having similar function and risk profiles and may not be looked upon favorably by some tax authorities. It is simply provided to illustrate that with a little creativity it is possible to come up with mechanisms that lower compliance and administrative costs on transactions where there is limited income at risk while protecting tax authorities in the case of transactions where more substantial income is at stake.

**Easing compliance burden:**

The OECD should encourage tax authorities to apply safe harbour concepts in ways that ease compliance burdens, even if they do not provide full fledged safe harbour protection. For example, a tax authority could publish “safe” ranges for low risk distributors, low risk contract manufacturers, with the transfer pricing documentation requirement limited to a short statement as to why these ranges are appropriate to the tested party. Tax authorities would have the right to audit and challenge that taxpayer’s rationale for using the safe ranges, but as a practical matter taxpayers are likely to use this only when they feel that there is a high chance that they can in fact persuade the tax authority that the safe range applies. As a practical matter, this may simply be publicizing approaches that tax authorities are already using in audits.
Lessons from the EU Joint Transfer Pricing Forum ("JTPF"):

The 27 EU Tax Administrations and the 16 representatives of the private sector comprising the EU JTPF, have explicitly or implicitly, supported the use of safe harbours.

Safe harbours are also explicitly endorsed in the EU JTPF report “Transfer Pricing and Small and Medium-Sized Enterprises (SMEs)” of 4 March 2011 as a means of providing “a measure of simplification for SMEs as well as saving on administrative resources and reducing compliance burden.”

The EU JTPF report “Guidelines on Low Value Adding Intra-Group Services” includes mark-up considerations similar to a safe harbour approach. It is noted that in regard to low value adding services the mark-up usually falls within a range of 3-10 percent, often around 5 percent. However, more important than an appropriate mark-up is establishing an appropriate cost base. We agree with the approach of the JTPF that the determination of an appropriate cost base is essential. Thus, we recommend that the importance of such determination of the cost base should be considered in the OECD safe harbour guidance.

The content of both EU JTPF reports have been made within the boundaries of the OECD transfer pricing guidelines and the meetings of the EU JTPF, where these documents have been prepared and finalized, have been attended by a representative of the OECD.

Local safe harbours as starting points:

KPMG appreciates the goal of having Competent Authorities agree on safe harbours that apply to both jurisdictions and would encourage tax authorities to explore this approach. KPMG notes that certain countries already have safe harbours in place. We would encourage tax authorities to consider accepting local and proven safe harbours for bilateral application. Adopting a safe harbour that is already in effect in a trading partner may allow the more rapid deployment of safe harbour rules than going through a long Competent Authority negotiation.

Permanent discussion forum:

KPMG suggests setting up a permanent forum for the discussion and sharing of ideas on how to use safe harbours effectively.

Comments on sample Memoranda of Understanding (MOUs):

Bilateral MOUs could be very helpful to business, and could be made to work where there are active competent authority relations or political/business pressure. The transparency of the process is important in reducing the perception of cosy deals and incentives. The bilateral nature under the terms of the Treaty is crucial, and removes the limitations in the EU JTPF approach (where further progress could not be achieved on a EU-wide basis because of different economic and legal situations between countries).
The Discussion Draft does not address Section F on APAs, but we do suggest a simplified APA process. In a way, the MOUs under the Competent Authority process are a template for quicker APA agreements. The APAs we normally see respond to the facts and circumstances of the applicants and agree critical assumptions underpinning the pricing that fit those facts and circumstances. The MOU turns the process around and starts with critical assumptions which, if met by the parties, would determine the pricing. It does not really matter whether we call the process safe harbours or simplified APAs, but politically it might be better to call them simplified APAs.

We do also note that the sample MOUs look a little complex, especially considering that they are templates and that actual MOUs are likely to add to rather than subtract from these templates. KPMG encourages the OECD to simplify the sample MOUs as much as possible.

- Paragraph 50 refers to the transfer pricing rules of each state. It would be appropriate to also refer to the Associated Enterprises article of the relevant income tax convention.
- Paragraph 52(e): it is not clear why a taxpayer having undergone a transfer pricing audit in either Contracting State should be precluded from benefitting from the safe harbour. On the contrary, this type of clause could arguably lead to an unfair application of the domestic transfer pricing legislation where a taxpayer would have been subject to an audit resulting in an arbitrary or capricious reassessment. Arguably, this unfairness could be multiplied by barring access to the safe harbour to this taxpayer.
- Paragraph 62: it is not clear that one could truly preclude recourse to the courts in all jurisdictions. Furthermore, it is also not clear that such a mechanism is desirable: as taxpayers are not parties to income tax conventions or to the related MOUs, it may be very difficult for them to have the rights arguably conferred upon them pursuant to such MOUs observed and applied in their domestic jurisdictions. Thus, we would suggest that recourse to domestic courts should be allowed.
- Paragraph 74, fifth bullet: the obligation to include audited financial statements in the notice is unduly strict. Some enterprises do not have audited financial statements at all. This obligation may also arguably carve out small and medium-sized businesses.
- Paragraph 82(e): as it stands, this paragraph would not extend the R&D services MOU to any R&D services provider that utilizes know-how, trade secrets, or other intangibles in performing its R&D services. It is hard to see how any R&D services provider could provide such services without at least some know-how.
September 6, 2012

VIA EMAIL

Mr. Joe Andrus
Head, Transfer Pricing Unit
Tax Treaty, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
OECD
2, rue André Pascal
75775 Paris Cedex 16

Re: Comments: Proposed Revision of Guidelines Chapter IV Section on Safe Harbors

Dear Mr. Andrus:

This letter and attachment respond to the invitation of the Centre for Tax Policy and Administration for comments regarding the discussion draft on safe harbors released by Working Party No. 6 on June 6, 2012 (the “Draft”). Reiterating views I expressed last year when commenting on the safe harbor aspect of the OECD’s overall transfer pricing administration project, I am optimistic that well-designed safe harbor approaches can enhance compliance and administration of transfer pricing regimes, increase fiscal revenues, and reduce impediments to cross-border business. The Draft represents a major, proactive, and admirable development in this regard.

My detailed comments on the Draft are set forth in the attached article I recently authored, entitled “Safe at Last? Transfer Pricing Safe Harbors on the Horizon” (Tax Management Transfer Pricing Report, 9/6/2012).\(^1\) The article (and this letter) represents my personal views only, and was not commissioned by, or prepared in the specific interest of, any clients of my firm or on behalf of my firm.

As can be seen in my comments, I believe that the Draft’s increased policy openness to safe harbors and its sample MOU tool provide a particularly constructive approach for moving the debate forward. Proposal of bilateral MOUs adroitly resolves many concerns about safe

\(^1\) The article is attached in both pdf and Word formats.
harbors, and the MOUs themselves allow taxpayers and tax authorities alike to test drive the concepts. Although initially restrictive in some aspects (perhaps intentionally), the MOUs demonstrate the feasibility and flexibility of safe harbors and should ultimately facilitate the proliferation of appropriately tailored mechanisms. (I would like to consider “MOU” as standing for “Many Ought to Use.”)

To repeat the conclusions in the article:

“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.”

Working Party No. 6, through its detailed consideration and obvious hard work, has teed up the issues well. The project’s approach demonstrates the beneficial impact the OECD can have for member countries and their taxpayers.

I appreciate the opportunity to submit my comments regarding safe harbors; please don’t hesitate to contact me if further explication of any aspects would be of use.

Sincerely yours,

[Signature]

Patricia G. Lewis

Enclosure
Safe at Last? Transfer Pricing Safe Harbors on the Horizon

By Patricia Gimbel Lewis, Caplin & Drysdale

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.

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, simplification rests on the development of

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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.
safe harbor approaches that emulate arm's-length results. 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 and a "cost only" safe harbor permitting routine intercompany services to be performed without a profit markup. 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. 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.”

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).

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].
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 in order to eliminate the possibility of inappropriate use of the provision by large taxpayers … The final concern was that

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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).

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-efficient 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 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

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11 See note 6 above.
12 Para. 3.
13 Para. 5.
administrative simplicity for all on the one hand versus the possibility of tax revenue erosion on the other.\textsuperscript{14}

2. **Safe harbor concept.**

   At the core of the draft's definitional section\textsuperscript{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."\textsuperscript{16}

4. **Concerns.**

   The draft lists four concerns:\textsuperscript{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 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

\textsuperscript{14} Para. 31.
\textsuperscript{15} Paras. 7-10.
\textsuperscript{16} Para. 15.
\textsuperscript{17} Notably, "problems," per the 1995 guidelines, have been downgraded to "concerns."
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.\(^\text{18}\)

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."\(^\text{19}\) 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.\(^\text{20}\) 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.\(^\text{21}\)

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.\(^\text{22}\) 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.

\(^{18}\) 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.
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 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, 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 (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

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\(^{25}\) 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.
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

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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.
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. 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 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 benefitting 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. 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.**

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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.
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 and administrative appeals. 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

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32 See note 8 above.
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.
By e-mail

Mr. Joe Andrus  
Head of Transfer Pricing Unit  
OECD

FROM Harmen van Dam  
REFERENCE 12330004  
DATE 13 September 2012  
RE Comments on proposed revision of the section on safe harbours in chapter IV of the OECD Transfer Pricing Guidelines

Dear Mr. Andrus,

In response to the invitation of the Committee on Fiscal Affairs to interested parties to provide comments on the public discussion draft “Proposed revision of the section on safe harbours in chapter IV of the OECD Transfer Pricing Guidelines and draft sample memoranda of understanding for competent authorities to establish bilateral safe harbours” (the “Proposed Revision”), please find in this letter the comments on the Proposed Revision on behalf of Loyens & Loeff N.V. (“Loyens & Loeff”, “we” or derivative terms). More information about Loyens & Loeff can be found in Enclosure 1.

Loyens & Loeff appreciates the work done by Working Party No. 6 of the Committee on Fiscal Affairs, in reviewing the current guidance on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines. We have examined with great interest the proposed revisions of Chapter IV, and we welcome the opportunity to submit comments on that draft.

As the interests of our various clients are far from identical, we have refrained from discussing the Proposed Revision with them. The comments we provide in this letter are therefore only our own comments as tax professionals.

We have prepared comments to the Proposed Revision, as well as to the identification of parties entitled to intangible related returns in the “Revision of the special consideration for intangibles in chapter VI of the OECD Transfer Pricing Guidelines and related provisions”. Our comments to revision of chapter VI are included in the submission of the IBA.

Our comments to the Proposed Revision are included in this letter and are divided in two
categories, i.e. general comments and specific comments on a selection of the proposed revisions of the section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines.

1 General remarks

In addition to the proposed “safe harbours” an alternative could be considered achieving a substantial part of the benefits stated in chapter E.3 of the Proposed Revision but seriously reducing the concerns over safe harbours stated in chapter E.4. The alternative would be that the “safe harbour” provides for the transfer pricing system, the structure of the report and benchmark parameters. The company specific benchmark is still needed but the taxpayer has solid ground to rely the outcome is acceptable. In the Netherlands the tax authorities informally utilize this alternative for transactions that occur regularly situations that don’t differ enormously, for example in respect of intercompany financing.

2 Specific comments

This section contains our comments on a selection of the proposed revisions of the section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines.

2.1 Paragraph E.3

- In our experience “predictability” is very important for taxpayers. The Proposed Revision clearly increases the predictability of transfer pricing in circumstances where the taxpayer can design its business arrangements to meet the safe harbour conditions. This benefit is different than certainty and reduced costs for compliance.

2.2 Paragraph E.3

- In our experience “objectivity” is very important for tax authorities. The Proposed Revision clearly increases the objectivity of transfer pricing. Tax authorities often prefer well-established transfer pricing systems over “out of the ordinary but potentially better” transfer pricing systems. This is extremely frustrating for taxpayers as they firmly believe their system better reflects economic reality than the “well-established systems”. The tax authorities likely prefer the well-established system (like TNMM with total costs as profit level indicator) as they understand the systems very well and they can more easily compare the result with other situations (i.e. taxpayers) they have reviewed before.

2.3 Paragraph E.3

- Some countries have relatively relaxed transfer pricing documentation requirements. For example timing and contents conditions are not requiring full documentation (including benchmarks) before the transaction is engaged in. Based on the increased demand taxpayers have for “correct” tax returns to the external stakeholders like shareholders (for
example FIN 48), the current need for transfer pricing documentation might be further reaching than the local legal requirements. The Proposed Revision would clearly reduce the burden for complying with these interests.

2.4 Paragraph E.4.1

- In E.4 the Proposed Revision indicates safe harbours might be not in accordance with the arm’s length principle. We have the feeling the paragraph is unrealistically optimistic about the correctness of the application of the arm’s length principle without safe harbours. In practice we encounter often that business people have difficulty acknowledging the outcome of transfer pricing reports that have been prepared following all instructions of the OECD. We feel safe harbours might be wrong but might still be better than standard transfer pricing reports.

2.5 Paragraph E.4.2 (20)

- In many countries the fear countries could establish safe harbours favourable for themselves might be reduced if tax authorities would be stimulated to apply the safe harbours both in inbound and outbound transactions. It should be noted that this might increase the risk safe harbours conflict with the at arm’s length standard as the arm’s length returns on transactions might differ in different geographical areas.

2.6 Paragraph E.4.2 (24)

- Please explain why intended unilateral application of a “below at arm’s length” result in respect of transactions would be any different from applying for example a more favourable tax rate to transactions. Such treatment would often not be “a distortion of investment and trade” but competition between countries that is often subject to well-established rules (like state-aid within the European Union).

2.7 Paragraph E.4.3 (28)

- Is it “bad” if businesses adjust to safe harbour rules. The paragraph tendentious mentions “artificial arrangements”. Assuming the transactions do not differ from transactions of single purpose entities, why would safe harbour rules prevent taxpayers combining these activities in one legal entity? Although not included in the Proposed Revision’s main text, the exhibits introduce as characteristic the taxpayers are (almost) single purpose entities. This forces taxpayers to “artificially” breakup entities that can often easily be combined without endangering the appropriateness of the application of safe harbours. We suggest eliminating the single purpose entity characteristic. It could be replaced by the condition that the taxpayer can show “sufficiently” separated functional analysis and sub-accounts. This would eliminate the need (and the “fear”) for “artificial arrangements”.


2.8  Paragraph E.4.3 (29)

- In the paragraph the report suggests safe-harbours could open the possibilities for “more cost-effective companies” to engage in tax planning. We fail seeing why this would be different for applying the “at arm’s length standard”. Either the company has “something” (an intangible?) which leads to the higher cost –efficiency which would probably lead to the safe-harbour not being applicable or it would not have “something”. In such situation also the at arm’s length standard following the regular route (functional analysis and benchmark) would lead to a “wrong(?)” result, as all its comparables would show a lower profit in similar situations. This is an unavoidable element of looking at “comparables” which seems acceptable to the tax authorities and businesses.

2.9  Exhibit 2 (67)

- The characteristics suggest the taxpayer using the safe harbour should (almost) be a single purpose entity. Characteristic (a) limits the possibility to be active in several countries, (e) excludes the possibility also engaging in manufacturing or assembly activities, and (g) also excludes the possibility for other supporting activities. These characteristics conflict with the trends to (i) reduce the number of legal entities and (ii) align boards of companies with the way business decisions are taken (a realistic risk will be the local entity will have difficulty finding efficiently the appropriate people to create the board of directors. This problem currently arises frequently. There are little non-tax reasons continuing the current separation in legal entities. As mentioned under 8 above, we suggest replacing these conditions with characteristics the taxpayer can show “sufficiently” separated functional analysis and sub-accounts.

2.10  Exhibit 2 (65, 67, 69 and 72)

- We are concerned with the wording in exhibit 2 preamble, paragraph 67(b), and paragraph 69 that the low risk distribution services are performed “on behalf of” the other enterprise, which may be interpreted in some jurisdictions as “for risk and account” potentially including “in the name of”. We expect in many countries (including the Netherlands) such engagement would trigger a permanent establishment of the enterprise (principal) in the other country. This is not necessary and counter-productive. The clause in paragraph 72 that the activities “will not be deemed to a permanent establishment” offer little protection in case of a “real” permanent establishment. We note that this concern would not arise if the wording in paragraph 72 were “will be deemed to be not a permanent establishment”; however, such clause might raise serious questions concerning the legal validity of such statement in many countries. We therefore recommend modifying "on behalf of" to eliminate this source of controversy.

2.11  Exhibit 2 (70)
- The exhibit refers to the GAAP in the residence country of the Qualifying Enterprise. We expect the link needs to be made to the accounting system used by the comparables supporting the percentage as stated in sub (a) of this paragraph. Although often this will be the GAAP of the residence country, it might avoid misunderstanding making this explicit.

2.12 Exhibit 2 (70)
- Under the characteristics mentioned in paragraph 67, in many situations the distribution services will be limited to provision of information to the other party. We feel the suggested transfer pricing system should be a TNMM with cost as profit level indicator.

2.13 Exhibit 2 (70)
- The exhibit refers to “net income before tax”. In practice, for these type of transactions often profit levels at EBIT level are used. Is it intentional utilizing the profit after interest costs notwithstanding the different current practice?

2.14 Exhibit 2 (70)
- The exhibit refers to the costs basis in a lot of detail. Wouldn’t a little bit of flexibility be more appropriate based on the risk allocation of the transaction?

We make the same remarks in respect of Exhibit 1 and 3.

Respectfully submitted,

Yours sincerely,

Loyens & Loeff N.V.

Harmen van Dam
Enclosure 1 – About Loyens & Loeff

Profile

Loyens & Loeff is an independent full-service law firm specialised in providing legal and tax advice to enterprises, financial organisations and governments. The intensive cooperation between attorneys, tax lawyers and civil law notaries places us in a unique position in our home market, the Benelux. Internationally, Loyens & Loeff is a reputable adviser on tax law, corporate law, financial and capital markets, cross-border financing, private equity, real estate, the energy sector, European law, regulatory law, VAT, employment taxes and employment law. The collaboration between the various specialists within a single firm works to the client’s advantage, as issues are tackled from different angles, creating synergy and increasing efficiency.

International focus

Worldwide, Loyens & Loeff has about 1,500 employees, including more than 800 legal and tax experts in six Benelux offices and twelve branches in the major international financial centres. When providing international advice, Loyens & Loeff maintains close relationships with leading law firms and tax advisers in Europe, the Middle East, the United States and the Far East. In this way, Loyens & Loeff offers top-level advice worldwide and is capable of effectively structuring and supervising both domestic and international matters.

Pragmatic solutions

Loyens & Loeff’s culture is characterised by a strong sense of independence, entrepreneurship, providing high-quality services and involvement. The principles of quality, transparency and short-line communication form the foundation for an informal and inspiring culture. This culture stimulates the search for pragmatic solutions to complex legal and tax issues. Loyens & Loeff pays particular attention to education and training and to creating an exciting and challenging work environment. This enables Loyens & Loeff to attract young talent and to guarantee the quality of services.
14 September 2012
Our ref MJZ/MJZ/MJZ

Dear Mr Andrus

We write in response to the request for comments on the Discussion Draft (Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines) and the Draft on Timing Issues Relating to Transfer Pricing, both of 6 June 2012. We are pleased to offer our comments as follows:

Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines

The discussion draft sets out the arguments for and against the use for safe harbours very well. We agree that the only cases where the advantages prevail are for smaller taxpayers and less complex transactions. However, we feel that it is important to have very clear and consistent definitions of what "small" and "less complex" mean in this context. Taxpayers should be able to draw definite conclusions as to whether or not they qualify to elect a safe harbour regime. Ideally, definitions would be standardised. A parallel might be drawn with the concept of small and medium-sized enterprises as defined in EU law (EU recommendation 2003/361).

We also suggest that a ‘variance safety buffer’ would be needed. This should address the problem of taxpayers or transactions arbitrarily falling in and out of the definitions due to minor periodic variations. Taxpayers and transactions should not be pushed out of qualifying to elect safe harbours due to short-term minor fluctuations in meeting the eligibility criteria. An example would be where a transaction might cease to qualify, due to variations in exchanges rates, only to qualify again in the following period.

Draft on Timing Issues Relating to Transfer Pricing

[Omitted]

We understand that the OECD will hold a public consultation, in Paris on 12 – 14 November, on the three transfer pricing Discussion Drafts that were released in June 2012 including the above. We would be pleased to attend the consultation and would be ready to address any of the issues we have raised as requested.

Please contact the undersigned with any questions or comments.

Yours sincerely
Martin Zetter
Head of Transfer Pricing
on behalf of Macfarlanes LLP

DD +44 20 7849 2945
Martin.Zetter@macfarlanes.com
20 August 2012

Mr. Joseph L. Andrus  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
Organisation for Economic Co-Operation and Development  
2, rue André Pascal  
75775 Paris Cedex 16  
France

Re: Discussion Draft, Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours, issued on 6 June 2012

Dear Mr. Andrus,

I am pleased to respond to the OECD’s request for comments on this Discussion Draft.

I am a Chartered Accountant and Chartered Business Valuator who has specialized in transfer pricing since 1996. My career and practice at MDW Consulting Inc. deals with these issues and concerns. MDW is a member of the Altus Alliance, an international association of transfer pricing professionals.

Although safe harbours is a small section in Chapter IV, it is very important for those taxpayers and tax authorities looking to achieve the benefits described in order to redirect their scarce resources to other transactions of greater size, complexity and consequence – e.g., intangibles.

Although the memoranda of understanding (MOUs) for limited risk services might help the Competent Authorities resolve issues of double taxation, they might also be used by the tax authorities to dispute a taxpayer’s position – i.e., creating more double taxation for the Competent Authorities.

Please contact me should you wish to discuss the attached comments in further detail. I am available and interested in attending the public consultation to be held during the week of 5 November 2012.

Sincerely,

Matthew Wall CA CBV

Cc: Ms. Michelle Levac, Chair of Working Party No. 6 and of its Special Session on the Transfer Pricing Aspects of Intangibles
E. Safe Harbours

In general, I very much agree with the concept for and objectives of safe harbours, particularly for the “smaller taxpayers and less complex transactions” mentioned in paragraph 3. However, I am concerned with the suggestion expressed in paragraph 4 of having safe harbours “adopted on a bilateral or multilateral basis.” This might be misunderstood by taxpayers and become a deterrent for (i) the small taxpayer that is unable to spend the time and fees needed to obtain the bilateral or multilateral approval, (ii) all taxpayers regardless of size who might be unwilling to spend the time and fees needed to achieve the benefits of a safe harbour for a transaction they consider to be of low audit risk, or both.

Although paragraph 2 briefly describes the history of safe harbours, it is too negative and will likely discourage taxpayers from considering a safe harbour, particularly when it says “safe harbours are not generally advisable, and consequently the use of safe harbours was not recommended.” Please delete this paragraph and replace it with paragraphs 35 and 36 shown below, which will encourage those taxpayers with similar circumstances. Section E.4 can address the issues and concerns.

35. However, in cases involving smaller taxpayers or less complex transactions, the benefits of safe harbours may outweigh the issues and concerns described in section E of Chapter IV. It is in the mutual interest of the taxpayer and tax authority to ensure that countries adopt safe harbours, and can be elect to taxpayers, and can further limit the divergence from arm’s length pricing. Where countries adopt safe harbours, willingness to modified safe harbour outcomes in mutual agreement proceedings to limit the potential risk of double taxation is advisable.

36. Although taxpayers might choose to use a safe harbour on a unilateral basis, where safe harbours can be negotiated on a bilateral or multilateral basis, they may provide significant relief from compliance burdens and administrative complexity without creating problems of double taxation or double non-taxation. Therefore, the use of bilateral or multilateral safe harbours under the right circumstances should be encouraged.

To address the concerns for potential abuses of a safe harbour in paragraph 5, it would help to include in section E.1 or E.2 additional guidance, examples or both on the general criteria for what types of transactions qualify for a safe harbour, and what types of transactions do not qualify for a safe harbour. Please see page 3 for an example of a transaction that should qualify for a safe harbour.

Please reconsider and edit paragraph 17. Respectfully, the profit split method is normally used when the related parties each own, use or contribute to unique and valuable intangibles. These are complex issues that are often disputed – i.e., the profit split method should not be used in a safe harbour.

Paragraphs 17 to 32 discuss some of the potential disadvantages for a taxpayer and concerns for the tax authority. It also includes a few suggestions to overcome these. To improve on this guidance, it might help to consult those countries that have an APA program for small businesses. Their policies, public consultation, audit experience, etc. should be considered and used where appropriate for revising the guidance on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines. For example, the Canada Revenue Agency has such a program that is described in its Information Circular 94-4R.1

1 Click here for details on Information Circular 94-4R Advanced Pricing Arrangements for Small Businesses.
Example to Consider for Section E.1 or E.2

The following is taken from pages 2 and 3 of MDW’s letter and comments on 20 August 2012 regarding the Discussion Draft and Revision of the Special Considerations for Intangibles and Related Provisions.

A.1 Intangibles that should not be compensated

I agree with the principle in paragraph 9 that says “not all intangibles deserve separate compensation”.

Building on this, it would be helpful to include this principle and more guidance under a new section in or near A.1 in general to reduce the burden on a taxpayer from the more detailed analysis required by the remaining sections of the Discussion Draft if, after reviewing the facts and circumstances, the taxpayer has reached a conclusion that documents why their intangibles should not be compensated.

This section should include a new paragraph defining when intangibles should not be compensated. For example, to be consistent, I have edited paragraph 105 for intangibles that should be compensated to provide a sample definition for intangibles that should not be compensated, as shown below.

An intangible (i) that is not similar to intangibles used by or available to parties to potentially comparable transactions, (ii) whose use in business operations (e.g. in manufacturing, provision of services, marketing, sales, or administration) is not expected to yield greater future economic benefits than would be expected in the absence of the intangible, and (iii) whose use or transfer would not be remunerated in dealings between independent parties, will be referred to as a routine intangible that should not be compensated.

The example in paragraph 9 (shown below) helps illustrate the above principle and definition, although it would have greater authority and usefulness if this became Example 1 in the Annex to Chapter VI.

“… consider a situation in which an enterprise performs a service using non-unique know-how, where other comparable service providers have comparable know-how. In that case, even though know-how constitutes an intangible, it may be determined under the facts and circumstances that the know-how does not justify allocating a premium return to the enterprise, over and above normal returns to the functions it performs.”

These changes will help the OECD “simplify transfer pricing rules and compliance where possible.”

This could constitute a safe harbor for taxpayers that use intangibles that should not be compensated. The objective being to: simplify compliance for eligible taxpayers in determining arm's length conditions for routine intangibles that should not be compensated; providing assurance to a category of taxpayers that this transaction will be accepted by the tax authority without further review; and, relieving the tax authority from the task of conducting further examination and audits of this transaction. The benefits would include compliance relief, certainty, administrative simplicity, etc. for the taxpayer and tax authority.
Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours

The following is taken from pages 8 and 9 of MDW's letter and comments on 20 August 2012 regarding the Discussion Draft and Revision of the Special Considerations for Intangibles and Related Provisions.

*                    *                    *

The consultation process needs to consider the relationship between the draft MOUs and section B of the Discussion Draft for Intangibles issued on 6 June 2012, and the importance each section has on the other. Section B will need to be revised to reflect any changes in the draft MOUs, and vice versa.

It appears section B imposes strict guidelines and expectations on those taxpayers that outsource functions related to intangibles, and taxpayers should anticipate scrutiny of these transactions when audited by the tax authority unless the transactions are structured in compliance with the draft MOUs for low risk (1) manufacturing services, (2) distribution services or (3) research and development services.

The draft MOUs for low risk services clearly state what functions the related party can and cannot do in performing the services. For example, a low risk manufacturer must perform the manufacturing in its country and using a certain percentage of assets dedicated to manufacturing plant, equipment, raw material inventory, etc. but “shall not engage in advertising, marketing and distribution functions, credit and collection functions, or warranty administration functions with regard to the products it manufactures.”

Further, the draft MOUs include restrictions (expressed as a percentage of net sales) on the amount of “annual research, development, and product engineering expense”, on the amount of “total marketing and advertising expense”, or both as is required by the MOU for each low risk service.

There are other terms, conditions and restrictions for each MOU that need to be considered.

Ultimately, it is reasonable to expect the tax authority will rely on the terms and conditions defined in the MOUs for low risk manufacturing, low risk distribution and low risk research and development to determine if a taxpayer has outsourced important functions, or if a related party service provider has contributed to the value of unique and valuable intangibles by performing important functions.

It is reasonable to anticipate the tax authority might, after a series of queries, find the related party distributor incurred marketing expenses at a higher rate than its comparables or the limit stated in the MOUs for marketing and advertising expenses, and claim the related party distributor contributed to the value of intangibles which deserves a share of the intangible profits.

Respectfully, I am concerned the tax authorities might misunderstand and misuse section B.3 and the draft MOUs as a mechanical test to recharacterise and allocate a share of the intangible profits to the related party service provider if they incur a high amount of certain expenses. This could and would diminish the relevance and authority of the OECD Transfer Pricing Guidelines to enforce the arm’s length principle using a comparability analysis based on the facts and circumstances.
Although the memoranda of understanding (MOUs) for limited risk services might help the Competent Authorities resolve issues of double taxation, they might also be used by the tax authorities to dispute a taxpayer’s position – i.e., creating more double taxation for the Competent Authorities. It might happen that the MOUs create more cases of double taxation than they resolve.

Please edit section B, the draft MOUs or both to address the above concerns.
The Transfer Pricing Commission of the Mexican Chartered Accountants Institute (IMCP) supports in general the contents on the discussion draft. We would like, however, to make the following comments.

We concur with the statement included in the discussion draft that, in some cases, the application of the arm’s length principle may impose a heavy administrative burden on taxpayers and tax administrations that can be exacerbated by both complex rules and resulting compliance demands. The safe harbours, when properly designed and implemented, may provide a relief to such administrative burden.

We also acknowledge that the attitude towards the safe harbours as a viable alternative in order to simplify the application of the arm’s length principle has favorably changed over the recent years, with more countries adopting or considering adopting safe harbours in certain circumstances.

Next, we list a series of recommendations for an efficient application of the safe harbours. Some of them are already included in the discussion draft we nonetheless we would like to highlight their relevance based on the Mexican experience in the application of safe harbours in the maquiladora industry:

- We particularly favor the adoption of bilateral or multilateral safe harbours. While unilateral safe harbours may be useful in certain circumstances, we consider that the benefits of bilateral or multilateral safe harbours, particularly a reduction in the potential exposure for double taxation, clearly make bilateral or unilateral safe harbours preferable over unilateral ones.

- Safe harbours may divert form the arm’s length principle over time, especially if they are not updated on a regular basis. As it has been shown in the recent past years, the circumstances of industries or
economic sectors may dramatically change literally from one year to another, thus limiting the benefits for taxpayers or materializing the challenges described in the discussion draft for taxpayers and tax administrations if they do not reflect the current economic reality. We recommend encourage tax administrations that have decided to adopt a safe harbor to include a provision or statement in the implementation rules that require a regular update in the safe harbor provisions.

- Even if it is true that the draft document for the tax treatment of safe harbours provide contemporaneous and useful guidance in this topic, we consider that there are minor areas which would require some adjustments.

In this regard, we observed that in the three different examples of draft MOUs included in Exhibits 1 through 3 of the document referred to above, specific references to permanent establishment (PE) implications were included (specifically in paragraphs 57, 72 and 87).

In our opinion, the main purpose of the document (design, implementation and formalization of safe harbours by Tax Administrations) is affected when some other types of tax implications are included in the document. In our view, the implementation of safe harbours may not necessarily relate to a PE exposure of a foreign resident in the tax jurisdiction of the country in which the safe harbour rules are enacted. In our experience, we have the implications of paragraph 5(5)(b) of the Mexico-USA Tax Convention, in which one of the different options to alleviate foreign residents to create a PE in Mexico was the application of a safe harbor, but that option is limited to a particular group of taxpayers (maquila or in-bond industry operators) and its application cannot be extended to other taxpayers operating in different industries with their related parties.

PE exposure of foreign residents is a fact-finding tax implication in operations with foreign residents, and therefore, it cannot be regarded as a general rule. In the recently completed OECD work on the attribution of taxable income to PE's there is general consensus that Tax Authorities should privilege the use of functional analyses, application of recognized transfer pricing methodologies, etc., precisely to assign taxable income to PEs when such international tax implications materialize in a specific case.

We consider that the particular references to PE implications in the draft MOUs for safe harbours deviate the attention to the main
purpose of the document, could create confusion (as to the fact that in
the implementation of safe harbours, PE issues materialize, which
obviously is not the case) and may enter into direct conflict with the
existing OECD work on attribution of income to permanent
establishments.

Because of the foregoing, we recommend the elimination of
paragraphs 57, 72 and 87 of this draft report in order to eliminate
areas which may diverge from the main purpose of the document and
that could likely create areas of confusion.
1. Comments in relation to the OECD Discussion Draft - REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER VI OF THE OECD TRANSFER PRICING GUIDELINES AND RELATED PROVISIONS

[Omitted]

2. Comments in relation to the OECD Discussion Draft – DRAFT ON TIMING ISSUES RELATING TO TRANSFER PRICING

[Omitted]

3. Comments in relation to the OECD Discussion Draft – PROPOSED REVISION OF THE SECTION ON SAFE HARBOURS IN CHAPTER IV OF THE OECD TRANSFER PRICING GUIDELINES

Introductory Comments

Safe harbours are to be welcomed – they will however often generate non arm’s length results.

The certainty afforded by safe harbours, particularly in the case of transactions with Emerging Countries, is likely to more than offset the cost of suffering more than single taxation in many situations. Safe harbours also must be elective or their use might divert international trade unnecessarily.

Finally, safe harbours should not be used for more complex transactions. Paragraph 4 makes this point strongly and clearly. However, their application in routine day-to-day activities could be of significant use to business, particularly in reducing unnecessary and frankly non-productive compliance costs.

As an example of this, an explicit recognition that the de facto standard cost + 5% mechanism used for recharging of admin / back-office would almost certainly result in no material amounts of lost tax whilst greatly reducing unnecessary compliance burdens on business.

Specific comments

• Paragraph 1

Complex, contradictory and often spurious compliance demands are legion when operating a MNE, even in simple instances of seeking to support the application of the arm’s length principle.

In certain instances, the advantage of certain compliance requirements to local counsels is clear – their value to local tax administrations, less so.

To this end, this point could usefully be emphasised in this paragraph further. The following suggested change might be:

“…that can be exacerbated by both complex rules and resulting compliance demands [without necessarily achieving either taxpayer or tax administration desired outcomes].”

• **Paragraph 5**

Same comments as previously – there is material advantage to tax administrations as well as tax payers. Potential wording changes are made below:

“Although safe harbours primarily benefit taxpayers, by providing for a more optimal use of resources, they can benefit tax administrations as well.”

Again, the overemphasis of using safe harbours to generate double non-taxation opportunities seems wholly unnecessary and counter to the intention of these new sections by reinforcing an implication that the use of safe harbours may well be related to double non-taxation. As such the phrase “…the potential for creating inappropriate tax planning opportunities including double non-taxation of income…” could usefully be removed in its entirety.

• **Paragraph 14**

This paragraph is somewhat underemphasised. The value of certainty is very high, particularly in dealings with Emerging Markets.

• **Paragraph 16**

The second and third bullet points feel very over-emphasised. As previously commented, the OECD Guidelines are not a tool for tax administrations to seek to control abusive tax structures – they are a mechanism for seeking to avoid double taxation and to detail the general structures around which international trade can grow. Governments have a myriad of tools available to them to deal with what they may consider as being egregious or unacceptable tax practices but these should be dealt with in the appropriate sphere for this - national tax legislation.

Any appropriately designed safe harbour, is more likely to trigger more than single taxation than the inverse. Notwithstanding, as noted previously, the value of certainty is likely to render such a cost acceptable to businesses in many instances.

• **Paragraph 24**

This paragraph again is based on the principle that MNEs are willing to misrepresent their financial information in order to gain a tax advantage. Whilst there are bound to be instances where such a situation occurs, the role of advisors and auditors is to ensure that such a situation does not arise.

Any MNE found to be engaging in such practices deliberately would be in breach of a wide myriad of stock exchange and other financial regulations and would likely be liable for material penalties, primarily monetary, but also reputational.

The inclusion of this paragraph seems unnecessary and risks create a presumption that the use of safe harbours implies seeking to avoid due tax. Should this occur, the effect of these paragraphs might be actually to raise tax administration audit scrutiny of MNEs use of safe harbours by creating an insinuation that there is likely to be some form of double non-taxation behind the choice in their application.

Clearly, this runs entirely counter to the intention of the paragraphs related to safe harbours which is to lower compliance costs for MNEs and allow tax administrations to better focus their resources.

By preference, this paragraph should be removed.
Paragraph 35

The advantage of safe harbours is not just, or I would suggest even primarily, to MNEs but also yields material benefits to tax administrations. To reinforce this point, I would suggest the following wording could usefully be added to the end of the paragraph:

“…provide taxpayers with greater certainty [and allow tax administrations to concentrate scarce resources upon higher risk transactions.]”
Mr Joe Andrus  
Head of Transfer Pricing Unit  
OECD - Centre for Tax Policy & Administration  
2, Rue André Pascal  
75775 Paris  
France  

14 September 2012

Discussion draft on the revision of the guidance on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines

Dear Mr Andrus,  
Dear Joe,  
PwC welcomes the review of the guidance provided for safe harbours under Chapter IV of the OECD Transfer Pricing Guidelines and wishes to thank Working Party No. 6 for the opportunity to comment on the discussion draft.

Somewhat symptomatic, it was in 1922 that the editors of the newly founded Harvard Business Review (HBR) stated that “Unless we admit that rules of thumb, the limited experience of the executives in each individual business, and the general sentiment of the street, are the sole possible guides for executive decisions of major importance, it is pertinent to inquire how the representative practices of businessmen generally may be made available as a broader foundation for such decisions, and how a proper theory of business is to be obtained.”¹ The September 2012 HBR’s Editorial comments state that we have come a long way since then. We continue to honour the promise that best practices in business do not arise anecdotally but are the product of critical research. It is therefore only consequent that when evaluating business proceedings from a transfer pricing perspective, rules of thumb (in the form of safe harbour rules) have the potential to form a valuable tool to achieve reasonable assessments in a resource-efficient way as they are based on relevant and consistently-assessed experiences.

Overall, we feel that the proposed new wording of Section E in Chapter IV more accurately fits in with the current practices of tax jurisdictions around the world and the ongoing necessity to reduce red tape. In this respect, the discussion draft strikes a fairer balance between admittedly existing upsides and downsides of safe harbour provisions and offers, more importantly, valuable practical guidance to Competent Authorities as regards the conclusion of bilateral/multilateral agreements on the use of safe harbours. In this regard, we would like to stress again the importance of the OECD’s overall project on the administrative aspects of transfer pricing (as part of which the discussion draft has been

¹ See Harvard Business Review, September 2012 issue at p. 12 “From the Editor”.

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elaborated) which we expect to result in major benefits for all parties dealing with transfer pricing issues.

Having stated this, PwC would like to express a few additional thoughts and recommendations on certain aspects of the revised guidance on safe harbours, as included below. Before focussing on some of the particular features of the discussion draft, we would like to provide some general remarks as to how we feel the role of safe harbour provisions should be interpreted, taking into consideration the comprehensive guidance provided under the OECD Transfer Pricing Guidelines.

**General remarks on the role of safe harbours and the importance of risk assessment in transfer pricing**

Safe harbour rules have the potential to significantly reduce the compliance burden of taxpayers and the resource dedication of tax authorities, provided they are designed in line with the arm’s length principle and applied based on a careful evaluation of the facts and circumstances. In this respect, it should normally be possible to carve out low-risk transactions from the range of business flows the taxpayer might have with related parties. Such carve-out would facilitate the identification of business dealings which actually deserve particular attention as they are real “value and profit drivers”. The guidance provided in Chapter III of the OECD Transfer Pricing Guidelines will be of paramount importance when undertaking this analysis.

We are convinced that the discussion around safe harbour provisions can only be considered as an integral part of the fundamental debate as to how to better identify and manage risk in transfer pricing. In this respect, tax administrations, as taxpayers alike, struggle with the limited amount of resources available to deal with transfer pricing matters. Many tax administrations have developed administrative approaches as a result of which they label certain related party transactions as “risky” from a compliance perspective. In practice, these transactions are usually classified as risky due to their specific nature, industry or the transfer pricing method applied by the taxpayer. Many times, however, transfer pricing audits are driven by less strategic considerations, e.g. when tax authorities consider the extent of transfer pricing documentation submitted or take a periodical approach towards the scheduling of such audits. Such approaches may often fail to identify the real risk in transfer pricing and should ideally be combined with (or replaced by) more risk-focussed evaluation criteria.

Overall, it is important to ensure a globally consistent approach of policy-makers and tax administrations across developed and developing countries towards risk assessment in transfer pricing and the related use of safe harbour provisions. In this respect, it is heartening that the current draft working chapters of the UN Transfer Pricing Manual (which we understand is expected to be released next month) also contain a comprehensive and pragmatic discussion of safe harbour provisions. More precisely, the current wording in Chapter 3 of the Working Draft highlights that a comparability analysis and considerations surrounding administrability should be contemplated prior to discussing safe harbour provisions. In this context, safe harbour provisions are generally considered to be an attractive option to developing countries as they can result in low compliance cost, certainty for taxpayers as well as administrative simplicity for tax administrations. It is important that going forward, the OECD and the UN continue to enrol in an ongoing dialogue as to how transfer pricing risk
assessment and administrative simplification initiatives can be developed and possibly aligned between tax administrations across the globe.

Having made these general observations, we comment in the following on some of the particular provisions of the discussion draft published on 6 June 2012.

**Character of safe harbour provisions and their relation with the arm’s length principle**

Paragraphs 4.93 through 4.122 as currently contained in the OECD Transfer Pricing Guidelines appear to give a somewhat aloof recommendation on the use of safe harbours and list quite a number of drawbacks, whereas the discussion draft generally omits an explicit negative or positive recommendation (except for the use of bilateral or multilateral safe harbours which are openly encouraged). However, the discussion draft states that safe harbours should apply for “clearly and carefully defined transactions” (paragraph 7).

The discussion draft provides, in addition to the two previously recognised forms of safe harbours (simplified transfer pricing approaches and exemption of a defined group of taxpayers/transactions from the application of general transfer pricing rules), “alternative formulations” of safe harbours (paragraph 9). The example provided thereafter relates to “rebuttable presumptions” relating to mandatory pricing targets which would in principle be compulsory but grant the taxpayer the right to demonstrate that this price is not in line with the arm’s length principle in the particular case of the taxpayer.

We feel that such design of safe harbours risks impeding the achievement of compliance relief envisaged through the use of safe harbours. In this regard, especially in case of unilateral safe harbour provisions, we believe it is imperative to ensure the optional character of safe harbour provisions. A taxpayer should have the choice as to whether to apply a safe harbour or to follow the general principles of the arm’s length standard when demonstrating that related party transactions are correctly priced. From our perspective, only such optional approach would (i) achieve the desired compliance relief for taxpayers, and (ii) allow for sufficient flexibility, especially in case of unilateral safe harbours (lowering the risk of double taxation and transfer pricing disputes). We believe that the revised guidance on safe harbours should clearly advise not to implement obligatory safe harbours/mandatory pricing targets. In this respect, we feel that the example provided on alternative formulations may not be expedient.

Furthermore, the discussion draft expresses concerns about the possible divergence from the arm’s length principle insofar as safe harbours are used, as a simplified transfer pricing approach “may not correspond in all cases to the most appropriate method applicable to the facts and circumstances of the taxpayer” (paragraph 17). Whereas this is undoubtedly a strong argument, we believe that the exposure to such risk can be considerably lowered by designing safe harbour provisions based on a sound evaluation of past experience with arm’s length transfer pricing for a certain type of transaction/taxpayer. In this respect, the revised provisions on safe harbours could offer additional guidance on what factors to take into consideration when designing safe harbour provisions, which as a general principle should be set based on consistent past experience rather than arbitrariness and which should be properly monitored going-forward. Somewhat related to these considerations,
additional thought could also be given to the treatment of post-year-end adjustments and the appropriate time frame which should apply for safe harbour provisions. Whereas a single-year approach might overall appear reasonable, a multi-year approach testing weighted average results instead could be more reliable for certain types of transactions or industries as it allows taking into consideration potentially influencing business and product cycles. The OECD Transfer Pricing Guidelines evaluate the usefulness of using multiple year data already in their current guidance on comparability analysis (paragraph 3.75 et seq.).

**Guidance on eligible transactions/taxpayers for safe harbour provisions**

The discussion draft states that safe harbours can be most appropriate when directed at taxpayers and/or transactions which involve “low transfer pricing risks” (paragraph 4). Although the revised provisions themselves provide little examples on what kind of taxpayers and/or transactions are regularly assumed to be of a low risk character, guidance is offered through the three sample Memoranda of Understanding (MoUs) on low risk manufacturing services, low risk distribution services and low risk research and development services. Whereas we believe that this set of transactions represents a very useful starting point, we would like to encourage Working Party No. 6 to develop a list of example transactions which could normally be considered to be of a low risk character and hence particularly suitable to be the subject of a unilateral or bilateral safe harbour arrangement. Such (non-exhaustive) list would be of further assistance to Competent Authorities when considering the step of entering into bilateral or multilateral safe harbour agreements.

From our perspective, and in addition to the three transaction types included in the MoUs, we believe that such list could also explicitly mention business support services (low-value adding services), including e.g. IT support services, payroll or bookkeeping services. Within multinational groups, these types of services are often centralised within one or multiple entities servicing all group companies. When assessing these services from a transfer pricing perspective, taxpayers usually need to satisfy some kind of benefit criterion as e.g. stipulated under the OECD Transfer Pricing Guidelines on intra-group services (Chapter VII). The multilateral character of such centralised business support services may limit the applicability and use of bilateral safe harbour agreements, unless an overall benefit assumption was applicable for the entirety of service recipients. Such overall benefit assumption could however clash with differing requirements potentially applicable under local legislation, a fact which would require a case-by-case evaluation and may hence further complicate this approach.

Despite these practical challenges, the inclusion of business support services as an example for low-risk transactions suitable for safe harbour provisions would foster a consistent approach towards such type of transactions, especially in the light of the recent multilateral developments at the level of the European Union.² Working Party No. 6 could in this regard further explore, to what extent a consensus of all OECD member countries could be feasible. Possible other fields of application may be

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² EU Joint Transfer Pricing guidelines on low-value adding services (COM (2011) 16 final), which offer guidance on the transfer pricing methodology and the mark-up considerations applicable to these types of intra-group services.
related to non-complex financial transactions (e.g. interest rates for related party loans in a certain currency).

In general, we understand that in past discussions it was often considered to limit the application of safe harbour provisions to a certain category of taxpayers (e.g. small and medium-sized enterprises) and to deny their application to larger taxpayers/MNEs. While we understand that there may be certain arguments for this approach, we highly welcome that the current discussion draft appears to advocate that safe harbour provisions should generally be applicable to less complex transactions, regardless of the size of the taxpayer concerned.

**Definition of a Qualifying Enterprise under the suggested MoUs**

The sample MoUs provided with the discussion draft represent a welcome effort and an excellent starting point for the consideration of bilateral or multilateral agreements on the use of safe harbour provisions between Competent Authorities. However, we are of the opinion that especially the definition of a Qualifying Enterprise as currently suggested under the MoUs should be reflected about by Working Party No. 6 against practicality and necessity considerations, and, if applicable, refined. In this respect, the definition of a Qualifying Enterprise as currently stipulated under paragraph 52 of the discussion draft appears to be very restrictive, e.g. imposing limitations on the applicability of the safe harbour provision to entities which are “exclusively” conducting their business operations in the Contracting State. Although we understand that these limitations may fulfil a wider purpose, it appears questionable to which extent taxpayers will actually be able to meet this eligibility requirement and hence benefit from the bilateral safe harbour provisions. From our point of view, it appears undesirable that a taxpayer would potentially need to reorganise its business activities in order to be able to apply for a bilateral safe harbour (whereas sufficiently detailed internal reporting systems may provide for sufficient comfort in this respect).

Additionally, the current wording of paragraph 53 suggests that companies which have been subject to tax adjustments as a result of recent transfer pricing audits would be excluded from the application of safe harbours.

In our view, such limitation poses serious concerns as regards the impact of safe harbour provisions on equity and uniformity issues (which are accepted to be a concern over safe harbours). In this respect, this limitation does not appear to be suitable for determining a certain functional profile/industry, nor can we see any other benefit of including this item. In this regard, we feel this provision is not apposite to define a Qualifying Enterprise and would urge Working Party No. 6 to reconsider this notion in the sample MoUs.

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3 As the three sample MoUs are similar as regards the general provisions, we comment in the following on Exhibit 1 of the discussion draft (paragraph referencing). However, these remarks are equally valid for Exhibits 2 and 3.
August 21, 2012

By E-Mail: joe.andrus@oecd.org

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Re: Public Comments on the Proposed Revision of the Section on Safe Harbours

Dear Mr. Andrus,

Thank you for the opportunity to provide comments on the proposed revision of the section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines. Please find herewith our comments.

Comments on the Proposed Revision of the Section on Safe Harbours

General

1. After a thorough review of the proposed section on safe harbours (the “Section”), we are in full agreement with the analysis and conclusions reached by the OECD. We applaud the OECD for encouraging the use of safe harbours, which will facilitate transfer pricing compliance for many businesses.

2. Our experience in the practical application of transfer pricing policies is that the current transfer pricing rules and regulations place a significant burden on many businesses. In particular, it is especially burdensome for Small and Medium Enterprises, who often do not have the resources or expertise to comply with transfer pricing requirements, as established by each jurisdiction.

3. Another major advantage of safe harbours is the simplification of the administrative burden on tax authorities, enabling them to focus their resources on complex transfer pricing cases. The introduction of safe harbours thus also has the potential of reducing the number of pending cases to be resolved by the Competent Authority, as well as decrease the time to obtain resolutions.

Comments Regarding the Practical Application of Safe Harbours

We believe the following issues should be addressed in the revised Section:
1. Clarification regarding the certainty of acceptance
   
a. Paragraph 14 of the revised Section provides that “[q]ualifying taxpayers would have the assurance that they would not be subject to an audit or reassessment in connection with their transfer prices provided they have met the eligibility conditions of, and complied with, the safe harbour provisions.”

b. It is clear from the above that a taxpayer would not be subject to an audit or reassessment, provided they meet the eligibility criteria outlined in the safe harbour provisions. However, what is unclear is the extent to which taxation authorities will scrutinize the taxpayer further to make an assessment to determine whether the taxpayer meets the characteristics of a “qualifying enterprise” for safe harbour treatment. It would be helpful to have further clarification as to what additional information and documentation taxation authorities would reasonably require, in order to ensure that the burden of these requests does not neutralize any compliance relief that is gained by the use of safe harbours.

2. Relevance of industries with respect to safe harbour determination
   
a. Low risk distribution, contract manufacturing and contract research and development functions are considered to be routine in nature, without significant intangibles or know-how associated with these functions. As such, there is usually greater consideration given to functional comparability rather than product or industry comparability when selecting comparables.

b. However, to the extent that different industries may significantly affect profit level indicators, we would invite guidance from the OECD on whether industry comparability should be taken into account in establishing safe harbour ranges.

Conclusion

Thank you again for the opportunity to share our comments with the OECD on transfer pricing matters. As always, we welcome guidance from the OECD to facilitate the application of transfer pricing principles for both tax administrations and taxpayers.

Yours very truly,

Richter Consulting, Inc.

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Observations on interim draft on intangibles,  
safe harbors and timing issues of transfer pricing guidelines  
(june 2012)

1. General concepts,
I start with basic question included in the draft:

Business is requested to comment as to whether the formulation contained in section B, successfully communicates the economic principles at issue, or whether another approach would more clearly convey the message that the determination of returns that are attributable to intangibles within an MNE group should be determined on the basis of relevant functions, assets and risks (OECD interim draft on intangibles - June 2012- para 26).

I think that partly the formulation of the draft hits the above mentioned target.
Indeed in my opinions problems are not on theoretical definitions but on other parts of the drafts.
In any case I start with comments on general concepts.

On the theoretical point of view I think that reading the draft on intangibles in connection with already existing parts of OECD Transfer Pricing Guidelines (hereinafter Guidelines), the concept of the attribution of returns in compliance with activity, risks and assets should be clear.

But interpretation and application of Guidelines and of arm’s length principle (hereinafter ALP) is, in my opinion and as a matter of fact, currently so unsatisfactory. One circumstantial evidence of that is i.e., on side of Administrations, the sentence that

“Some countries recover very little tax from their transfer pricing audits or enquiries whereas others recover very large amounts from almost all their audits” included in the OECD Report “(Dealing Effectively with the Challenges of Transfer Pricing, OECD 2012 page 17)."}

*** I am grateful to prof. Giampaolo Arachi, Econpubblica Bocconi Milan, as well as Dr. Fabio Comelli of the IMF, who read a paper to be edited for International Transfer pricing journal by IBFD with similar concepts than in this paper, and to Prof. Angelo Baglioni, Economic of uncertainty Catholic University Milan, all, for helpful comments on economic studies of actual transfer pricing by firms, and on microeconomic theory. I am also grateful to Dr. Deloris Wright for helpful comments on the whole paper. Any opinion and/or error is solely attributable to me.

Please note I used the term circumstantial evidence and not full evidence because it’s also possible that all firms whose income was adjusted up (in Countries where all audits end in an adjustment by Administration) breached the arm’s length standard; that seems to me not probable while it seems more probable that in those Countries the arm’s length principle (ALP) is applied in a non consistent way with the way it’s applied in other Countries.

On the other side one of the prevailing conclusion of a lot of economic studies is that transfer pricing constitutes an important channel of tax planning, perceived as an illegal way to breach anti-avoidance legislations and the arm’s length principle despite tax Administrations audits based on the same principle.

The mentioned conclusion is groundless because those studies give only circumstantial evidence of what they conclude; only when are available information about how the firms’ integrated business risks have been split between associated units (located in various Countries) one can conclude whether intrafirms’ prices and contracts are (or aren’t) in compliance with arm’s length pricing (ALP).
In any case the concept of intangible is not strictly necessary to project transfer pricing rules. What is important (essential) is that a clear model of allocation (to associated entities) of returns and of group’s incomes is included in the regulation.

If I refer to current microeconomic studies about integrated businesses and to contract theory one of most important concepts used for depicting behaviors of independent parties is the concept of asset ownership as “the right to control the use of asset (in particular, the owner can exclude anyone else from using it)” 2. Few words are able to explain this point of view and related bargaining mechanism:

“Asset ownership is relevant because it determines the threat point of the date-2-bargaining game. If the buyer owns the asset, the default payoffs of both parties are zero. According to the Nash bargaining solution, the seller then gets half of the gains from trade at date 2, hence there will be underinvestment.

If the seller owns the asset, she could sell her good on the spot market, while the buyer’s default payoff is zero”3.

The (second) optimal solution (after ability to make a complete contract) to prevent underinvestment of firms, when specific investments are planned, to explain behaviours of firms acting at their best interest and possible equilibrium state is to give, in the contract, the right to use the business assets to the seller; what is important is just the (intangible?) property assigned by the contract: the right to use business assets, material or immaterial.

I try to resume.

The distributor position i.e. is the theoretical position of who is going to make a specific investment that has a value under a locked relationship (with producer); the group form of enterprise is just the solution to prevent the hold up of his investment in advertising while Group solution can’t be a solution for Governments that need an equitable division of tax revenues.

The first best solution to prevent underinvestment of firms, when specific investments are planned, to explain behaviours of firms acting at their best interest and possible equilibrium state, is the ability to make a complete contract where distributor is fairly remunerated for his investment in each possible event: this is what is depicted as a normal marketer (example 4).

The second best optimal solution (when the first best solution is not possible) is to give in the contract, the right (or a share of that right) to use the business assets (the name) sourcing from investment to the seller: this is depicted as abnormal marketer (example 5).

Here what is important is just the (intangible?) property assigned through the contract: the right to use business assets, material or immaterial.

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Economic studies which are based on database data to come to conclusion about generality (or categories) of firms (i.e. the Bundesbank MIDI database, and so on) are not based on appropriate information because database do not show how each group has individually split his own business risks.

For more details see an upcoming paper, A. Musselli, Saving arm’s length pricing: from economists studies myth to reality (provisional title), which will be edited in International transfer pricing journal, IBFD, November-December 2012 issue. Obviously some firms, in some cases (and this has been individually proved) have breached, breach and will breach ALP. 2


3 See Schmitz, supra note at page 13.

4 This way of thinking would be also coherent with all patterns describing capitalism, classical (Ricardo etc), neoclassical (Walras, Marshall), Marxian economics till modern microeconomic and firm theories. In all these patterns the concept of asset is fundamental in characterising capitalism.
This the right way theoretically pursued in the draft (para 49.50-51 of the draft) already included in chapter VI of Guidelines) that is not explicitly expressed. In any case also the concepts included in the intangibles’ draft (returns of a group entity must relate to functions performed, assets employed and risks assumed in the business) may reach similar effects as asset ownership concept that I above mentioned. This “non definition” of intangible included in the draft could be too abstract to be easily understood and could be enriched in the context I above mentioned giving reason of the bargaining game of parties in these contexts.

2. Guidelines as a *Janus Bifrons*: suggestion on economic valuations but target of ruling taxation. Necessity to separate the ex ante firms’ view from the Administration audit ex post view; timing issues draft

Indeed I frankly perceive that the most important problems of Guidelines interpretation and application source in force of the misunderstanding currently and actually present between the double nature of Guidelines (as *Janus Bifrons*): they are written as to explain what economic theory suggests about valuation process to set transfer prices with ALP but they are targeted to serve as fiscal law.

This is not the place to discuss about the juridical nature of Guidelines, that usually are not internal laws of OECD Countries, also if in some cases the internal legislation of some Countries is just interpreted in force of what suggested by Guidelines text and without any national specific detailed rule.

Here what I am going to underline is that in many circumstances Guidelines leave open some options to comply with ALP, (brief examples):

- **Arm’s length range**
  
  A range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm’s length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods (Guidelines glossary).

- transfer pricing is not an exact science (the requirement is found four times in the Guidelines at paras. 1.13, 3.55, 4.8 and 8.3, to always allow more than one result as the arm’s length price)"

I think that these words have (or should have) a practical juridical effect: firms have at the moment they are setting transfer prices more than one option to set them at arm’s length; this is particularly true when data on comparable transactions are extracted by databases where are included information about millions of firms and the user must extract the more comparable firms (in terms of function assets and risks – and other comparability factors recommended by Guidelines) to the intercompany ones.

Perfect comparability is often not possible just in these cases and more than one option is possible.

Here firms i.e. may choice (giving arguments to do so) a method (most of times a profit comparison with external comparables), and then a “target” PLI and, then, more, they must extract comparable firms’ and results.

All these processes and methods leave open more than one proceeding to set transfer prices; results produced by these different ways may end in having more than one, but all acceptable, arm’s length transfer prices.

This is clearly affirmed in Guidelines with the range concept of the arm’s length price.

But I know that actually where more than one option is allowed and Guidelines do not prescribe a mandatory aspect of the proceeding (and so it’s allowed a sort of flexibility) often when firms have calculated a certain price, several years later the Administrations (rejecting or non rejecting method or some aspects of it chosen by taxpayers) use different methods and different

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5 In fact if Guidelines would be well interpreted already now a lot of litigations should not exist

6 Some scholars call Guidelines “soft law”
comparables from those used by firms just to adjust firm’s transfer prices: they adjust upwardly the audited firm’s income neglecting the process used by firms years before. Therefore Legislator must do more than what is already done at this moment through the range concept (and other concepts already present in Guidelines text). Legislator might give a strong safeguard to firms, that are obliged to set in advance prices which will be audited later, that if they choose one of allowed options, then, years later, Administrations cannot neglect that –allowed– choice; obviously Administrations must challenge a non allowed choice; but if same Guidelines leave open a space to estimator to make some assessments those assessments can be amended (with information available at operation time and not after) only when they are irrational and not because other assessments could be equally rational!

In my opinion timing issues of Guidelines must be projected in coherence with the mentioned safeguard.

It’s not important if the comparable data to apply ALP must be available at the moment to do intragroup transactions or at the moment to fill the fiscal return or even later (so that data are of the same period of intragroup transaction and affected by same economic conjuncture); the real important thing is that Legislator specifies if one timing or both timings are allowed so that a clear rule can be applied by firms and then audited by Administrations; if both timings are allowed it is not acceptable that firms choose one of the allowed processes and then the Administrations (one Administration of a particular Country) neglect that choice on base of choosing the other one because “it’s more coherent with (economic?) ALP”!

About timing issues my opinion is that for practical reasons more than one option can be allowed at the sole condition that these rules are applied with coherence during firms’ life (i.e. more than one method is allowed but when firms have chosen one of them same firms must continue to apply that method and Administrations, given that both methods are allowed, cannot neglect firm’s choice).

If legislators want to restrict the options must clearly do that! And this is really what is important on timing issue!

3. The value, per se, of certainty about fiscal rules application

Economists underline that uncertainty surrounding the proper fiscal rule to apply is detrimental for business, because the immunity of property from arbitrary expropriation by governmental authorities is one of most important conditions for growth of economies. Uncertainty as to tax consequences (but also regarding administrative, labour law and other aspects of corporate existence) of cross-border transactions serves to discourage worldwide trade and investment, and worsens current difficulties related to growth. This is a significant negative consequence in terms of the lack of economic growth (not immediately and fully observable, but present nevertheless).

In this period of recession, these negative consequences must be carefully evaluated by judicious legislators. The first signal of what is going on in reality is also observable in some countries where multinational enterprises protest their lack of certainty as regards rules of law and threaten to under-invest in those countries.

I find some reference to these concepts in OECD draft on safe harbours (see i.e para 11), but I would like to underline that certainty about the rule to apply in real and specific cases is a value for taxpayers but for Administrations too; I think that certainty about the right rule to apply is a general value, is a value per se, because in providing certainty to eligible taxpayers the law aids

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7 Some aspects of the (i.e. timing issues in comparability) existing Guidelines are indeed not fully coherent with this target...

8 W.J. Baumol, *The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism* (Princeton University Press, 2002). See chapter 1. The limitation of state authority is historically significant: “The century after Magna Charta inaugurated the process of conceding the sanctity of property, including immunity from taxation without representation, a process carried to its conclusion in England in the struggle between Charles I and his parliaments” (at 69, emphasis added).
economic growth (and so more investments and more tax revenues for Countries) and also Administrations to more easily focus on the breach or the non breach of the clear (on what is right and what is wrong) enforced rules (avoiding they are same Administrations to depict the right rule to apply, ex post transactions, at the expense of legislator).

4. **What is necessary to clarify in the text of Guidelines and why is necessary to underline that pricing into an arm’s length range is a juridical concept (and not an economic suggestion).**

In my opinion Legislator (and OECD in this role) must take a clear decision:

a) or Guidelines enter more in details of rules to be applied suggesting (rectius: enforcing) only one procedure and one way of proceeding to set correct transfer prices when more options are in front of firms, all purportedly admitted by fiscal law

b) or they leave more than one option allowed but strongly underline that a range of transfer prices is possible and that this is not an economic suggestion but a juridical statement!

This last point of view might seem already included in Guidelines text but I think that often this is not complied with actually and in reality and so, given the fact what is mostly important is what really occur and not what might occur, OECD must find more incisive way to affirm the enforced rule also in changing some paragraphs of existing Guidelines.

I think that the most important work to be done on Guidelines text should be aimed just in parting when is necessary to act under the above mentioned line a) (working to better specify Guidelines text to focus clearer and binding concepts and behaviors asked to firms) and when is necessary to act under the above mentioned line b) (specifying that more than one method allowed to set transfer prices is a juridical mandatory statement).

5. **More details on intangible asset ownership assessment, leaving some flexibility in the calculation of non intangible owners’ remuneration and of both intangible owners remuneration (when both firms transact owning intangibles)**

I think that more details should be provided (previous point a)) in order to specify which is the group entity entitled to intangible returns of the business. While about the remuneration of non (intangible) asset owners, and of each of intangible owners when transactions are made between associated entities owning both intangible properties, Guidelines should clearly specify which are essential rules for calculating those remunerations but underlining that when more than one option is allowed, several (i.e a range) are the legal solutions. Obviously one time the proceeding is so planned it’s not acceptable that firms are blamed and that their incomes are adjusted up to have chosen one of allowed ways; if Legislator think to have left too much freedom to firms in setting transfer prices they have duty to enter in more details of regulations, narrowing allowed options (but I think this is not the best way, I repeat, in case of non intangible asset owner remuneration and when the double intangible problem is present).

Examples may become a useful tool in reaching certainty about rules to apply in compliance with what above projected and with required flexibility to reach mentioned goals.

I repeat that the step to give more details than details already given in Guidelines could be appropriate but it could be also appropriate to consider sufficient the details already present in Guidelines text if a strong safeguard (of no Challenges by Administrations) to firms that have chosen one of allowed prices would be enforced in same Guidelines text.
6. An “independent” study to monitor ALP application could allow to better understand which are concrete problems in applying Guidelines. A proposal about the study and on questions to be answered through it

To verify whether transfer prices truly comply with the arm’s length principle, due to the nature of the principle and to how this economic principle has become a legal standard data are required regarding how a group of companies has “individually” organized its proper business in terms of risks assumed and assets employed by its units in various countries. No other ways are capable to reach grounded conclusions and I criticized some economic studies which have based their conclusions on data extracted by databases but that are not able to know individual groups’ division of risks among units: conclusions reached in this way are groundless in proving (or in non proving) the non compliance with the ALP by firms. An “independent” study could be projected by Governments or OECD as part of the monitoring of the application of the OECD Guidelines, on a no-name basis (to respect the confidentiality of data of the tax Authorities and taxpayers) and with the target of improving future rules about the arm’s length principle, rather than at constituting a further appeal for resolving current litigations between firms and Administrations. This would allow a fine-tuning of the application of the arm’s length principle and a proposal of solutions to those problems. The OECD, with its highly skilled professionals, and in light of the organization’s authoritativeness, would really be the best body to carry out this proposed study. Are litigations based on intangible owner identification? Are they based on calculations about non intangible owners’ remuneration or on splitting of both intangible owners’ combined profit? Are they based on remuneration of hidden permanent establishment? Answers would give important inputs in projecting Guidelines text changes.


10 Indeed it would be important to project a study on ALP compliance through data of audited taxpayers by tax authorities and, perhaps, at the OECD level, on a no-name basis (with regard to both tax authorities and taxpayers) to be used to improve existing rules and not to constitute a further appeal on current litigations. Here are some (humble) suggestions on hypothesis to be studied.

On comparables extracted by database, it would be interesting to know:

- How much current litigation between taxpayers and tax authorities involves comparables extracted from public databases (set 1)?
- Among this pool of litigation (set 1), which cases involve the basic assessment of setting the arm’s length price in such a way that the tax authorities have asserted that the associated tested party was not comparable to the taxpayer’s database set because it was the owner of intangibles, or bearer of entrepreneurial risks for the group business (set 1a)?
- Under the pool of litigation remaining from set 1 after the litigation from set 1a is removed (and so where the challenge is not the categorization of the associated enterprise as an enterprise not involved in entrepreneurial risks that may be compared to independent enterprises in a database), which are litigations where the two involved Administrations do not agree on same transfer price (set 1b)?

On litigations based on the concept of hidden permanent establishment:

- How much current litigation involves a hidden permanent establishment that is challenged by tax authorities such that at the outset the tax authorities of one country have imposed a massive income increase related not to activities performed locally but to sales in a host country (set 2)?
- How much litigation included in set 2 has concluded with the assessment of limited income in the hands of the hidden permanent establishment related to the actual activity performed where the tax authorities have waived an assessment of income from sales in exchange for a waiver by the taxpayer of its right to appeal against recurrence of circumstances that trigger the deemed existence of the permanent establishment (set 2a)?
7. Specific observations on draft documents on safe harbours and intangibles

In any case apart from the proposed study (which indeed could help a lot to focus real problems in applying Guidelines) I make some specific observations on draft documents of OECD about safe harbours and intangibles.

8. The draft on safe harbours

I appreciate a lot the moving of the safe harbour draft on bilateral safe harbours just because:

- I above affirmed that certainty about rule to apply is essential: on non intangible owners’ remuneration some flexibility may be kept but in any case a safe harbour on remuneration when it has been assessed that the entity is a non intangible owner is a right way to solve the problem; here precision is exchanged against simplicity and certainty and this is a good job given the nature of non intangible owner entity (low risk firm) at audit.
- I do not subscribe to words on tax planning on the draft (see i.e. para 28)\(^\text{11}\). Obviously firms may misuse provided safe harbours but when this occurs Administrations has power to stop that misuse (and this would just be their duty). Tax planning must not be perceived generally and in every case as a “bad” job; tax planning is a bad job i.e. when transfer prices do not reflect activity (risks assumed, key function staff control and so on) of the involved firms; but tax planning has also a “good” meaning when one understands the need that firms, as per any other production factor, must know in advance which is the cost deriving from their activity localization (tax rate and taxable amount may be perceived as the cost for localizing firm in a specific territory).
- What I find also more appropriate is the protection of enterprises eligible for safe harbour against the challenge of being a permanent (hidden) permanent establishment of the foreign principal associated firm; this is a path that i.e. USA and Mexico have historically run about maquiladoras (with some specific aspects). This way of ruling is able to contrast the paradox that when enterprises are going to lower functions performed and risks assumed may become the (hidden) permanent establishment of the foreign entity; often the permanent establishment income is adjusted (here I do not call back reasons why this happens) to a value that is huge and not related to performed functions and assumed risks and this is just a paradox because the lower the risks and function are going to be performed and assumed the lower (average) remuneration (and volatility) must be; OECD Report (authorized approach) in 2008 on permanent establishment contrasts misuses of hidden permanent establishments adjustments but often this is not sufficient; paradoxically this happens to the simplest economic firm as the low risk permanent establishment. The draft in this case is particularly appreciable on certainty provided to taxpayers about the fact that when the price is correctly included in the safe harbour rule the entity may be not challenged as a permanent establishment of the foreign associated Principal.
- The drawback of this way of doing is that the bilateral safe harbour program is a voluntary program given to Countries; the bilateral safe harbours will be current only between those Countries that will do that negotiation and so the real and actual influence on the transfer pricing arena will be disclosed only when one will be able to count which Countries will adhere to the program

9. The interim draft on intangibles

10. The definitional aspect

\(^{11}\)See para 28 “Enterprises may have an incentive to modify their transfer prices in order to shift taxable income to other jurisdictions. This may also possibly induce tax avoidance, to the extent that artificial arrangements are entered into for the purpose of exploiting the safe harbour provisions. For instance, as safe harbours are generally applicable to “simple” or “small” transactions, taxpayers may be tempted to break transactions up into parts to make them seem simple or small”
The draft (para 5 above all -and following) is focused on what is not an intangible (is not a physical or a financial asset); then the draft continues in specifying that one must not focus on legal or accounting definitions because the target is to match the behaviour of independent parties.

Here I think that in any case the non definition is a better way than the wrong definition, maybe reached in attempting just to define.

However what I can suggest is to follow the line of the independent parties behaviour already chosen in paragraph 5, but to try to go further on. I think that the best way to give a broad definition of intangibles in this context is just to exclude what it’s not intangible (as till now this is done) but also specifying which is the model implied in Guidelines to match independent parties’ behaviour.

The notion of bottleneck input as sunk costs creating a competitive advantage for existing firms or a barrier to free entry of new firms is one of best way to give an idea of what is an “intangible” also in the transfer pricing context.

Therefore also right to use an asset as the ownership of that asset, physical or immaterial, may constitute an intangible contractually disposed; a physical asset (including goodwill of the business) too may become an intangible when is able to create a barrier to free entry of new firms and/or a competitive advantage on other existing firms and is contractually disposed; ownership, we say again, may have contractual origin (and this is recognized in the interim draft) because in certain cases when investment create externalities the property ownership factor agreed in a contract may solve the underinvestment problem and may prevent moral hazard conducts of the buyer.

This is the typical case of the distributor-marketer who without an appropriate remuneration or a reward set as a portion of the ownership of the commercial name that is trying to improve would not make marketing investment at the sole benefit of the producer. Here a spot transaction is not able to allow business (marketing of distributor) while only contractually is possible to give rules in a way to prevent moral hazard of producer at expense of distributor.

I think United Kingdom Administration (HMRC) makes reference to similar concepts, observing that it is necessary to investigate which is the implied model in the OECD Guidelines. You can see HMRC Manual on transfer pricing 12 where is affirmed that “Although the term ‘bargaining power’ is not used in the OECD Transfer Pricing Guidelines the concept is implicit in references to relative bargaining and competitive positions, for example at 1.30 and 3.19”(emphasis added).

The model implying the assumption of specific risk pertaining to the single enterprise (multinational) that in a case of positive development of the investments become an intangible, in term of a bottleneck input granting a competitive advantage will be dealt with also further on.

11. Identifying intangibles

From para 13 to 26 analysis is dealt with in saying what may constitute intangibles and what may not; I agree with the great part of analysis; but I think conclusions of this part depend many times to facts and circumstances while solutions of what may constitute or may not constitute an intangible could be better dealt with by reference to the economic model implied in guidelines that I above mentioned.

12. The economic model implied in para 26 and 37?

I refer to Hines economic model14 when the arm’s length principle is complied with by assigning:

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12. available at www.hmrc.gov.uk/manuals/intmanual/INTM467085.htm

13. Specific risk pertaining to the multinational at focus are depicted in contrast to generic functions assuming risk available on the (functional) market

14. J. Hines, The Transfer Pricing Problem: Where the Profits Are, NBER Working Paper w3538 (December 1990), at 26, available at http://ssrn.com/abstract=226838. When intangibles are developed not simultaneously but rather in sequence, the rule is not appropriate because connecting costs, when they have been invested at different times, would not allow an appropriate consideration of the different degrees of their risks.
- anything more than a “normal” economic return ¹⁵ to those affiliates that do not participate in risks (hereinafter also named entrepreneurial risks) that generate potential extra profits or losses .
- extra profits or losses (that remains from global results of the whole group after having assigned normal returns as above) have to be parted on location base costs (and on related affiliates) share assuming entrepreneurial risks .

I think that para 26 and para 37 correctly refer to functions , asset and risks and are affected (consciously or not) by the above mentioned economic model in identifying intangible owners (extra profit or loss collectors of the whole business); nor are the arrangements or the formal registrations of patents or trademarks , that may change this perspective related to real activity performed!

This is an appropriate point of view that (as specified in the draft) must be coordinated with chapter IX of Guidelines instruction where key relevant staff is requested to assess that certain risks are assumed by an entity.

13. Contract marketer
Para 50 let’s one understands that marketing is not a special function per se , and so when risks of marketing investments are assumed by another enterprise on respect of that performing marketing activity also marketer is a contract marketer (like contract manufacturer) performing a service for a Principal .

This is nothing new but I well know how marketing distributors have been object of challenges by Administrations and so I will make specific consideration especially about following marketing examples (in special mode example 3).

14. Difference between use and transfer of intangibles
I subscribe to para from 59 to 75 illustrating what is using and what is transferring intangibles

15. Comparability analysis : group interest vs single associated firms’ interest?
Para 81 and following ,and example 19 ,deal with some issues raised in the business restructuring part of Guidelines (chapter IX). Here the general problem is about the options realistically available to firms. It would be too long for the comment by my side to re consider some observation made to that part of Guidelines some years ago ¹⁶ . What Legislator might not do , in my opinion, is presenting the group interest as an interest contrasting with interests of single associated firms ; single business units do integrated business in view of reaching advantages that in a sole interest

Entrepreneurial risk is the risk that when all inputs are combined together by the global firm the final result of the same firm is a profit or a loss .

Chapter IX of the OECD Guidelines seeks a further requirement that tax administrations accept a risk allocation as it is decided by group entities (“In the absence of comparables evidencing the consistency with the arm’s length principle of the risk allocation in a controlled transaction, the examination of which party has greater control over the risk can be a relevant factor to assist in the determination of whether a similar risk allocation would have been agreed between independent parties in comparable circumstances. In such situations, if risks are allocated to the party to the controlled transaction that has relatively less control over them, the tax administration may decide to challenge the arm’s length nature of such risk allocation”).


¹⁶ If one is patient could look at , Musselli A, Musselli A.C. , Observations on OECD Discussion Draft on Business Restructuring: Is the Notion of Control over Risk at Arm’s Length?, INTERNATIONAL TRANSFER PRICING JOURNAL , IBFD, JULY/AUGUST 2009, at 239, and to Musselli A, the comments at the OECD draft posted at http://www.oecd.org/tax/transferpricing/42266748.pdf
point of view of the business they could not reach; the consequence is also that they could suffer losses too for similar arguments (when investments reveal unsuccessfully). Delicate problems rises when one gives the power to Governments to interpret which is the “commercially rational manner” to manage a private business, granting a power to same Governments to not recognize some business operations considered not commercially rational.

This is not the place to reconsider those issues while I would like to make specific observations further on example 19 (see following point).

16. Arm’s length conditions in cases involving intangibles

I agree with what affirmed in para from 87 to 89: here is a suggestion to Administrations and firms to not rejecting comparables when it’s not clear that they use different intangibles; the draft makes example that also independent distributors (included in a sample of comparables) may have commercial contacts with clients as could have the associated tested party. Here is at focus the problem of information which are available i.e. by using commercial database which are not able to provide so detailed data. The reasonable argumentation is that one can imagine (suppose) that also comparables have the same level of “expertise” about customers like tested party distributor has and so that only when there is a clear evidence they have not such an expertise, he is allowed to reject that comparison.

This is a prescription (suggestion?) included in a discursive part of the draft that if well interpreted could give really more certainty to taxpayers (and Administrations too) giving a sort of shift of burden of proof about comparables rejection. I fear that if this suggestion is not enlarged in a general issue about the flexibility of more options allowed (as I mentioned more times above) will not have power to stop or limit litigations.

17. Comparability of intangibles

These parts of the draft relate to economic concepts and are of good sense: nothing new. Novelty is the discourage about royalty rates (external CUP) extracted from databases and about possibility to know all information previously listed in the draft to effectively conduct a comparability analysis.

Discouraging may not be intended as a juridical ban to use external comparables on royalty rates but better as sort of shift of burden of proof for that when it’s taxpayer that uses these tools he must evidence that the comparison is appropriate.

In any case also this passage of the draft is a further step about certainty of rules to be applied.

18. Use of valuation techniques

Here is a novelty but I ask particular attention to this issue.

I personally well know how is complicated, and on certain point of view subjective, to valuate business and assets with Discounted cash flow techniques (DCF- and other similar).

I have used this type of valuations during my professional life having been concrete valuation studies on real firms and so having been included on Milan Judicial Authority register of expert also on field of “valuation of firms”.

I well know that there are a lot of issues in applying a valuation technique which may be due to a subjective choice of the estimator expert. It’s also obvious that this last has the duty to give and to explicitly explain reasons of his choices.

These concerns are included in the draft:

149. When applying valuation techniques, it is important to recognise that the estimates of value based on such techniques can be highly volatile. Small changes in one or another of the assumptions underlying the valuation model or in one or more of the valuation parameters can lead to extreme swings in the intangible value the model produces. A small percentage change in the discount rate, a small percentage change in the growth rates assumed in producing financial projections, or a small change in the assumptions regarding the useful life of the intangible can each have a profound effect on the ultimate valuation. Moreover, this volatility is often compounded when changes are made simultaneously to two or more valuation assumptions or parameters.

The draft give some suggestions on how reducing drawbacks:
151. Because of the importance of the underlying assumptions and valuation parameters, taxpayers and tax administrations making use of valuation techniques in determining arm’s length prices for transferred intangibles should explicitly set out each of the relevant assumptions made in creating the valuation model, should describe the basis for selecting valuation parameters, and should be prepared to defend the reasonableness of such assumptions and valuation parameters. Moreover, it is a good practice for taxpayers relying on valuation techniques to present as part of their transfer pricing documentation some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted.

In my opinion the point of view chosen in the draft is the one underlined in the best and most authoritative economic perspective but that will be not sufficient to avoid litigations between firms and Administrations and between Administrations of various Countries.

The draft must be aimed in reducing litigations and this opening to valuation techniques, if strong legal safeguards for users are not built, may turn to enhance litigations and not to reduce them.

I call back considerations I made at the opening of this paper:

In my opinion Legislator (and OECD in this role) must take a clear decision:

a) or Guidelines enter more in details of rules to be applied suggesting (rectius: enforcing) only one correct procedure and one way of proceeding to set correct transfer prices when more options are in front of firms (and Administrations)

b) or they leave more than one option allowed but strongly underline that a range of transfer prices is possible and that this is not an economic suggestion but a juridical statement.

DCF is a process where a final number (the result of valuation) comes out then a lot of assumptions and arguments by the estimator are made.

Firms set transfer prices and then Administrations audit them: only when it is allowed a sort of flexibility of results (a range as Guidelines affirm) all to be considered as in compliance with ALP it's suitable to quote DCF in the Guidelines, while if this is not actually granted the novelty may be counterproductive on respect to the target to have more certainty about the right rule to apply.

In any case when assumptions are made by estimator it must not be allowed to disregard them using information not available at estimation time (hindsight) because if this is allowed litigations are sure consequence.

On respect of specific aspects of DCF use in transfer pricing valuation I find appropriate to explain cases when this “technique” may be used.

For example a cost valuation about intangible is generally discouraged (para 112 value has no link to costs).

But the cost evaluation has a sense when the intangible is easily to be replaced (para 113).

In my opinion it could be appropriate to link more strictly also such a type of valuation to the model of assessing arm’s length condition implied in Guidelines and to link also such a valuation to level of information about business profitability available to operators at valuation moment.

I allude to argument I developed in 2005 at OECD Paris Business restructuring roundtable where I wrote about the possibility to compensate the going to be stripped of functions firms:

- When strategy [ ndr here the meaning of strategy is about the knowledge – or the non knowledge- of future results deriving from investments carried out previously by the “going to lose “function operator and is not used in the sense of the term used i.e. in Guidelines] is still uncertain a fully fledged operator and its foreign commitment are indifferent to turn the old contract into a

17 Ban of hindsight is already included in Guidelines text but it is not sufficient to avoid, actually and effectively, drawbacks as those I mentioned......

18 The previous part of the sentence means that “when a fully fledged operator (who is going to lose function- that is , is going to sell activities) is still not aware about actual results of its investments and is managing business in a competitive market .........
relationship between a foreign Principal and a low risk operator, like if this relationship would be agreed from the beginning. So the “turned”, now low risk, operator is entitled (eventually by a foreign producer payment) to cover costs of its past investments plus a mark-up similar to that gained, in the free market, by comparable low risk operators. Independent parties would have insisted, ex ante, for a so designed termination clause, before of carrying on transactions and investments

19. Valuation when using and when transferring intangibles
I agree with the choice to further divide both parts of the draft in a) when comparables are available and b) when comparables are not available. This is just coherent with the sense of existing guidelines.
I think further detail might be developed in examples about how comparables are extracted and managed.
I well know that this task is already explained in the “general parts” of Guidelines, but I think that more details might be provided in examples parting when comparables are based on complete contracts with independent parties (i.e. internal cup with all clauses, on marketing, product guarantee and so on) and when comparables are based on PLIs (profit level indicators) of independent companies extracted by databases (and as everybody know currently the majority of cases—or a great part—are solved in such a way). My point of view will be clearer when discussing about examples where I will develop the argument. I will discuss just there about normal versus abnormal marketer in relation to the fact of having or non having comparable arrangements and prices and so eventually having necessity to make profit comparisons.

20. Profit split is eligible when comparables are not available and valuation techniques (financial valuation) may support a profit split.
Here we are in a very “subjective” world where many prices (and processes to arrive to prices) may be considered at arm’s length; also the economic model (I named Hines model) I referred above may not give so definite solutions.

“Where one intangible is already developed and another is going to be developed, it is not permissible to use shared costs of developing both intangibles to split integrated results, as it is necessary to assign a value to the former related to the latter, based on market values and not based on development costs. In any case, no uncertainty is acceptable with regard to the arm’s length principle from a legislative perspective; more clear rules need to be promulgated by legislators regarding behaviour requested of taxpayers. Otherwise, the discretionary authority of taxpayers cannot be blamed and considered a breach of the arm’s length principle, as determined in the legal standard

But here it is strongly necessary that OECD legislator gives its proper sense to the nature of fiscal regulations that guidelines must have: Guidelines are not an economic handbook but a fiscal regulation and so I see in their front the usual (and more times called back in this paper) alternative in front of legislators to grant certainty about the rule of law.
OECD Guidelines could decide to enter in more details enforcing binding and (detailed) processes to calculate arm’s length pricing; or, as in the case I am commenting, Guidelines may leave more flexibility for taxpayers to choose the mentioned measurements, clearly allowing for more results to be regarded as legally acceptable arm’s length pricing.

19 See A. Musselli, Comments about “stripping of functions” issues, edited in 2005 at OECD website as a comment to roundtable on business restructuring and transfer pricing aspects.
Time of investment, information available at that time (and the ban of Guidelines to use hindsight) are fundamental to assess the degree of risk of that investment.

20 This is what I write (before of knowing the text of the OECD draft on intangibles) in a forthcoming article to be published on International Transfer pricing Journal edited by IBFD.

21 So also the para 147 of the draft
Also in this case, a clear decision on the text of the regulations is to be taken as a matter of legislative policy so that eventual residual litigation, concerning only facts and circumstances, will be left to judicial authorities.

*It is no longer acceptable for companies and tax authorities to quote the OECD Guidelines regarding the assertion that “transfer pricing is not an exact science” in order to justify “everything and its opposite” as regards arm’s length pricing. Indeed, this state of affairs could even exist in the field of economic theory surrounding the arm’s length principle, but must not exist in the field of tax regulations because it has a worse economic effect in the latter case (because of the uncertainty it creates for investors). Uncertainty surrounding the legal application of the arm’s length principle cannot be the aim of prudent legislators (and the OECD is certainly one of them)*

If the arm’s length principle is applied so as to create uncertainty for businesses (and for tax authorities in auditing the activities of businesses) the supremacy under unitary rules of splitting a multinational business result is certainly lost.

**21. Valuation of intangibles when income from use is uncertain;**

This issue is the so called and well note problem of periodic adjustment (under the US experience). I agree with projected rules but I fear they are not able to solve with effectiveness real cases. Considering examples 20 -21 and 22 the solutions are clearly already included in presented facts and I subscribe those solutions.

In fact the pharmaceutical cases there depicted with the royalty rate prefixed for long time when is already known high profitability of the intangible and difficulties in understanding real income flows deriving from use (but with high profitability sure) and with a comparison with industry standard of “eccentricity” of a so prefixed royalty rate for long time, ask for an Administration adjustment.

The absolute unpredictable event of example 21 ,indeed , doesn’t allow an Administration adjustment.

It could be targeted to grant more certainty to taxpayers in explaining what Legislator require in other cases. I propose one of them.

Another point to bear in mind concerns the possibility of incurring marketing expenses in fragmented amounts so as to limit the amount at risk connected to these last expenses, allowing the resolution **23** of uncertainties related to demand before making relevant amounts of marketing investments. Examples proposed in the draft seem to me to under evaluate the importance of intangibles already current on production side when the distributor is going to start his duties..

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**21** This is what I write in a forthcoming paper , see one of previous footnote. The difficulties involved in OECD work are well known, as before the OECD can have its own position there must be consent of Member countries (and this is often not a simple affair).

**22** This behavior is confirmed by empirical studies on the economics of real multinational enterprises. See thesis of I. Horstmann and J. Markusen, *Exploring New Markets: Direct Investment, Contractual Relationships, and the Multinational Enterprise*, 37 Int’l Econ. Rev.1 (1996) (companies which will enter foreign markets in the presence of uncertain demand might prefer to explore the new market through “independent” licensees rather than affiliates, in order to avoid fixed set-up expenditures; an incentive remuneration must be granted to that licensee for inducing a truthful revelation regarding the state of the demand in the particular market)
For example\textsuperscript{24}, one may consider that when a pharmaceutical active ingredient has become a patented drug, the degree of risk for the business is drastically changed from the time when there was no conception of that active ingredient and some research expenses were incurred just to discover that ingredient.\textsuperscript{25} In this case, the value of patented drug is not related to the discovery costs, but to the profit arising from future business. Also when there is uncertainty surrounding the integrated business results (including distribution and marketing activities), that uncertainty may be resolved in the future with marketing costs at risk in fragmented amounts so as to be recovered over time and ultimately permitting an understanding (without assuming new relevant risks) of the actual value of the drug.\textsuperscript{26}

In these cases business may be managed reducing amount of marketing investment at risk and so agreement with distributors, enforced for long periods of time and setting prefixed conditions, are to be considered unusual......

22. Examples

Now I come to comment the most interesting part of the draft on examples, where I focused my attention.

23. Example 1

I agree with example facts and conclusion.

24. Example 2

I agree with conclusions but I think that facts and arguments to come to conclusions should be improved to have an example proper for more complicated and general cases. It’s not explained how it has been calculated the arm’s length return for \textit{S}; if a comparison with independent prices (internal cup?) has been done for calculating the intercompany prices it’s the analysis of that prices with other conditions of contracts that doesn’t match with intercompany conditions; Auditors (and firm before) should have possibility to check that in the independent contract the costs of recall of the product are costs to be assumed by Primero (producer of the drug) and not by \textit{S} (distributor at limited risk); the contract would have shown that a cover for costs of recall of product would have been addressed to Primero. But what is if the independent contract where it was extracted the price to be considered as arm’s length price was agreed with liability of recall assumed by \textit{S} and so the price was adjusted for that guarantee? Indeed the example is built on these assumptions: given \textit{S} a limited risk distributor – given arm’s length return for limited risks – given substantial costs for recall – (ergo) therefore the Administration adjustment is on price to be lowered in reason of liability to be assumed by \textit{S} or on costs of recall of the product to be charged by \textit{S} to Primero.

The problems of the example are more extensive when we suppose that the arm’s length return for \textit{S} is calculated (as the most part of cases at now days) with a net profit return; here the costs for liability are already included in the net profit and so the return of \textit{S} is not affected by recall costs because the greater are the operating expenses, given the fact operating profit is prefixed, the lower the intercompany purchase costs become.

I well understand that an example should involve the maximum of possible cases (and so without giving information about how is calculated the arm’s length return for \textit{S} may involve a lot of cases

\textsuperscript{24} This is what I write (before of knowing the text of the OECD draft on intangibles) in a forthcoming (November – December 2012 issue) article to be published on International Transfer Pricing Journal edited by IBFD

\textsuperscript{25} J. Hejazi, \textit{Transfer Pricing within the North American Pharmaceutical Industry: Has There Been a Structural Shift in Risk?}, 13 Int’l Transfer Pricing J. 1 (2006), at 8 (observing that in recent years with the explosion of generic drugs, one sees the “erosion of patent protection [that] increases the level of risk bearing on the R&D function”).

\textsuperscript{26} This type of analysis was applied to the US Glaxo case in, A. Musselli and D. Marchetti Hunter, \textit{Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues}, 14 Int’l Transfer Pricing J. 3 (2007), at 165, Journals IBFD supra n 32.
where this return has been calculated with different methods) but this way of producing examples has the great risk that misunderstand can source.

I think that more detailed information on facts and on how it has been calculated the arm’s length return for S should be provided.

Here are now the examples on marketing.

25. Example 3, starting marketing examples: the agent distributor
In example 3 the price for the watch is complying with ALP (by independent comparables) and gives compensation for selling and distribution activities of S.
The marketing expenses of S (distributor) take the form of a service of S (distributor) to Primair (producer) and so there is a fee which covers cost and allow an appropriate profit (extracted from comparable independent marketing agents).
The conclusion is for no challenge allowed to intercompany transactions. I agree with conclusion but I would like more explications also on other frequent cases because the conclusion is implied by making assumptions that are not so frequent that one is able to meet in real cases; the example assumptions are two: the fact that is possible to conclude that the purchase price is at arm’s length by comparables and the fact that the purchase price may be analyzed separately from the advertising service performed by S.
This type of analysis is certainly possible when an uncontrolled comparable price for R watches is available (internal cup) but may present difficulties when that is not available.
In reason of assumptions the example comes to correct conclusions.
But now I come to deal with other frequent cases to be ruled.
I allude to necessity to rule also cases to be solved through profit comparisons when it’s not so easy to distinguish in comparable distributor sample (i.e. when extracted by commercial databases) the type of marketing are performing the distributors included in that sample.
In fact it’s not easy to understand in extracted companies from databases the operating expenses volume and it’s near impossible to have access to contracts eventually regulating marketing activity.
What is about a net margin extracted from such a type of comparable sample but that (for its nature) is going to cover all operating expenses of the associated entity (S) - distributor?
The real problem in this case is that the profit margin would be a single profit margin (applied to the full amount of operating expenses = distribution costs and other operating expenses + marketing expenses, while in the example all operating expenses are covered and it’s allowed a margin for distributor but the margin of marketing expenses may be different from that of distribution activities).
Here is another dilemma in fiscal regulation: the analysis may be not perfect due to constraints in having perfect information on independent comparables but in giving anyway a “right” rule in the example (by regulating in such a way I do the audited transaction) the OECD would give certainty of taxation to firms and Administrations when easy “perfect” solutions are not at sight; in this way OECD would avoid that the real rule to apply to this case will be developed ex post transaction at eventual litigation moment by Judges (and one well knows what a variety of situations include this term in mentioned contexts - Countries’ judicial Authorities, Competent Authorities under international Treaties and so on).
I think that with regard to ex post transactions, during a tax audit carried out years after the commencement of distribution activities, the tax authorities might have a clear way to assess if the ALP has been breached or not in similar cases.
When a normal net profit return (maybe tested to what is gained by independent distributors) has been left in the hands of the distributor for each audited period, the Administrations have an incontrovertible evidence that marketing expenses (if any have been assumed) have been borne not at the risk of the distributor. This assessment becomes an (historical) question of fact.
In this case, the actual conduct of the parties prevails over any (even written) agreement.
Transfer prices are in ALP compliance because the normal return on activity under a distribution contract was appropriate in any case, i.e. – in case a marketing activity was unnecessary or non at risk (because the name was already well known) or in case a risky marketing activity was appropriate but by a choice of group it was not performed at distributor risk. If and well applied I think that this assessment could stop a lot of litigations.

It’s totally irrelevant in the example the circumstance that at the end of marketing period the name R of marketed watches by S becomes well known; the fact that the name becomes well known may induce misunderstanding because the remuneration of S might not change also if after marketing the name R remains “unknown” (given the fact S is a limited risk distributor); Legislator should specify that if returns from intangibles are attributable to P in case of successfully marketing those returns (in a lower measure maybe to reach a business loss) are specularly attributable to P in case of unsuccessfully marketing.

26. Example 4 : the distributor normal marketer and its remuneration

Here S is marketer at his own risk: the example is built with an assumption on slim margins of S and high operating expenses (marketing costs) on first activity period.

This is one of central examples to explain the rule about distributors. The final conclusion is that S is entitled to a portion (with another portion for Primair – the producer) of the returns granted by trade name R, which was unknown at the beginning of distribution activity while has become well known due to marketing expenses assumed by S. It’s not clear till the end of the example how transfer price of watches has been set. It’s specified that the price is lower than in example 3 (but in this case that price is going to recover part of marketing expenses......) and that different criteria are used for identifying comparables here than in example 3.

The bulk of analysis could seem 27 that S gains slim margins and assumes high operating expenses (before of good exploitation of the name).

But at the end of the example it’s affirmed that “information on comparable uncontrolled arrangements suggests that the return earned by company S provides it with the arm’s length return for its functions, risks, costs and its resulting entitlement to intangible returns”. This seems to be the best tool to give a solution to facts of the example: the firm is able to make comparisons with arrangements between independent parties.

Now I am able to understand that firms and auditors had comparable uncontrolled arrangements to give support at analysis; are they making internal comparisons?

In any case when I have these arrangements and I think that transactions are really comparable (with adjustments or not) to those at audit (this is the bulk of the assessment) I have prices and other clauses about rights and duties of parties included marketing activity (i.e. I have clause on liabilities for guarantee on products and so on). The independent arrangements rule out also about the consequences of such a marketing activity performed by S and so about the proper entitlement to a portion of returns attributable to development of R name (or on an appropriate return for development). Obligations and rights of the contract are all and clearly disclosed in independent arrangements: a distributor is not going to invest in marketing (at the benefit of name owner) if he has not agreed his remuneration under all circumstances (present and future); i.e. distributor would agree with producer what type of investment would do, which type of purchase price would be set at present and in the future for reselling goods in a way would have a chance to recover investment done (but also having possibility to lose investment put at risk......), terms of life of the contract and possible termination clauses.....

Existing independent arrangements could be the base, with eventual adjustments for differences, in planning the intragroup transaction.

In any case the slim margins and high operating expenses are not the bulk of analysis of the example and the driver for conclusion because they seem a consequence of applying rules of the

27 note the verb to seem because this is not what it is in reality about the existence of comparable uncontrolled arrangements
independent arrangements to the activity of S in first years of business when the R name was not known in target market.

I think that the example could try to further rule the issue with projecting how it’s possible to give instruction when comparable independent arrangements are not available. This could really be a step forward in giving certainty to Taxpayers and Administrations because a lot of current litigations are about the role of the distributor and the “correct” amount of marketing expenses and comparable independent arrangements are not available.

Therefore I have to start with a new hypothesis: independent arrangements are not available.

It’s time of depicting the marketer at his own interest with profit comparison, maybe with data extracted by public databases.

The problems are several in this case but here are welcome some simplifications, to be paid as lower “perfection” of solutions, that may give further guidance and certainty to Taxpayers and Administrations.

The bulk of analysis must be how to characterize and detail a marketer distributor which is going to invest at risk some of his proper capital and so is entitled to a portion of return generated by successfully development of the name while has possibility to recover a loss when and if the development reveals unsuccessfully.

The role of the marketer at his own risk by S necessarily implies a recognition of marketing expenses that must be classified as risky expenses for that slim distributor margins are reached for first years of activity in comparison of a non marketer distributor; obviously a slim margin of the associated distributor is due to three different aspects:

a) a comparison with normal margins of independent reselling distributors
b) a setting of intragroup transfer price for goods to be resold
c) a given level of marketing expenses included in operating expenses of associated distributor.

I analyze the three aspects of this first period of life of an hypothetical arm’s length agreement.

a) The normal margin of a distributor (for reselling distribution activities).

When I search comparable distributors from databases usually data show actual figures included in the balance sheet and in profit and loss but do not show contracts between parties where are agreed clauses related to events that are supposed to set, if any, volatility of possible results.

First I can try to select firms with a low level of marketing expenses and activities.

Here I could have a range and a mean (or average) of distributor net profit margin to be considered appropriate for selling activities.

The slim margin of the associated entity is just by comparison with the profit of the independent mere reselling distributors.

b) The purchase price of goods to be resold is a transfer price and causes how the distributor margin is slim in comparison with normal above mentioned

c) The level of marketing is the factor that I focus in operating expenses that causes (among others) a slim margin of the associated entity as above mentioned

The contract with such a starting period is in compliance with ALP if it is built in a way that is sufficiently long to have a second time of life where it’s possible to test if marketing revealed successfully or unsuccessfully and to provide consequences.

In the case the marketing revealed successfully I must check that distributor margins are higher than margin of selling distributors (as those above mentioned extracted by databases).

This may happen in various ways; or by a change in purchase price of goods to be resold, or by a lowering of advertising costs per unit, or by a rise of returns by reselling activities and to be considered attributable to distributor (or in other ways like the attribution of a portion of name ownership ...); the effect of all or one of this factor is clearly a rise on net margin of associated distributor.

28 It is evident that I focus only some aspects of economics of the distributor because the slim margin could be due also just to inefficiency of his proper managing the business.
The marketing may reveal unsuccessfully and so the lower distributor margin (or the loss) for past years cannot be recovered.

Here comes the problem that when there is not chance to recover loss with future activity that activity must even cease.

The agreement between independent parties would rule all these aspects in a sole moment, before of starting distribution and marketing by distributor.

But here we have not an independent agreement as a benchmark.

Therefore I must try a way to assess when the marketing is successfully developed and when is unsuccessfully developed; this aspect is not ruled in the example 29 while it's important to have guidance also on that; I think a line between successfully and unsuccessfully development may be drawn only having data on the full line of integrated business and so knowing combined results (profits or losses) coming from producing and selling goods in the distributor market.

In this way I could test if marketing costs (as all other costs) have been covered and in what extent by combined activity of producer and distributor (successfully marketing) or if losses (unsuccessfully marketing investment) were generated.

Also a temporal line must be drawn in connection with the time when marketing expenses may reveal a success or a failure (i.e. in the example the time is 3 years).

Now I can build a complete contract with the last assumption (i.e. 50% 30) about the degree of probability of success or of failure of mentioned marketing.

The contract enforces that if marketing revealed successfully the distributor, in the second period of the contract, could gain an extra profit mirroring difference, in positive (plus a premium on risk31), between slim margins (or losses) and margins from mere reselling activity; if marketing revealed unsuccessfully, in the second period, the distributor margin must be aligned to reselling distribution activity (or with combined activity not profitable the activity may be ceased for a producer decision), without possibility for distributor the covering of past investment with extra profits.

I think that without further guidance taxpayers and Administrations would litigate a lot in depicting the normal versus abnormal marketer when a comparable contract was not available and so when transfer prices would be set only with data extracted by public databases and with profit comparison methods (the most of cases actually dealt with by Taxpayers and Administrations…).

I drafted some concepts but others could be projected 32: what is important is that in a so delicate context regulations goes further more in detailing what is asked to firms to do and in a way it’s clear what Administrations have to audit then Taxpayers have set prices, in the spirit that when what is right and what is wrong is clearly depicted to avoid litigations (and to solve them by Judges) will be easier.

27. Example 5: the abnormal marketer; how to test abnormality when comparable arrangements are not available?

The facts are those of example four but the level of marketing performed by S is excessive (here is the role of abnormal marketer).

Also here the first issue is to disclose how data have been obtained and which data allow to conclude that “the comparability analysis (that) identifies several uncontrolled companies engaged

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29 There is only the affirmation that the name becomes well known

30 Obviously if 30% was assumed the results is going to change; this is why , as I called back many times in the paper, Guidelines must specify that reasonable assumptions cannot be neglected by Administrations; see specifically what I observed on introduction of valuation techniques and DCF calculation in the Guidelines

31 The greater the difference between slim margin and normal margin is the greater the premium must be.

32 i.e. where I am able to select comparable distributors performing marketing activity at their own risk I could consider results in the low boundaries of a range as marketer in the first stage and results in the high boundaries of the range as successfully marketing distributors.
in similar marketing and distribution functions under similar long term marketing and distribution arrangements”.

I understand that is possible to identifies companies but also distribution arrangements. More, I am able to compare the marketing of S with marketing of comparables having possibility to conclude that marketing expenses of S far exceed those incurred by comparables (abnormal marketer).

It’s not called that at a certain moment the R name becomes well known but calling facts as in example 4 also this fact should be implied. As a consequence marketing expenses beyond what independent enterprises would assume with similar rights at their own benefit determine significantly lower profits for S than such independent enterprises.

Abnormal marketer is depicted in reason of lower profits due to set transfer prices in connection to higher, than comparables, operating expenses and without appropriate future projected or possible returns in comparison with set conditions in independent similar arrangements.

Then Administration in auditing S (the one who has interest to do so) is allowed to make some upward adjustments to income of S through different ways (reducing transfer prices or splitting residual profit from brand S or directly compensating S for marketing).

I think that example is similar to example 4 but without “happy ending” for S. Therefore I think that considerations I made for example 4 are recallable.

In particular OECD could go further on in analysis, by separating cases where comparable independent contracts are available from cases where more assumptions might be done (profit comparison and databases data), in order to build an arm’s length distributorship agreement.

In any case I have a concern related to the great importance OECD is giving to distributor role that is going to lower importance of producer in the integrated business.

I think OECD might run also another (further) step (perhaps with a new example) where it is not appropriate to refer only to the distributor’s activity when determining an appropriate transfer price.

OECD must give a pattern about how to value marketing intangibles (when some authors even consider they do not exist!) in the context of an integrated business for that without a valuable product, marketing can do nothing (or, that is the same thing “marketing is a routinary activity, aimed only to inform customers about product features”).

The starting point must be an assessment of risks assumed by a distributor related to risks already assumed by the manufacturer (or, with same results, the total risks of the integrated business): one estimator is faced with an eventual marketing intangible to be developed by distributor that must be connected to the intangibles developed on the production side. This must be a clear pattern, able to divide cases when it is sufficient to look at the sole distributor side to project a remuneration rule and when this is not correct. Concepts to build such a rule are identifiable in assessing that when marketing costs are put at risk, many times, valuable bottleneck inputs have been created on production side just because, usually, marketing is performed at the end of whole investment process and when the market value of the output is going to be disclosed.

Profits, in an integrated business, is generated by the fact that resources are to be committed before of having information about output value33 and so when time for having disclosed the output value is short (marketing at the end of investment process) most of risks are over34.

Here more than one economic pattern may consent to assess arm’s length conditions and time of investments, I repeat, time (time of investment on the production side versus time of making a marketing investment) is an important factor when evaluating the different degrees of investment risk. At the end of the investment process the market value of the output is disclosed (or near to be

33 See Hines quoted supra at note 14
34 Please consider that I use the term risk in the sense given by economics and so the fact that a risk is over means (simplifying) that a single result is possible (now near to be actual), that may be positive result (a profit) but also a negative result (a loss).
disclosed) and so when marketing costs are put at risk, many times valuable bottleneck inputs have been created on production side.....

I think one of examples might be targeted to reaffirm these principles maybe at expense of losing a sort of perfection of the analysis. In any case the most part of level of analysis is developed now days , in real transfer pricing cases, with imperfect data like those extracted by databases.

Now I come back to conclusion of example 5: the example concludes (between allowed options) about a profit split and this is a correct solution ; example gives the power to Administration of Country Y to adjust the income of S under profit split method , but without other details as I wished.

28. When distributor cannot develop marketing intangibles cause marketing has no risk in reason of choices of group management in exploring a new market ; the challenges of Administrations charged to tax producers: absence of examples

Another problem to be dealt with to give certainty for distributorship is to complete regulations in a way to rule totality of cases. In my opinion till now it's not dealt with the case where no marketing intangibles can be developed and I refer to a necessary link between what is considered periodic adjustment in other part of Guidelines and the starting point of distribution examples. Is fiscal regulation over evaluating the role of marketing intangibles in an integrated business?

I am going to express my opinion.

I consider the distributor saga:

- Example 3 is about distributor marketer agent ; here the name of producer is not well known but the distributor will not become intangible (name) owner cause marketing is not at his risk
- Example 4 is like example 3 , and distributor is partly intangible owner
- Example 5 is like example 4 and distributor ,given excessive marketing and “poor” related returns , has not been adequately remunerated.

But what is about the case where the producer is going to market (also when the name is not known before) a product that has a so important value that marketing expenses are not risky expenses (and so there is any marketing intangible that can be developed)?

I allude also to cases where valuable patents are in the hands of producers........

Consider what some empirical studies underline about multinationals and the development of new markets : companies which will enter foreign markets in the presence of uncertain demand might prefer to explore the new market through “independent” licensees rather than affiliates, in order to avoid fixed set-up expenditures; an incentive remuneration must be granted to that licensee for inducing a truthful revelation regarding the state of the demand in the particular market.

If I deal with this case in fiscal regulation I am going to think to a sort of periodic adjustment ,and so to the necessity that producer and distributor must agree short term contract in order that Licensor (producer) is allowed to capture all extra profits which were not projectable at the first moment in entering the new market , but that are going to be projectable when licensee – distributor “explores” a new market without assuming marketing risks.

In this case the sole arm’s length contract is the one where distributor is going to assume the role of normal distributor (rectius: marketer agent distributor where risk are not current for the whole integrated business).

In this case , usually, the Administration interested to deal with the problem would be the one charged to tax the foreign producer while all examples are targeted to focus adjustments that will be done by Administration charged to tax the distributor.

I made some considerations above at point 21.

The starting point of such an analysis must be the detection of the situation when real risks are in front of integrated business and when they are not in front (also in reason of the behaviors of

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group managers in exploring the new market) , so to understand if marketing really presents risks........
Also here if one example (and I think that OECD should project that) is made it must be done in a way to give certainty to Firms and Administrations

29. The distributor role and paragraph 2.73 of Guidelines: a further example on unique factor causing profit or loss; using net profit level indicator frustrates the relevance of functional risks assumed by tested group entities

I think it could be interesting to project a further example about distributor and for specifying a frequent situation that could recur into para 2.73 of existing guidelines (it could be addressed also in other parts of guidelines ...). It’s newly the case of profit comparison (TNMM) and what could be interesting would be to rule the case when I am going to reward a distributor with profit comparison and I use a PLI with net profit (margin).

I can extract a sample of independent distributors similar to the associated one having opportunity to build a range and a mean (average) of arm’s length net profit. Is S, the associate distributor, allowed to gain a “positive” profit in any circumstance?

Consider that, S, has an important client going to bankruptcy.

Net profit of the sample is already affected by losses on accounts receivable. But S is able to show:

a) That account receivable/sales - ratio -of the sample as an average, was not so different from the one of S (obviously I must have available data to allow such a comparison – here I must argue similarly as for abnormal marketer)

b) The losses on account receivable (credit losses/receivables –ratio-) of the sample was as an average so much lower than the one experienced by S including the loss due to mentioned bankruptcy

c) S was responsible with appropriate staff of credit policy to clients of managing the credit risk

In this case the difference between real credit losses experienced by S and losses that S would have suffered if it had reached a ratio -credit losses/receivable- as the one of independent firms produces a cost that may affect the net profit (of S) over what is the comparable net profit of the sample. Obviously the reverse case would be if a unique factor of profitability would have affected S business.

I think that a so projected example could enrich the distributor examples of guidelines enriching the distributor’s saga and giving more certainty to Taxpayers and Administrations.

A further work of OECD (this is a too long task for these notes) should be targeted in asking that in intragroup contracts the risks are assumed as independent operators really would do while currently net profit level processes tend to give to group operators a normal profit in any circumstance; with reference to net profit the group operators are not affected by risks really assumed by independent parties in their proper business. Considering the example that I proposed, with a net profit indicator the abnormal loss on credit is automatically attributed to producer and not to distributor: this may be correct only if a contract provides so (before of knowing if a real abnormal loss will become an actual fact) and key people of the producer have managed credit risks of distributor customers. In other words: the fact that some risks at arm’s length are assumed by the tested group entity (also when risks are pertinent to performed function but in any case are proper of the single group business) is practically frustrated when net profit level indicators (especially when they are means or averages) are used. Indeed also group operators which are functionally comparable to limited risk independent firms may assume some proper risks by a choice (and an agreement) that must be evident before the fact setting the risk happens.

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36 Please see what I think is the appropriate role of examples in the Guidelines context at point 5
37 Here some assumptions must due to the fact that the net profit mean (or range) of comparables already includes a mean (or a range) of risks assumed by those operators...... but that the fact resulting in a risk for the group operator when happens may cause further effects on his profit and loss
Para 2.73 of OECD Guidelines does not give the proper relevance to this case which (seems totally due to judgment of firms) is so important about ALP.
This would really close more net profit level indicators legal processes with the economic principle and obviously also here it would be necessary to create rules with would allow certainty about requested behaviors to be applied.

Now I resume a lot my observations

30. Example 6
I agree with facts and conclusions.

31. Example 7
I agree with fact and conclusions. I only observe that conclusion are generally drawn on royalties not appropriate in case of obtaining only the right to use the name but what might result from the example is that it’s the reward of S that is not appropriate considering both transfer price and royalty (together).
So it could be even appropriate the mentioned reward, maybe, when a royalty was current but was current also a lower transfer price.
Distributor is going to invest in marketing when has possibility in a prefixed contract (agreed before of investment) for that he may suffer a loss or may gain a profit (adequate to assumed risk considering purchase price and any other transaction like royalty, maybe) or when same distributor has a right to use (ownership- partial ownership) the property (the commercial name) sourcing from that investment (economics of contract).

32. Example 8
I agree with fact and conclusion but I observe that the bulk of the example is the analysis that the marketing of S far exceed that of independent distributors under similar long term agreements.
I newly call that this concept should be further explained just in reason of how comparables are searched and are available.
On the contrary (and I am currently well aware of that) a lot of litigations between firms and Administrations and between Administrations of different Countries too will source on the notion of abnormal marketer (see observations to examples 4 and 5).

33. Examples 9-10-11-12-13-14
I agree with facts and examples’ conclusions.

34. Example 19
This example is based on different evaluation of a business (with DCF- discounted cash flow) and related intangibles when is going to be managed by a company Pervichnyi (P), using a contract manufacturer (with lower production costs and a lower tax rate) from when is going to be sold to the same contract manufacturer (that has the same production costs but has also a lower tax rate on income sourcing from the business and so the business has more value for him than for the seller).
The target of the example just seem to underline that the buyer of a business and of related intangibles, when he has a lower tax rate, may have possibility to evaluate more that business due to the fact that discounted cash flows (net of taxes) are higher than for the seller (which has a greater tax rate).
Conclusion is that one must look at both perspective, the seller and the buyer one, to set an acceptable transfer price for both entities.
I feel some inconsistency of what is here affirmed with what is affirmed in chapter IX of Guidelines (and US Regulations) about “location savings”.
Under location saving principle any saving of costs (typical is of labour costs) that is due to the fact that a certain firm is located in a Country where the factors of production cost less than in other Countries do not pertain to the firm located in that Country when an associated firm is going to agree a contract manufacturing with the mentioned firm.

38 the reality is that sometimes available data give difficulties in doing that and so the focus in Guidelines text must be shifted from firm discretionary power to availability of data
The economic mechanism is simple: all other firms of the Country with lower labour costs are allowed to gain labour advantages and so a private auction on de localizing business would end to make that cost advantages would be transferred to the de localizing firm.\footnote{when certain well known conditions are met.}

In my opinion in example 19 the logical correct passage should be: is the group decision to sell the business from P to S? If the answer is yes, I have to estimate an arm’s length transfer price (in view of both firms maximum interest). This transfer price must be 941, that is the transfer price that another (independent) company, located in same Country of S would pay for that business, having granted the same (lower) tax rate than S.

The fact that S has granted a lower tax rate in his Country must be considered at the same level as for other production factors allowed in the same Country (the tax rate is nothing other than a production factor to be paid for localizing in that Country the business and due to the payment of public services performed in the Country).

I feel other problems in the example, on side of eventual differences between projected revenues and actual ones and other assumptions for using DCF techniques: here I call back what I observed when dealing with the introduction of DCF in the text of Guidelines and cautions to avoid litigations.

Nothing is said in the example on the problem of periodic adjustment when I well know that just here the problem of periodic adjustment could source if the sold intangible is considered as an intangible sold for a lump sum (as it’s without a doubt) but whose income was uncertain at the moment of sale. When an example on DCF is built, the problem of the comparison between actual results sourcing from the intangible and projected ones with a clear judgement about unpredictable events and information available at sale moment might be done.

The link between the use of valuation techniques and the problem of periodic adjustment could be deepened just in this example.

35. Example 20-21-22

See what I observed above commenting paragraphs on periodic adjustment.

36. Limited Conclusion – reminder to specific conclusions drawn on previous issues

I do not want to call back all observations specifically drawn on single points of the drafts that I made above; these are some limited conclusions and this is a reminder to consider them.

a) The concept of intangible is not strictly necessary to project transfer pricing rules.

\textbf{What is important (essential) is that a clear model of allocation (to associated entities) of returns of group’s incomes is included in the regulation}. The best method rule (and para from 26 to 37 of the draft) depicts a mode that, when and if fairly interpreted, could give a profit allocation which would be in compliance with the economic model I drafted at point 12 and which would come to predictable rules. \textit{This is what should be in theory but some problems are underlined following.}

First I give my opinion on what is in theory, problems will follow.

The distributor position i.e. is the theoretical position of who is going to make a specific investment that has a value under a locked relationship (with producer); the group form of enterprise is just the solution to prevent the hold up of his investment in advertising while Group solution can’t be a solution for Governments that need an equitable division of tax revenues.

\textbf{The first best solution} to prevent underinvestment of firms, when specific investments are planned, to explain behaviours of firms acting at their best (conflicting) interests to come to a possible \textit{equilibrium state}, is the ability to make a complete contract where distributor is fairly remunerated for his investment in each possible future event: this is what is depicted as a \textit{normal marketer} (example 4) and in general part of the draft.

\textbf{The second best optimal solution} (when the first best solution is not possible because for well note reasons to build a complete contract is very difficult in forecasting all possible future events\footnote{And this is why the vertical integration (the form of group of an enterprise) is an economic solution (where it is not a solution on tax problem.)}) is to
give in the contract, the right (or a share of that right) to use the business assets (the name) sourcing from investments to the seller: this is what depicted as abnormal marketer (in example 5 and in general part of the draft). Here what is important is just the (intangible?) property assigned through the contract: the right to use business assets, material or immaterial (see back point 1 about contract theory and related references).

This the right way pursued in the drafts (para 49.50-51 of the draft, already included in chapter VI of Guidelines) also if these concepts are included into the Guidelines and into the drafts without explicit reference to the model.

As a conclusion, in my opinion, the concepts included in the intangibles’ draft (returns of a group entity must relate to functions performed, assets employed and risks assumed in the business) may reach similar effects as asset ownership concepts that I above mentioned also without explicit reference to the model. But this “non definition” of intangible included in the draft could be too abstract to be easily understood and could be enriched with concepts I above mentioned giving reason of the bargaining game of parties; this could be useful just to “find” a concrete rule when some doubts arise as in the contexts I underline following.

b) Second I want to underline a problem about the way to “produce” legislation that is independent from economic concepts I above referred but that has a huge effect on economic system and society. I think Legislator (OECD) must give more certainty to Firms and Administrations in applying ALP and when this target is not reached underinvestment of firms (or investment only in Countries assuring that principle) arises, with a (not simple to be measured but certainly current) recessionary effect.

If the certainty about the correct rule to apply is the real target to be reached an important change in projecting fiscal rules must be done, because one can easily ascertain that under the present text of Guidelines a lot of litigations just about which is the correct rule to apply, are widely current.

I think that Legislator must give more details on asked behaviors to firms when he wants that a specific process is used to set transfer prices in a wished way; providing further details should allow firms and Administrations to follow issued guidelines with less uncertainties than now; but when more options are allowed by Guidelines text it must be clear that this is not an economic suggestion but a juridical statement!

Therefore Legislator (I repeat, if certainty about the right rule to apply is the wished outcome) must give a strong safeguard to firms, obliged to set in advance prices which will be audited later, that if they (firms) choose one of allowed options, then, years later, Administrations cannot neglect that –allowed – choice; obviously Administrations must challenge a non allowed choice; but if same Guidelines leave open a space to one estimator (first, a firm) to make some assessments those assessments can be amended only when they are irrational (or non in compliance with Guidelines text) and not because other assessments could be equally rational. In my opinion the sole “range “ concept of the arm’s length price is not sufficient in actually and effectively stopping misunderstandings on this fundamental issue; this is an allegation which is historically proved by presence of wide litigations and new tools are to be provided in addition.

[^41]: If the asset property, sourcing from distributor investments, is given to producer (buyer) the bargaining power of the distributor (seller) is lost because the investment has value only in the locked relationship and so there is no incentive for distributor in making investments.

[^42]: At least in some Countries as it’s mentioned also in OECD 2012 Report “Dealing effectively with transfer pricing challenges” at page 17

[^43]: It would be too long for the paper to propose these tools; a lot of concepts already included in Guidelines should lead to the mentioned target but I fear that just the strain of Guidelines is too much discursive (cause Guidelines have to be implemented by internal legislation?) : this doesn’t help; it would be necessary to insist on what it’s possible to do with a reasonable burden in order to comply with a certain (and well identified by
c) About intangibles ownership I think more details could be given as to the **way to identify** which is the associated entity that becomes intangible owner (or the entity entitled to intangibles return). This, above all, will be clearer further when I will deal with marketing intangibles in case no comparable arrangements are available about distributor role. Indeed fundamental guidelines must be given (and already they have been substantially given in current Guidelines’ text) on non intangible owners reward calculations and on way to split combined profits when both transaction parties are intangible owners; in these last cases I think than more than one method and several options must be allowed on those calculations. This could be the right choice of OECD combined with the safeguard mentioned above.

d) **The introduction of DCF valuation (and/or of other financial techniques)** in Guidelines text may have two different alternative effects, the one positive or the other very negative. If DCF is considered (as a *bona fide* interpretation would consent) a way to **round** the value of an intangible, this may be another good tool provided to firms and to Administrations to make compliance with ALP; but as any estimator well knows, if Legislator lets that firms proceed with a calculation and that then during an audit, maybe years later and using information current at time of the audit, Administrations are allowed to easily remove i.e. the discounting -adjusted for risk-rate used by firms also by a little amendment (one % point less or one % point more ?), neglecting argument provided by firms for choosing just that rate, the same ALP concept is no more a rule for that it is possible to predict ex ante the requested correct values (or at less a range of correct values) 44.

e) **About Examples of Guidelines** I think that just examples may be one of most appropriate legislative tools to reach the certainty about the right rule to apply:

- **In case of intangible owner identification** the examples may give more details just to make less complex the analysis also at expense of a sort of precision and “perfection” of economic analysis when available data do not consent such a perfect analysis.

- **In case of calculations** the examples may give a way to be followed (similarly to what constitutes a safe harbor) so that other ways of proceeding are equally allowed when available data consent more rigorous analysis, but providing safeguard that following example behaviors no challenges are possible.

Guidelines) concept of (legal) ALP. As mentioned in the text it could help a strong legal statement about arm’s length compliance as a proceeding, different for the two fundamental actors of the game (firms and Administrations). Firms must set prices in advance and using information available at transaction time; Administrations’ audit should be targeted to prove the evident irrationality and non compliance with issued Guidelines of the firm assessment and not targeted on the possibility to calculate other (from those calculated by firms) reasonable (in compliance with ALP) prices.

44 APAs become the sole way to have an ex ante rule to apply ALP; this couldn’t involve (for clear quantitative limits) the millions of Taxpayers affected by transfer pricing.

45 Let me call back my vision about examples role in Guidelines. Examples may become a useful tool in reaching certainty about rules to apply in compliance with what above mentioned project and with required flexibility to reach above mentioned goals. The Example may become a way where Legislator is able to give some detailed instructions in order to consider as current some principles enforced in the general part of guidelines (also at expense of precision of analysis and so by making some simplifying assumptions); in this way readers of Guidelines are able to understand that if a severe analysis is possible, also given available data, conclusions follow the analysis but if available data do not allow conclusion in compliance with enforced principles (enforced in the general part of Guidelines) simplified assumptions (as much as possible coherent to the general rule) allow to give a rule to specific case that may be followed with predictable behaviors; those behaviors when complied with by firms can’t be challenged, years later, by Administrations (similarly to safe harbors but that operates in a different way...).

I repeat that Legislator might also choice to leave more flexibility to firms by not giving a secure behavior in the examples but when this is the chosen rule, firms cannot be blamed for choosing one of allowed options.
f) In marketing examples I think Legislator must divide the analysis in when independent comparable arrangements of distributors are available (and so the rule is already done because all intragroup conditions must correspond-with eventual no relevant adjustments- to the independent ones) and in when such arrangements are not available. This would match also what is dealt with in the general part of the draft where this division is done. I think examples now current in the draft are not clear about this partition (my observations are expressed back at points 25 and following of this paper).

When independent arrangements are not available I think legislator must give in any case a rule, also at expense of a perfect analysis that in this context may be impossible, to solve in the best way, at arm’s length (and coherently with economic model I referred at point 12, that I think is implied in Guidelines text), the case with current information constraints.

g) The first target is to give a clear rule for the marketing agent distributor (also when are not available comparable arrangements).

Here it’s possible a simple rule whose compliance with is tested also ex post transactions during an Administration audit managed years later those transactions.

When a “normal” net profit return (maybe tested to what is gained by independent “normal” distributors or also by a provider of “similar services” extracted by databases) has been left in the hands of the distributor for each audited period, the Administrations have an incontrovertible evidence that marketing expenses (if any have been assumed) have been borne not at the risk of the distributor. This assessment becomes an (historical) question of fact (irrespective of contracts) and is able to solve a lot of real cases, where eventual returns (profits or losses) from name (intangible) development, if any, are attributable to foreign producer and not to distributor. This will avoid litigations in a case where the plain application of ALP can come only to mentioned conclusion. Example 3 must give a solution not only when comparable arrangements of distribution are available but also when they are not.

The fact that in example 3 the Legislator specifies that marketing expenses have enhanced the group commercial name may create misunderstandings: the rule about the marketing agent correctly might conclude that distributor remuneration is irrespective of what happens about the promoted name and so the same rule would have been applied also if the name exploitation would have resulted in a failure.

h) When comparable independent arrangements on distributor are not available and the distributor is not a mere marketing agent of the producer the role of normal marketer versus the abnormal marketer 46 must be depicted with more details in reference of what is present now in the draft which seems to base that partition on presence of comparable independent distributorship agreements.

I think that if these details are not provided firms and Administrations and also Administrations of different Countries will litigate a lot about the notion of “excessive marketing” of the distributor (just when comparable independent agreements are not available) and about the identification of normality or abnormality of marketing).

I made some proposals on details to be provided (point 26) 47 in a profit comparison context where the difference between normal distributor return and the slim margin (due to marketing investments) of associated distributor may be used to build an arm’s length arrangement: i.e. if the name is successfully developed the extra profit is specularly measured just with the mentioned...

46 A lot of litigations between firms and Administrations and between Administrations of different countries currently are just due to different interpretation of the excessive versus normal level of marketing expenses of the distributor; clear words also when comparable independent arrangements are not available are necessary......

47 See back point 26 about details to be provided and proposed solutions (How to test the successfully versus unsuccessfully development of a commercial name? – which are consequences of the non successfully development of the name?)
I think (see back point 28) that in the draft regulation is also absent an example of when distributor cannot develop marketing intangibles just cause marketing may be managed without risk (further cases of periodic adjustments)! This is an analysis ending to (periodic adjustment concept) necessity to agree only short terms contracts between producer and distributor.

I allude to cases where the value is on short side of the patent producer and when challenges to eventual sharing of value between producer and distributor should be moved (when income is not appropriately assigned to him) just by Administrations charged to tax that foreign producer. The starting point of such an analysis must be the detection of the situation when real risks are in front of integrated business and when they are not, so to understand if marketing presents those purported risks which are considered current only with the sentence, included in examples, that the “commercial name is not known in the distributor market” (and then the positive effect of marketing is current with the sentence that “the name has become well established”) ....... also when the name is not known is possible to manage marketing under an integrated business, in a way to reduce risks!

I think also that OECD might run in detail (see back point 27) a new fundamental example with another case where it is not appropriate, similarly to previous point of view, to refer only to the distributor’s activity when determining an appropriate transfer price and where intangibles on producing side are valuable and to be taken in account! Here I must give a pattern about how to value marketing intangibles (when some authors even consider they do not exist!) in the context of an integrated business for that without a valuable product, marketing can do nothing (or, that is the same thing “marketing is a routinary activity, aimed only to inform customers about product features”).

The starting point must be an assessment of risks assumed by a distributor related to risks already assumed by the manufacturer (or, with same results, the total risks of the integrated business): one estimator is faced with an eventual marketing intangible to be developed by distributor that must be connected to the intangibles developed on the production side. This must be a clear pattern,

48 The greater the difference between slim margin and normal margin is the greater the premium must be.
49 I newly specify that here one must appreciate that the solution is the best way to give a clear and predictable solution to otherwise impossible cases to be ruled in a “perfect” (impossible) way, due to information constraints. Certainty about the rule of law is the prize to be reached at the expense of some analysis simplifications. In my opinion the first target of OECD guidelines must be to rule real cases with available information in the hands of Taxpayers and Administrations and not to contribute to economic theory! To leave the situation as it’s now is to let that the ALP looses any capacity to produce predictable rules and positive features of its application (incentive to efficiency and equitable division of profits to Countries) are completely offset by that failure about certainty: the supremacy of ALP on unitary rules to split multinational business results is lost!
50 For details about the fact that the name was not known (and then successfully developed) see back point 26.
51 I newly call back (I beg your pardon) that Horstmann and Markusen, [Exploring New Markets: Direct Investment, Contractual Relationships, and the Multinational Enterprise, 37 Int’l Econ. Rev.1 (1996)] suggests real behaviors of multinational enterprises in order to limit risks in exploring new markets; the name is not known but some behaviors are targeted to limit risks in the new market (companies which will enter foreign markets in the presence of uncertain demand might prefer to explore the new market through “independent” licensees rather than affiliates, in order to avoid fixed set-up expenditures; an incentive remuneration must be granted to that licensee for inducing a truthful revelation regarding the state of the demand in the particular market)
52 In example 5 of the draft Administration is allowed to split combined profit of producer and distributor but I think that just the example may give more details in that
able to divide cases when it is sufficient to look at the sole distributor side to project a remuneration rule and when this is not correct. Concepts to build such a rule are identifiable in assessing that when marketing costs are put at risk, many times, valuable bottleneck inputs have been created on production side just because, usually, marketing is performed at the end of whole investment process and when the market value of the output is going to be disclosed. This is the sole way to have coherence between the implied profit allocation rule included in Guidelines and the case at focus!

Profits (or losses), in an integrated business, are due to “uncertainty and risks”, and are generated by the fact that resources are to be committed before of having information about output value and so when time for having disclosed the output value is short (marketing at the end of investment process) most of risks are to be supposed, at that moment, over.

I repeat that the rule above is also the model to share integrated profits between associated units that is implied in OECD Guidelines current text, and that I am able to derive from best method rule (and other parts of Guidelines); if I want to change this rule and to apply another one I might explain and motivate the change to have coherence between specific rule and general principles.

Details about the right way to proceed provided in an example would have the sense of giving certainty with a safe behaviour (for firms and Administrations) by some simplifying assumptions; the target is just to allow a solution in difficult cases when available data do not consent a more rigorous analysis; that rigorous analysis is indeed a live option of Guidelines when available data consent it (some concepts to reach the goal are drafted at point 27).

The example 5 correctly concludes (between allowed options) about a profit split, but without the details and concepts I drafted here this cannot be a secure guidance to avoid litigations and leaves open the way to unending discussions!

k) I see problems of inconsistency about the principle of “location savings” present at chapter IX of Guidelines and principles affirmed in example 19 of (intangibles) draft. When a group decides to sell the business (and related intangibles) from an high tax rate company to a lower tax rate company the transfer price is calculated through what would pay for the going to be sold business another (independent) company, located in same Country of the associated buyer (if the associated company is not the sole buyer) and having granted the same (lower) tax rate; therefore when a target return on investment is set net of taxes, the advantages on tax rate of the buyer are economically transferred (as an higher transfer price) to the seller under principles surrounded by location saving. In contrary case, I might explain reasons to derail from the general principle.

l) A further task (see back point 29) of OECD (this is a too long task for these notes) should be targeted in asking that in intragroup contracts the risks are assumed as independent operators really would do while currently net profit level processes tend to give to tested group operators a normal-average profit (which is the result of assuming “normal-average” risks as assumed by the sample of comparables) in any circumstance; when I apply net profit of comparables to the (tested party) group operator (distributor) this last is no more affected by risks (his correct quote -as for distributors, i.e. for credit risks) assumed by group in his individual activity. Indeed also group operators which are functionally comparable to limited risk independent firms may assume some proper risks (coherently with performed function) by a choice (and an

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53 See Hines model quoted supra at note 14
54 Please consider that I use the term risk in the sense given by economics and so the fact that a risk is over means (simplifying) that a single result is possible (now near to be actual), that may be positive result (a profit) but also a negative result (a loss).
55 Here some assumptions must due to the fact that the net profit mean (or range) of comparables already includes a mean (or a range) of risks assumed by those operators..... but that the fact resulting in a risk for the group operator when happens may cause further effects on his profit and loss
agreement) and whose effect is unique cause is pertinent to the specific group activity at focus; the setting of risk in a particular mode must be evident before the fact (setting the risk) happens.

Para 2.73 of OECD Guidelines does not give the proper relevance to this case which (seems totally due to judgment of firms while) is so important about ALP: I think that this aspect, maybe in compliance with current text of para 2.73 of Guidelines, is generally and actually undervalued in a lot of transfer pricing studies (while it might not).

This would really close more net profit level indicators legal processes with the economic principle; I made some specific observations at point 29 of this paper about credit risk and possibility for distributor to be affected by “abnormal” losses on credits as actually realized by his proper activity (his proper customers that are different from customers of comparables) also in a net profit comparison context; considering the example that I proposed, with a net profit indicator, without the care I proposed, the abnormal loss on credit is automatically attributed to producer and not to distributor: this may be correct only if a contract provides so (before of knowing if a real abnormal loss will become an actual fact) and key people of the producer have managed credit risks of distributor customers.

Obviously here it would be necessary to create rules with would allow certainty about requested behaviors to be applied, specially to part when data on comparables allow to apply such a rule and when they do not.

Dear Sirs,

I appreciated a lot the choice of OECD of circulating a well done interim draft on intangibles (safe harbor, timing issues) so that a deep debate on (all these aspects as a whole) may source at an early moment of the enforcing process.

I made the devil advocate about it and I beg your pardon for this role.

In my opinion litigations are widely current on ALP application, at less in some Countries as an 2012 OECD document refers, and (this is my opinion too) they are due to some lacks in Guidelines text that I have (humbly and with public spirit) pointed out in the paper.

Legislator must take his historical responsibility (and OECD is historically a judicious and authoritative Legislator) to make that the right rule to apply is made known to Taxpayers and Administrations (this is in compliance with economic ALP or not) in a clearly and predictable mode in advance time of transactions.

Sometimes when available data do not consent enforcing of a simple rule Legislator is in front of an alternative:

- Or he allows that more processes are used by Taxpayers to come to a number (the set transfer price); but in this case, more than one results were ex ante possible and firms cannot be blamed in having chosen one of them
- Or he gives further guidance (also at expense of analysis precision) in a way it’s clear which are narrowed allowed processes to come to set a transfer price.

When rigorous rules allow to understand which associated entities are intangible owners inside a group (or rectius: which associated entities must be affected by general-combined- results of the group business) the great part of the job to prevent (illegal) profit shifting by firms is done. Then it’s a good compromise any simplification in calculations associated to more certainty granted to Taxpayers and Administrations in predicting the right rule to apply!

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56 While the reality is that sometimes available data give difficulties in doing that
57 in my opinion, litigations are projected to rise in the future if adjustments to legislative texts are not early taken
58 Dealing Effectively with the Challenges of Transfer Pricing, OECD 2012 page 17
59 The “independent study”, managed at OECD level and with target to monitor ALP application (and not to be the appeal of current litigations), I proposed at previous point 6 would just be aimed to understand if current litigations are mainly focused on the entity to be considered intangible owner or on other issues.
The lack of certainty about the right rule to apply has an high cost in term of lack of growth (due to the procrastination of investments or localization of them in Countries where the said certainty is granted).

I hope the paper may be useful for your future work and in any case I thank you for having given me possibility to express my vision on it.

Kind regards.

Milano, September 14\textsuperscript{th} 2012

Andrea Musselli
September 2012
Taxand

OECD
Joe Andrus
Head
Transfer Pricing Unit
Centre for Tax Policy and Administration
joe.andrus@oecd.org

Dear Joe,

Re: Taxand Responds to the OECD Discussion Draft on Safe Harbours in Transfer Pricing

Further to the publication of the OECD’s discussion draft “Safe Harbours in Transfer Pricing”, Taxand is pleased to provide combined feedback from around the world.

We would like to commend the OECD Committee of Fiscal Affairs efforts for its continual improvement and updating the OECD Transfer Pricing Guidelines which is an essential tool for coordinating international taxation in the business community.

Taxand is in agreement with the key principles set out in the discussion draft:

- Safe harbours can reduce the administrative burden on businesses and administrations
- The appropriateness of safe harbours is most apparent when directed at low risk situations
- Many administrations apply safe harbours in practice with success

We would add that in the current environment, many businesses have already started to reduce the level of economic support in place for low risk transactions, and are adopting reasonable ‘non-statutory’ safe harbour positions or generally acceptable norms.

However, the following should be noted:

Operation in practice and concerns over the arm’s length principle
The concerns raised in section E.4.1 about income not being arm’s length are going to be relevant in many situations and will be the price paid for the benefits from introducing safe harbours. The operation of safe harbours in practice is commensurate with exemptions already provided in many jurisdictions (such as small company exemptions or de-minimis exemptions). The effect is to take the relevant transactions out of the arm’s length requirement and replace this with a basic price (zero in the case of the exemptions).
Therefore, the introduction of safe harbours should be possible with minimal disruption to the existing legislation as these transactions would be freed from the arm’s length requirement making section E.4.1 redundant.

Additional concerns not raised in sections E.4.1-E.4.4
An additional concern exists: in many jurisdictions, transfer pricing adjustments can only occur where tax has been underpaid and there is limited recourse if a company has a transaction which is below an introduced safe harbour (save for re-stating accounts which is a difficult process). A grandfathering period should assist with such situations.

Tax arbitrage opportunities
The concern raised at section E.4.3 around safe harbours creating “inappropriate tax planning opportunities” is inflammatory and we recommend that this wording is changed to “artificial tax arrangements” to be consistent with recognised international case law principles. If a safe harbour is introduced in a particular jurisdiction, businesses should be able to seek tax arbitrage opportunities where they exist around commercial transactions.

Taxand’s Take
Taxand’s response to this draft can be summarised in three points:

1. The concern about safe harbours leading to non-arm’s length results will have to be accepted should these harbours be introduced. The operation of safe harbour legislation may be facilitated by an approach similar to that already taken for exemptions in local legislation.

2. Taxand recommends a grandfathering period to ensure that businesses that are below safe harbour prices can have recourse. Such a period may also facilitate successful operation of the legislation.

3. “inappropriate tax planning opportunities” should be replaced with “artificial tax arrangements” to be consistent with recognised international case law principles.

We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further and/or to participate in any discussion on these matters.

More information about Taxand is provided as Appendix I. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate. Please do not hesitate to get in touch with me directly via the contact details below.

Yours sincerely,

Taxand
APPENDIX I

CONTACT DETAILS
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ABOUT TAXAND
Taxand provides high quality, integrated tax advice worldwide. Our tax professionals - nearly 400 tax partners and over 2,000 tax advisors in nearly 50 countries - grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

We're passionate about tax. We collaborate and share knowledge, capitalising on our collective expertise to provide you with high quality, tailored advice that helps relieve the pressures associated with making complex tax decisions.

We're also independent — ensuring that you adhere both to best practice and to tax law and that we remain free from time-consuming audit-based conflict checks. This enables us to deliver practical advice, responsively.

Taxand has achieved worldwide market recognition. In the International Tax Review’s (ITR) World Tax 2012, over 95% of Taxand locations are ranked top. 35 countries were voted top in the ITR Transaction Tax Survey 2012 and in the ITR Tax Planning Survey 2012. Taxand has received over 40 national awards and 13 regional awards in the ITR European, Americas and Asia Tax Awards since 2009. These include European Private Equity Tax Firm of the Year, European Indirect Tax Firm of the Year, European Tax Policy Firm of the Year, Asia Transfer Pricing Firm of the Year, Asia Tax Policy Firm of the Year, and Latin America Tax Disputes Firm of the Year. Full details of awards and further information about Taxand can be viewed at
www.taxand.com/media/factsheet
www.taxand.com
Mr. Joseph L. Andrus  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
Organisation for Economic Co-operation and Development  
2, Rue Andre Pascal  
75775 Paris, France  

Via email: joe.andrus@oecd.org  

Re: OECD Discussion Drafts on Timing Issues and Safe Harbours Related to Transfer Pricing  

Dear Mr. Andrus:

In 2010, the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development (OECD) announced a project on the transfer pricing aspects of intangible assets in respect of the OECD’s Transfer Pricing Guidelines (OECD Guidelines). The OECD subsequently published a scoping paper and held three public consultations with interested commentators. On 6 June 2012, the OECD released three discussion drafts setting forth proposed revisions to the OECD Guidelines and recently announced a public consultation on the three drafts, which will be held on 12-14 November 2012. On behalf of Tax Executives Institute, Inc., I am pleased to provide the following comments on the Draft on Timing Issues Relating to Transfer Pricing (Timing Issues Draft) and the Draft regarding proposed revisions of the section on Safe Harbours in Chapter IV of the OECD Guidelines (Safe Harbour Draft).¹

TEI Background

Tax Executives Institute (TEI) was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in Europe, North America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our 7,000 members represent 3,000 of the largest companies in Europe, the United States, Canada, and Asia.

¹ TEI commented on the OECD discussion draft on the Transfer Pricing Aspects of Intangibles on 21 September 2012.
General Comments on the Timing Issues Draft

[Omitted]

Comments on Proposed Revisions in the Timing Issues Draft

[Omitted]

Comments on the Safe Harbour Draft

TEI commends the OECD for its work in creating the Safe Harbour Draft. Many tax authorities currently use safe havens (also known as simplified tax regimes) and we applaud the OECD for moving away from the previous, generally negative view of safe havens to a more balanced one. We also welcome the Draft’s focus on using safe havens for non-entrepreneurial, routine tasks because such an approach will make taxpayer transfer pricing compliance less burdensome.

TEI agrees with the statement in several paragraphs\(^2\) that transfer pricing safe havens should be optional for taxpayers and that it should not be treated as a rebuttable presumption of the “correct” arm’s length price by tax authorities. Instead, the price should be treated as an option for a taxpayer to simplify its transfer pricing compliance burden, and the Draft should acknowledge that the true arm’s length price may or may not fall within the safe haven, depending on the circumstances.

Further, since the price set by a safe haven should be elective for a taxpayer, it should not be treated as a rebuttable presumption of the “correct” arm’s length price by tax authorities. Instead, the price should be treated as an option for a taxpayer to simplify its transfer pricing compliance burden, and the Draft should acknowledge that the true arm’s length price may or may not fall within the safe haven, depending on the circumstances.

In general, we disagree with the Safe Harbour Draft’s approach of encouraging the use of bilateral memorandums of understanding (MOUs). The bilateral safe haven MOU approach would complicate rather than simplify the multinational tax system. Monitoring multiple MOUs with different rules and ranges will require continuous supervision of each transaction by the tax department. MNEs that leave their business units free to set prices and then document the arm’s length nature of the transactions will be unable to continue using that practice in a multi-MOU world.

\(^2\) See, e.g., Safe Harbour Draft at paragraphs 19, 22, and 35.
In addition, from a practical point of view, it seems unlikely that tax authorities will extensively use MOUs. Negotiating an MOU will be a complex and time-consuming process, perhaps comparable to the effort required to negotiate bilateral advance pricing agreements or similar competent authority agreements. If few or no Member States use MOUs to set bilateral safe harbours, the credibility of this OECD initiative will be undermined.

We recommend that the Safe Harbour Draft move away from stating that MOUs are the recommended approach and acknowledge that unilateral safe harbours are widely used and will remain the most common form of safe harbour. If tax authorities have the time and resources, entering into a bilateral MOU on safe harbours could be another option.

The Safe Harbour Draft expressly declines to address “tax provisions designed to prevent ‘excessive’ debt in a foreign subsidiary (‘thin capitalisation’ rules).” Since thin capitalisation rules are one of the most commonly used safe harbours, there may not be a need to discuss them in the Draft, but we recommend that the OECD explain why it chose not to include such rules.

If the MOU approach is retained, we note that the Safe Harbour Draft does not discuss or provide a sample MOU for interest rate safe harbours, which are also widely used. In contrast with a thin capitalisation safe harbour, which depending on its form could have significant adverse consequences for MNEs, we believe that an interest rate safe harbour and MOU could benefit taxpayers and tax authorities, and recommend that the OECD develop one.

Regrettably, the Draft does not suggest ranges for the proposed safe harbours in its sample MOUs, but instead leaves these to the Member States to decide. Even if the ranges were bracketed in the Draft’s MOUs, they would provide Members States with rough guidance on what might be the “appropriate” range for certain activities. This would promote uniformity across MOUs, further decreasing transfer pricing compliance costs and disputes.

Finally, the Draft could be improved by providing a list of transactions that are viewed or are recommended to be viewed as possible candidates for a safe harbour. For example, return on sales for low-risk distributors, back office functions, shared services centers, interest rates, low value-added services generally, etc., in addition to those already included in the Draft. This would also promote uniformity across MOUs.

Conclusion

TEI appreciates the opportunity to comment on the OECD’s Discussion Drafts. These comments were prepared under the aegis of TEI’s European Direct Tax Committee, whose Chair is Anna M. L. Theeuwes. If you have any questions about the submission, please contact Ms. Theeuwes at +31 70 377 3199 (or An.M.L.Theeuwes@shell.com) or Benjamin R. Shreck of the Institute’s legal staff, at +1 202 638 5601 (or bshreck@tei.org).

Respectfully submitted,
Carita R. Twinem

International President
The OECD, acting through the OECD Committee on Fiscal Affairs Working Party No. 6, has released a safe harbor transfer pricing discussion draft on June 6, 2012. The OECD designed this measure to boost safe harbor implementation. The issuance of the draft follows both a project that the OECD has designed to improve the administrative aspects of transfer pricing through the implementation of safe harbors, and a survey of these simplification measures. As part of this evaluation process, Working Party No. 6 reviewed the current guidance as to safe harbors in Chapter IV of the July 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The June 6, 2012 draft would remove paragraphs 4.93 through 4.122 of the 2010 Guidance, replacing this material with 39 new paragraphs.

The reader should be aware that, as a matter of policy, the OECD has switched gears when it comes to the evaluation of transfer pricing safe harbors. After casting aspersions on transfer pricing safe harbors in its prior 2010 and earlier commentary, the OECD now looks to favorable experiences that multinational taxpayers and tax administrations have had with these transfer pricing safe harbors. The drafters of these June 6, 2012 proposed revisions, in looking back to these past approaches, comment that the Guidelines then had a “somewhat negative tone” regarding these transfer pricing safe harbors. The discussion draft includes more positive impacts to proposed revisions to Chapter IV of the Guidelines.

The current 2010 guidance is largely silent as to implementing bilateral agreement procedures that would establish such safe harbor. Nevertheless, some countries have favorable experiences with such bilateral agreements. The discussion draft, independent of this analysis, includes sample Memoranda of Understanding that competent authorities are to use in establishing bilateral safe harbors.

As transfer pricing practitioners, it is our view that the June 2, 2012 draft of the safe harbor provisions are close to being in final form. It is our view that the OECD Commission on Financial Affairs will accept a close version of the safe harbor provision draft in the relatively near future.

Safe Harbors

At the outset, the drafters recognize that the process of applying the arm’s length principle, whether by the multinational enterprise or by the tax administration, can be resource-intensive. Multinational enterprises and tax administrations might have a heavy burden in applying the arm’s length principle. The presence of both complex rules and resulting compliance demands can exacerbate this administrative burden to the multinational enterprise or the tax administration. The impact of the administrative burden has led OECD member
countries to consider whether, and when, the safe harbor rules would be appropriate in the transfer pricing arena.iii

The OECD adopted the transfer pricing Guidelines in 1995. At the time the OECD adopted these Guidelines, the OECD expressed a negative view regarding safe harbor mechanisms. There had been strong opposition to transfer pricing safe harbors by multinational enterprises and tax administrations. These opponents viewed safe harbors as being antithetical to the arm’s length method. The opponents to the safe harbor mechanism suggested that, while safe harbors could simplify transfer pricing compliance and administration, the safe harbor rules might raise fundamental problems. Further, the opponents asserted that the fundamental problems potentially could have perverse effects on enterprises’ pricing decisions where these enterprises were engaged in controlled transactions.

Safe harbor opponents suggested that unilateral safe harbors might have a negative impact on the tax revenues of the country implementing the safe harbor. There could be such a huge negative impact on the tax revenues of countries whose associated enterprises engage in controlled transactions with taxpayers that elect such a safe harbor. Opponents to the safe harbor approach argued that safe harbors might not be compatible with the arm’s length principle. The OECD then concluded that tax administrations should not go forward with transfer pricing safe harbors. Accordingly, the OECD did not recommend safe harbors in their promulgations of the transfer pricing Guidelines.iv

The OECD, then, as an overall position, had adopted negative views toward adopting a transfer pricing safe harbor. Nevertheless, despite the OECD’s negative viewpoint, a number of countries adopted safe harbor rules. Tax administrations have applied these safe harbor provisions to smaller taxpayers and to less complex transactions without such negative impacts.

Both tax administrations and taxpayers generally are in the process of evaluating safe harbors. These tax administrations and taxpayers indicate that the benefits of safe harbors outweigh the relative concerns when:v

- The tax administration carefully targets and prescribes the rules.
- The tax administration or the multinational enterprise makes the effort to avoid problems that could arise from poorly-considered safe harbor regimes.

As a general manner, safe harbors are most appropriate when these safe harbors are:
- directed at taxpayers or transactions which involve low transfer pricing risks, and
- when tax administrations adopt the safe harbor on a bilateral or multilateral basis

The drafters make clear that a safe harbor provision might not bind or limit the tax administration in any way, except that tax administrations might have expressly adopted this safe harbor.vi

The presence of a safe harbor can benefit taxpayers, can benefit tax administrations, or can benefit both. Such a safe harbor might primarily benefit the taxpayers by providing them
with a more optimal use of their resources. Nevertheless, the safe harbor can benefit tax administrations as well. Tax administrations can shift scarce audit and examination resources from smaller transactions and less complex transactions to better review more complex, higher value cases. The tax administration might be able to resolve less complex transactions on a consistent basis both as to transfer pricing methodology and to the actual results.

The drafters acknowledge that, at the same time the tax administration set up the tax harbor determination, safe harbors enable taxpayers to price eligible transactions and to file their tax returns with more certainty and with lower compliance burdens. However, the design of safe harbors requires the multinational enterprise or the tax administration provide careful attention about the degree of approximation to arm’s length prices that the tax administration would permit for various purposes, such as the following, in determining transfer prices under the safe harbor rules for eligible taxpayers: vii

- The potential for creating inappropriate tax planning opportunities, including double non-taxation income,
- The equitable treatment of similarly situated taxpayers, and
- The potential for double taxation resulting from the possible incompatibility of the safe harbors and with the arm’s length principle or with the practices of other countries.

The following discussion considers the benefits of safe harbor provisions and the considerations regarding safe harbor provisions. This analysis provides guidance regarding the circumstances under which the multinational enterprise or the tax administration can apply the guidance in a transfer pricing system that is based on the arm’ length principle. viii

**Definition and Concept of Safe Harbors**

The drafters suggest that the multinational enterprise or the tax administration can avoid difficulties when they apply the arm’s length principle. The multinational enterprise or the tax administration could provide the circumstances in which the eligible taxpayers might elect to follow a simple set of prescribed transfer pricing rules, i.e. through the safe harbor. The multinational enterprise or the tax administration could take these actions by adopting clarity, and by providing clearly-defined transactions. The tax administration, then, would automatically accept the transfer prices that they expressly adopted. These elective procedures are the safe harbors.ix

The multinational enterprise or the tax administration makes use of a safe harbor, i.e., the making that safe harbor determination for transfer pricing purposes. In that situation, the safe harbor applies to a defined category of taxpayers or applies to a defined category of transactions. As a general matter, the safe harbor relieves eligible transactions from certain obligations otherwise imposed by a country’s general pricing rules.

As a general matter, a safe harbor substitutes limited compliance with simpler obligations that a country’s general pricing rules determines. Such a safe harbor provision, for
example, allows taxpayers to establish transfer pricing prices in a specific way, i.e., by applying a transfer pricing group approach that the tax administration provides. Alternatively, a safe harbor could exempt a defined category of taxpayers or transactions from applying all or part of the tax administration’s general pricing rules. Often, the tax administration will relieve the multinational enterprise from its burdensome compliance obligations, including some or all of its associated transfer pricing documentation requirements.

Other alternative safe harbor transfer pricing formulations are also possible. For example, a tax administration could set up a reputable presumption where the tax administration could establish a mandatory pricing target. The taxpayer could then accept the transfer price and establish that the target price is inconsistent with the arm’s length principle when the tax administration applies this computation. The drafters suggest that it would be essential for the system to permit the resolution of double taxation cases arising from the application of the mandatory pricing target through the mutual agreement process.

The discussion in this section pertains to portions of the Administrative Approaches of Chapter IV. The drafters provide that safe harbors do not include administrative simplification measures where these measures do not directly involve the determination of arm’s length prices. Thus, these safe harbor provisions would not apply to simplified documentation requirements, or exception from documentation requirements, in the absence of a pricing determination. These safe harbor provisions would not apply to procedures whereby a tax administration and a taxpayer agree on transfer pricing in advance of the controlled transactions through advance pricing agreements, as discussed in the memoranda of understanding process. The discussion in this section also does not extend to the tax provisions designed to prevent “excessive” debt in a foreign subsidiary, i.e., the thin capitalization rules.

Benefits of Safe Harbors

The draft enumerates three basic benefits of safe harbors:

- The safe harbor would simplify compliance. The safe harbor would reduce compliance costs for eligible taxpayers in determining and documenting conditions for qualifying controlled transactions.
- The safe harbor would provide certainty to eligible taxpayers that the price charged or paid on qualifying controlled transactions will be accepted by the tax administration. The tax administration would have adopted the safe harbor that provides for a limited audit, or without an audit. The tax administration has no obligations beyond ensuring that the taxpayer has met the eligibility conditions of the safe harbor provisions and complied with the safe harbor provisions.
- The safe harbor would permit tax administrations to direct their administrative resources from the examination of lower risk transactions to examinations of more complex or higher risk transactions and taxpayers.

Compliance Relief
The drafters recognize that the application of the arm’s length principle might require the collection and analysis of data that might be difficult for the tax administration to obtain or to evaluate. The drafters equally recognize that, in certain cases, such complexity might be disproportionate to the size of the taxpayer, its functions performed, and the transfer pricing risks inherent in its controlled transactions. The drafters failed to address the exclusion of transactions having limited value in this context.\textsuperscript{xiv}

The drafters become an advocate for safe harbors, suggesting that these safe harbors might significantly ease the compliance burdens by eliminating data collection and associated documentation requirements. The tax administration would exchange its data collection and associated documentation requirements for the taxpayer pricing qualifying transactions within the parameters set forth by the safe harbor. Such a trade-off might be mutually advantageous to taxpayers and tax administrations when the transfer pricing risks are small and the burden of compliance and documentation is disproportionate to the transfer pricing exposure. Under such a safe harbor, the taxpayers would be able to establish transfer prices which the tax administrations will not challenge. The multinational enterprise could apply the safe harbor without being obligated to search for comparable transactions, or to expend resources to demonstrate transfer pricing compliance to such tax administrations.\textsuperscript{ xv}

\textbf{Certainty}

The drafters view the presence of certainty as being “another advantage” of having a safe harbor. The certainty to which the drafters refer is that the tax administration will accept the taxpayer’s behavior as the taxpayer’s transfer price if the price is within the safe harbor. The qualifying taxpayers seek to have the assurance that they would not be subjected to an audit or a reassessment in connection with their transfer prices.

Taxpayers can have the assurance they seek provided they have in fact met the eligibility conditions the safe harbor provisions, and in fact they have met the safe harbor provisions. The drafters contemplate that the tax administration would accept the taxpayer’s transfer prices that take place within the safe harbor parameters. This acceptance on the part of the tax administration means that they accept the taxpayer’s transfer pricing, making limited scrutiny or making no scrutiny. The drafters suggest that tax administrations could provide the taxpayers with the relevant parameters. These relevant parameters would provide a transfer price for the taxpayer that the tax administration would deem appropriate for the qualifying transactions.\textsuperscript{xvi}

\textbf{Administrative Simplicity}

The drafters recognize that, as a general rule, a safe harbor would result in “a degree of administrative simplicity” for the tax administration. The drafters, however, suggest that the tax administration would need to carefully evaluate the eligibility of particular taxpayers or transactions for the safe harbor. Such eligibility might depend on the specific safe harbor provisions. It is possible for the tax administration to use auditors who have no transfer pricing
expertise to make this evaluation. The drafters fail to address that the tax administration would need to carefully craft the safe harbor parameters to make this goal possible.

Once the tax administration has established the safe harbor parameters, the tax administration would require qualifying taxpayers to meet minimum examination standards as to the transfer prices of controlled transactions that qualify for the safe harbor. This safe harbor process would enable tax administrations to secure tax revenues in low risk situations, doing so with a limited commitment of administrative resources. The tax administrations will be able to concentrate their efforts on the examination of more complex transactions and taxpayers, or higher risk transactions and taxpayers. Further, the drafters comment that a safe harbor might also increase the level of compliance among small taxpayers that otherwise believe that their transfer pricing practices might escape scrutiny.\textsuperscript{xvii}

**Concerns Over Safe Harbors**

Although providing general approval to multinational enterprises and tax administrations as to these tax harbors, the drafters are cautious about safe harbors in certain situations, recognizing that safe harbors might have adverse consequences.\textsuperscript{xviii} The drafters’ concerns as to safe harbors depend on the following four facets:

- When a given country establishes a safe harbor, taxpayers in that country might report taxable income that is not in accordance with the arm’s length principle.
- Countries might adopt safe harbors unilaterally. The application of safe harbors might increase the risk of double taxation, or the risk of double non-taxation, when a country adopts safe harbors unilaterally.
- The presence of safe harbors potentially opens up avenues for inappropriate tax planning.
- Safe harbors might raise issues of equity and uniformity.

**Divergence from the Arm’s Length Principle**

The drafters recognize that, when a tax administration provides a safe harbor, i.e., a simplified transfer pricing approach, this safe harbor might not correspond in all instances to the “most appropriate” transfer pricing method. Thus, this transfer pricing method might not be applicable to the facts and circumstances of the taxpayer under the general pricing provisions. The drafters have developed an example that indicates disparities in transfer pricing methods. In this example, a safe harbor might require the taxpayer to use a particular application of a profit method.

In contrast to applying this safe harbor, the taxpayer could have otherwise determined that the comparable uncontrolled price or applying another transfer pricing method was the most appropriate method under the specific facts and circumstances. The drafters conclude that the multinational enterprise or the tax administration could treat such an occurrence as inconsistent with the arm’s length principle, which requires the enterprise to use the most appropriate transfer pricing method. As transfer pricing practitioners, it is our view that the
drafters’ example, relying on the application of the profit method as a safe harbor, is somewhat misleading because, at least for the present, tax administrations eschew safe harbor profit methods. xix

The drafters call to our attention that safe harbors involve a trade-off between strict compliance with the arm’s length principle, on one hand, with administrability, on the other hand. These safe harbors are not tailored to fit exactly the varying facts and circumstances of the individual taxpayers and transactions. The drafters suggest that the tax administration improve the degree of approximation of the prices the tax administration determines under the safe harbor in accordance with the arm’s length principle. The tax administration could achieve this improvement objective by collecting, collating, and frequently updating a pool of information regarding pricing and pricing developments. This data would pertain to the relevant types of transactions between uncontrolled parties of the relevant nature. Nevertheless, the drafters caution that securing such efforts to set safe harbor parameters accurately enough to satisfy the arm’s length principle could erode the administrative simplicity of the safe harbor. xx

Taxpayers might find it disadvantageous for them to be in situations in which the safe harbors diverge from arm’s length pricing. Nevertheless, taxpayers can avoid being in this disadvantageous situation when they have the option to either select the safe harbor or to price its transactions in accordance with the arm’s length principle. With such a dual approach, a taxpayer that believes that the safe harbor would require them to report an amount of income that exceeds the arm’s length amount could apply the general pricing rules instead. However, the drafters caution that having such a safe harbor approach might limit the divergence from arm’s length pricing under a safe harbor regime. The applying of this transfer pricing regime would also limit the tax administration’s administrative benefits of having the safe harbor regime. Moreover, the drafters point out that the tax administrations would need to consider the potential loss of revenue from such dual approach where taxpayers will pay tax only on the lesser of the safe harbor amount or on the arm’s length amount.

Countries might also be concerned about the ability of taxpayers to opt in and opt out of a safe harbor. Taxpayers could reach their decision depending on whether the use of the safe harbor is favorable to the taxpayer in a given year. Countries might be able to gain greater comfort regarding the taxpayers opt in / opt out risk by controlling the conditions under which a taxpayer can be eligible for the safe harbor. For example, a country can mitigate the taxpayers opt in / opt out risk by requiring taxpayers to notify the tax authority in advance of using the safe harbor, or the country could commit the taxpayer to use the safe harbor for a certain number of years. xxi

Risk of Double Taxation, Double Non-Taxation, and Mutual Agreement Concerns

Taxpayers frequently raise the concern that a safe harbor could increase the risk of double taxation. For example, a tax administration might set safe harbor parameters at levels
that are either above arm’s length prices or below arm’s length prices in order to increase reported profits in its country. Such a tax administration might induce taxpayers to modify the prices that they would otherwise have charged or paid to controlled parties.

The taxpayer might modify its behavior in order to avoid transfer pricing scrutiny in the safe harbor country. The taxpayer’s concern that it might be overstating taxable income in a country that provides the safe harbor is greater where that country imposes significant penalties for understatement of tax, or for failure to meet documentation requirements. The result is that in that particular country there might be added incentives to ensure that transfer pricing in accepted in that country without further review.xxii

The drafters recognize that the safe harbor might cause taxpayers to report income that is above arm’s length levels. Such a result quite obviously would work to the benefit of the tax administration that provides the safe harbor. In such a situation, the tax administration would be reporting more taxable income earned by such domestic taxpayers.

On the other hand, the presence of the safe harbor might lead to less taxable income reported in the tax jurisdiction by the foreign associated enterprise that is the other party to the transaction, i.e. the counterparty. That counterparty in the transaction might then challenge prices that the taxpayer derives from the application of the safe harbor. The result is that the taxpayer would face the prospect of double taxation. Accordingly, any administrative benefits that the tax administration of the safe harbor country does gain, might do so at the expense of the other countries.

These other countries would act in order to protect their tax base. These other countries would have to determine systematically whether the prices or results the safe harbor permits are consistent with the amounts the country would obtain by applying its own transfer pricing rules. The country offering the safe harbor saves its administrative burden. The country offering the safe harbor shifts its administrative burden to the foreign jurisdictions.xxiii

The transfer pricing cases might involve smaller taxpayers or less complex transactions. In such situations, the safe harbor benefits might outweigh the problems that those situations create. In situations in which the safe harbor is elective, taxpayers might consider that a moderate level of double taxation that arises because of the safe harbor, if any, is acceptable. The taxpayer might incur a moderate level of taxation, viewing this payment as an acceptable price that the taxpayer must pay in order to obtain relief from the necessity of complying with the complex transfer pricing rules. The drafters comment that the taxpayer might or might not be capable of making its own decisions in selecting the safe harbor as to whether the possibility that double taxation exists or not.xxiv

An enterprise might unilaterally adopt these safe harbors. In such a situation, the country adopting the safe harbor should generally be prepared to consider the possibility of modification of the safe-harbor outcome in individual cases. Such a taxpayer might seek to use mutual agreement procedures to mitigate the risk of double taxation.
The drafters suggest that the country that offers the safe harbor to taxpayers should be explicit in doing do, providing this information in advance as to the impact of the safe harbor. The county should specify whether the country would attempt to alleviate any eventual double taxation that would otherwise result from the application of the safe harbor. At a minimum, such a country would need to be forthright as to this process in order to insure that that taxpayer makes its decisions on a fully informed basis. The drafters point out that the safe harbor might not be elective. If such the country in question refuses to consider double tax relief, the risk of double taxation arising from the safe harbor would be unacceptably high, and be inconsistent with the double tax relief provisions that treaties provide.\textsuperscript{xxv}

A country might provide a unilateral tax harbor. Such a unilateral tax harbor permits taxpayers to report income that is below arm’s length levels in the country providing the safe harbor. In that situation, taxpayers would have an incentive to elect to apply this safe harbor. The drafters point out that, in such a situation, there would be no assurance that the taxpayer would report income in other countries on a consistent basis, or to reflect levels that are above arm’s length levels based on the safe harbor.

The drafters point out that it is unlikely that other tax administrations would have the authority to require the country to report that income that is above arm’s length levels. Such a burden of reflecting over-taxation in such situation would fall exclusively on the country adopting the safe harbor provision. This burden should not adversely affect the ability of other countries to tax the arm’s length amounts of income. Nevertheless, double non-taxation would be avoidable. This distortion could result in distortions of investment and trade.\textsuperscript{xxvi}

The drafters, by switching positions as to the use of safe harbors, now take a position in favor of adopting safe harbor agreements through a bilateral basis, or through a multilateral basis. The countries would formalize this relationship by means of establishing competent authority agreements between these counties, i.e. through a memorandum of understanding. The drafters suggest that this agreement process could largely eliminate the problems of determining non-arm’s length results and potential double taxation and double non-taxation.

Under such a memorandum of understanding, two or more countries could, by agreement, define category of taxpayers and/or transactions to which a safe harbor provision would apply. By agreement, the parties could establish parameters that each contracting party would accept if the other party consistently accepts the arrangement. The governments could issue such agreements in advance, and taxpayers could consistently report the results in each of the affiliated countries in accordance with the agreement.\textsuperscript{xxvii}

The drafters view the process of effectuating a safe harbor arrangement through the memorandum of understanding process as vigorous. Thus, the vigorousness of having two or more countries with potentially divergent interests agree to such safe harbor should serve to limit some of the arbitrariness that otherwise might characterize a unilateral safe harbor. The
countries’ use of the memorandum of understanding process should largely eliminate the
double taxation that safe harbors create and the double non-taxation that safe harbors create.

The OECD, then, provides an endorsement particularly for smaller taxpayers and less
complex transactions. The goal is to achieve the “creation of bilateral or multilateral safe
harbors by competent authority agreement.” Such an agreement might provide “a worthwhile
approach to transfer pricing simplification” where such an agreement would avoid some of the
potential pitfalls of unilateral safe harbor regimes.xxviii

Chapter IV of the OECD transfer pricing Guidelines contains an annex that contains
sample memoranda of understanding that the country competent authorities might use. The
country’s competent authorities might use such sample memoranda of understanding to
establish bilateral safe harbors or to establish multilateral safe harbors in appropriate situations
for common cases of transfer pricing cases. The drafters take the approach that the tax
administration should not consider the use of these sample memoranda of understanding as
either mandatory or as being prescriptive in establishing bilateral safe harbors or multilateral
safe harbors. Rather, the drafters take the position that these sample memoranda of
understanding are intended to provide a possible framework for adaptation to the particular
needs of the tax authorities of the countries concerned.xxix

Possibility of Operating Avenues for Tax Planning

The drafters are cognizant that the presence of safe harbors might also provide
taxpayers with tax planning opportunities. Such enterprises might have an incentive to modify
their transfer prices in order to shift taxable income to other jurisdictions. The presence of such
a possibility might induce tax avoidance.

Such an enterprise might enter into artificial arrangements, doing so for the purpose of
exploiting the safe harbor provisions. Consider the possibility that a safe harbor could be
generally available for the benefit of simple transactions or for the benefit of small transactions.
In that event, taxpayers might be tempted to break up the transactions into parts to make
these parts seem simple or small. xxx

The drafters touch in passing a safe harbor phased in terms of an industry average. If a
tax administration were to apply such an industry average safe harbor, the drafters comment
that tax planning opportunities would exist for taxpayers having better than average
profitability. In this regard, consider the following tax pattern:

- A cost-efficient company selling at arm’s length might be earning a mark-up of 15
  percent of controlled sales.
- The country adopts a safe harbor requiring a 10 percent mark-up.
- Such a company might have an incentive to comply with the safe harbor and shift
  the remaining 5 percent of the gross to a lower-taxed jurisdiction.

If the enterprise applies this approach on a large scale, this approach could mean significant
revenue loss for the country offering the safe harbor.xxxi
Countries might be able to avoid income-shifting concerns by means of adopting competent authority agreements between countries pursuant to paragraph 25. Such a country could adopt safe harbors on a bilateral basis or on a multilateral basis. Thus, the countries could limit the application of safe harbors to transactions involving countries with similar transfer pricing concerns.

The drafters warn that tax administrations need to be aware that the establishment of an extensive network of bilateral or multilateral safe harbors could potentially encourage “safe harbor shopping.” Taxpayers could engage in such safe harbor shopping by routing of transactions through territories with more favorable tax harbors. The countries, then, would need to take appropriate steps to avoid the country’s use of “safe harbor shopping.”

The drafters advise countries that adopt bilateral safe harbors to target fairly narrow ranges of acceptable results. Such a country should require consistent reporting of income in each country that is a party to the safe harbor arrangement. Countries can rely on treaty exchanges of information provisions where necessary to confirm the use of consistent reporting under such bilateral safe harbor.xxxii

The drafters recognize that whether a country is prepared to possibly suffer some erosion of its own tax base in implementing a safe harbor is for that country to decide. There is a basic trade-off in making such a policy decision. The decision is between certainty and administrative simplicity of the safe harbor for taxpayers and tax administrations, on one hand, and the possibility of tax revenue erosion on the other hand.xxxiii

**Equity and Uniformity Issues**

The safe harbor process might raise both equity issues and uniformity issues. When a country creates a safe harbor, the creation process creates two sets of rules in the transfer pricing context. The drafters warn that a tax administration must clearly and carefully design the applicable criteria to differentiate between those taxpayers or transactions that are eligible for the safe harbor and those taxpayers or transactions which are not eligible. The tax administration should undertake an analytical process to minimize the possibility of similar and possibly competing taxpayers finding themselves on opposite side of the safe harbor threshold. Conversely, the tax administration should seek to preclude unidentified taxpayers or the transactions from claiming the safe harbor.

The drafters are concerned with the process of defining the safe harbor. The taxpayer might apply insufficiently precise criteria, receiving different tax treatments. Consider the diverse possibilities:

- The tax administration permits the taxpayer to meet the safe harbor rules, relieving the taxpayer from the general transfer pricing compliance provisions,
• The tax administration does not permit the taxpayer to meet safe harbor rules, obliging the taxpayer to price its transactions in conformity with the general transfer pricing compliance provisions.

The drafters address the issues and preferences concerning specific categories of taxpayers. Preferential tax treatment under safe harbor regimes for a specific category of taxpayers could potentially entail discrimination and competitive distortions. The drafters warn that, in some circumstances, the adoption of bilateral or multilateral safe harbors could increase the potential of a divergence in tax treatment. There are two types of divergence:

• Between different but similar taxpayers
• Between similar transactions the same taxpayer carries out with associated enterprises in different jurisdictions.

Recommendations on the Use of Safe Harbors

In recommending the application of safe harbor structures to a tax administration, the drafters acknowledge that transfer pricing compliance and administration are often complex. Without delineating such “properly designed safe harbor provisions,” the drafters provide that the proper design of such safe harbor provisions, applied by the country in “appropriate circumstances,” can relieve some of these transfer pricing burdens, and would provide taxpayers with greater certainty. The drafters fail to delineate such appropriate circumstances.

The drafters recognize that the safe harbor provisions themselves might raise a plethora of tax issues. The tax harbor might create perverse effects on the pricing decisions that enterprises engaged in controlled decisions might take. These decisions might create a negative impact on the tax revenues of the country implementing the safe harbor, as well as on other countries, where the associated enterprises engage in controlled transactions with taxpayers electing a safe harbor. Further, the drafters reiterate that unilateral safe harbors might lead to the potential for double taxation or double non-taxation.

The drafters recognize that the case in favor of tax harbors might be different in cases that involve smaller taxpayers or less complex transactions. The benefits of having safe harbors might outweigh the potential for double taxation or double non-taxation. Making such safe harbors elective to taxpayers can further the divergence from arm’s length pricing. The drafters suggest that where countries do adopt safe harbors, these countries should be willing to modify safe-harbor outcomes in mutual agreement proceedings to limit the potential risk of double taxation.

Countries might be able to negotiate safe harbors on bilateral basis or on a multilateral basis. Such safe harbors might provide the multinational enterprise and the tax administrations with significant relief from both compliance burdens and administrative complexity, doing so without creating problems of double taxation or of double non-taxation. The drafters
encourage the use of bilateral safe harbors and unilateral safe harbors “under the right circumstances.” The drafters, however, fail to define or delimit the “right circumstances.”

The drafters address the issues of precedent, stating that it should be clearly recognized that a safe harbor, whether adopted on a unilateral basis or on a bilateral basis, is in no way binding on, or precedential for, countries which have not themselves adopted the safe harbor.

The drafters eschew safe harbors for more complex and higher risk transfer pricing matters. The drafters comment that it is unlikely that safe harbors will provide a workable alternative to a rigorous, case by case analysis application of the arm’s length principle under the provisions of these Guidelines.

The drafters conclude that country tax administrations should carefully weigh the benefits of safe harbors and its concerns regarding safe harbors. The drafters recommend that country tax administrations should make use of the safe harbor provisions when the country tax administrators deem it to be appropriate.

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3 Proposed revision, paragraph 1
4 Proposed revision, paragraph 2
5 Proposed revision, paragraph 3
6 Proposed revision, paragraph 4
7 Proposed revision, paragraph 5
8 Proposed revision, paragraph 6
9 Proposed revision, paragraph 7
10 Proposed revision, paragraph 8
11 Proposed revision, paragraph 9
12 Proposed revision, paragraph 10
13 Proposed revision, paragraph 11
14 Proposed revision, paragraph 12
15 Proposed revision, paragraph 13
16 Proposed revision, paragraph 14
17 Proposed revision, paragraph 15
18 Proposed revision, paragraph 16
19 Proposed revision, paragraph 17
20 Proposed revision, paragraph 18
21 Proposed revision, paragraph 19
22 Proposed revision, paragraph 20
23 Proposed revision, paragraph 21
24 Proposed revision, paragraph 22
25 Proposed revision, paragraph 23
26 Proposed revision, paragraph 24
27 Proposed revision, paragraph 25
28 Proposed revision, paragraph 26
29 Proposed revision, paragraph 27
Memoranda of Understanding for Transfer Pricing Safe Harbors

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The OECD is strongly contemplating that tax administrations should adopt Memoranda of Understanding (MOU) process as part of its transfer pricing safe harbor analysis. The OECD developed this MOU process working through the Committee on Fiscal Affairs Working Party No. 6, which released a safe harbor transfer pricing discussion draft on June 6, 2012. Here is the background:

1. The issuance of the draft follows a project that the OECD has designed to improve the administrative aspects of transfer pricing through the implementation of safe harbors.\(^1\)
2. The issuance includes a survey of these simplification measures.\(^2\)

The reader should be aware that, as a matter of policy, the OECD has switched gears when it comes to the evaluation of transfer pricing safe harbors. After casting aspersions on transfer pricing safe harbors in its prior 2010 and earlier commentary, the OECD now looks to favorable experiences that multinational taxpayers and tax administrations have had with these transfer pricing safe harbors. The drafters of these June 6, 2012 proposed revisions, in looking back to these past approaches, comment that the Guidelines then had a “somewhat negative tone” regarding these transfer pricing safe harbors. The discussion draft includes more positive impacts to proposed revisions to Chapter IV of the Guidelines.

The current 2010 transfer pricing guidance is largely silent as to implementing bilateral agreement procedures that would establish such safe harbor. Nevertheless, some countries have favorable experiences with such bilateral agreements. The discussion draft includes sample Memoranda of Understanding that competent authorities are to use in establishing bilateral safe harbors.

Working Party No. 6 has been working on the development of various sample Memoranda of Understanding (MOUs) in the safe harbor context. The drafters envisage the Competent Authorities could negotiate together in building bilateral safe harbors. The Working Party No. 6 procedures apply to “common categories of transfer pricing cases,” where these cases involve any of three enumerated situations:

- “low risk distribution functions,”
- “low risk manufacturing functions,” and
- “low risk research and development functions”

The reader is forewarned that the drafters fail to address the parameters for “low risk” activities, nor the grouping of distribution, manufacturing, nor research and development. It would seem that, instead, risk analysis should be part of the picture. As transfer pricing practitioners, it our view that, the MOU process is “not ready for prime time;” and the OECD needs to expend considerable effort for this process to work effectively. Having made this
comment, we recall that in the TV context, the “not ready for prime time players” and its progeny have been carrying forward for 37 years.

The drafters present sample MOUs in this development context. The drafters, however, fail to define the scope of the “common categories” to which they refer. The drafters are now in the process of developing three enumerated MOUs. Nevertheless, it could be possible that the drafters might be contemplating adding additional MOUs in the future. The drafters address bilateral MOUs only, leaving for the future the concept that MOUs would ultimately address multilateral agreements. The MOU process that the drafters visualize is open-ended in that competent authorities could modify, add, or delete any provision of the sample MOU agreement when completing their own bilateral agreements.

The drafters intend that the OECD would be publishing these three sample MOUs in the OECD website. Further, the OECD would then ultimately include the MOUs as an Annex to the Transfer Pricing Guidelines. The drafters intend to provide tax administrations with a tool the countries could adopt and use from a transfer pricing perspective. The drafters’ goal is to address, on a bilateral safe harbor basis, transfer pricing cases that preclude the case-by-case analysis, an analysis that would comprise a great deal of effort if the parties were to proceed on a case by case basis. The drafters’ goal appears to create a broad-based APA process into which the multinational enterprise could fit its operations into a pre-established MOU.

Reasons for Contemplating a Bilateral Safe Harbor

The drafters express their concern that taxpayer’s income under the safe harbor process might not meld into the arm’s length amount. This likelihood that the safe harbor process might meld into the arm’s length amount is strongest when the safe harbor pricing is unilateral. Such a unilateral safe harbor increases the risk of double taxation and the risk of double non-taxation. Double taxation or double non-taxation can occur in a situation such as the following:

- The country that grants the unilateral safe harbor shades the safe harbor toward the high-end of an acceptable arm’s length profit range, while
- A treaty partner on the other end of the transaction disagrees with the assertion that a defined safe harbor profit level reflects arm’s length dealing.

Some business commentators contend that there is a tendency for tax administrations to increase profit margins over time; and that tendency could exacerbate this potential transfer pricing problem. Some drafters sometimes suggest that unilateral safe harbors can tend to force taxpayers into reporting higher than arm’s length levels of income. Thus, those unilateral safe harbors could cause taxpayers to incur some resulting double taxation as a price that it pays for administrative convenience and simplicity. The drafters note that unilateral safe harbors can, at times, provide a windfall to the taxpayers where the taxpayer’s specific facts might suggest that income above the safe harbor level would be more consistent with arm’s length dealing.
The multinational enterprise is likely to find that these double tax issues and these windfall tax issues are likely to be quite pronounced where these transactions take place in connection with safe harbors that are directed at some of the most common types of transfer pricing transactions, such as:

- Transactions such as sales of goods to a local distribution affiliate for resale on a limited risk basis in the local market,
- Contract manufacturing arrangements, and
- Contract research arrangements

The drafters note that few countries, if any, have developed functional safe harbors for dealing with these common types of transfer pricing issues. The drafters, in reaching such a conclusion, describe the cause as being double tax issues and windfall tax issues.

The drafters seek to rely on the presence of common and consistent distribution margins and of manufacturing mark-up margins as part of the safe harbor process. As transfer pricing practitioners it is our view that this “common standard” approach would subvert the arm’s length standard. The drafters take the approach that such margins and mark-ups “can sometimes be consistent across geographies and across many industries.” The drafters presuppose the presence of “normal settlement ranges,” and would have multinational enterprises and tax administrations rely on such “normal settlement ranges” for these types of cases. The drafters assert that such guidance could have the effect of reducing the number of transfer pricing audits, and on reducing competent authority dockets and other transfer pricing controversies by a substantial margin if the tax administrations could bilaterally agree to and publish reasonable ranges of results.

The drafters suggest that competent authorities address these types of cases through bilateral MOUs, including the competent authorities’ publication of these cases. The MOU process fails to address the confidentiality issues affecting the taxpayer. The drafters note that some countries have adopted such arrangements on a bilateral basis. Most countries, in assessing the transfer pricing disputes, take the position that the Article 25(3) of the OECD Model Tax Convention covers this situation. The countries take the approach that the Convention provides sufficient authority to support a bilateral competent authority agreement on a safe harbor rule that would apply to numerous similarly-situated taxpayers.

Article 25(3) provides as follows: “The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.” A competent authority agreement can pertain to a bilateral safe harbor. The parties should characterize the competent authority agreement as “mutual agreement” that “resolves difficulties or doubts that arise as to the interpretation or application” of Article 9 of the Treaty.

Each country’s competent authorities could adopt safe harbor provisions under Article 25(3) on a multilateral basis if the conditions and circumstances so allow. Nevertheless, the
drafters conclude that the transactions described as such that a bilateral agreement would often be the most appropriate approach.\(^\text{viii}\) The drafters are conscious of a MOU between two countries might not exist, but if such MOUs did exist, the qualifying taxpayers would then be able to manage their financial results to fall with the agreed-upon safe harbor range. The qualifying taxpayers could operate in a secure manner, knowing that each country or all countries agreed to the MOU. Drafters frequently site as an MOU arrangement the United States-Mexico safe harbor profit ranges for maquiladora operations.\(^\text{ix}\)

The drafters suggest that a bilateral approach to the development of safe harbors would have a number of advantages over unilateral transfer pricing safe harbors.\(^A\) The drafters mention six of these advantages:

- The MOU is a bilateral approach that competent authorities execute. MOUs can increase the likelihood that the safe harbor provisions do not result in double taxation or double non-taxation.
- The economics of a particular market and other circumstances can cause the countries to tailor bilateral safe harbors. Thus, these bilateral safe harbors are compatible with the arm’s length principle.
- Countries can enter into bilateral safe harbors on a selective basis with countries having similar tax rates. This relationship minimizes the possibility that the safe harbor provision itself would create opportunities for transfer pricing manipulation. This relationship provides a means for limiting the application of the safe harbor to situations where the transfer pricing risk is quite low.
- At the request of the country participants, the countries can initially limit bilateral safe harbors to small taxpayers and to small transactions in order to limit exposures to government tax revenues that the safe harbor might otherwise create.
- The competent authority can adopt safe harbors through the MOU mechanism. The competent authority can review and modify this agreement from time to time. This arrangement can assure that the provisions stay up to date to reflect developments in the broader economy.
- The drafters realize that developing countries might have serious constraints. In those situations, bilateral MOUs entered into with a number of treaty partners could provide these countries with a means of protecting the local tax base in common fact patterns, doing so without an inordinate enforcement effort.

The drafters spell out the following elements that might be relevant in the negotiation and the conclusion of a MOU:\(^{xi}\)

1. The country is to describe and qualify the criteria the enterprise is to perform. These facets could include the following:
   a. A description of the functions that the country requires the participating enterprise to perform, or the functions that the country would disallow, as a condition to the application of the safe harbor.
b. The risks that the country’s participating enterprise assumes, the risks that the participating enterprise would assume as a condition of applying the safe harbor.
c. The mix of assets the country’s participating enterprise assumes as a condition of applying the safe harbor.
d. The description of the classes of entities the country excludes from the safe harbor by virtue of size, industry, and so forth.

2. Description of the qualifying transactions the MOU covers.
3. Determination of the arm’s length range of the tested party’s compensation.
4. The years to which the MOU applies.
5. A statement that the MOU is binding on both of the tax administrations involved.
6. The reporting procedures and the monitoring procedures for the MOU.
7. The documentation procedures and the information procedures the participating enterprises are to maintain.
8. A description of the mechanism for resolving disputes.

As transfer pricing practitioners, it is our view that item 3, above, would preclude by inference the profit split method. It is our view that the MOU, if the countries desire, authorize a profit split method with the competent authorities delineating the profit components, which should presumably include assets, risks, and other profit components.

The drafters set forth draft MOUs for three types of transactions:
1. Performance of low-risk manufacturing services
2. Performance of low-risk distribution services
3. Performance of low-risk contract research and development services

The drafters suggest that the OECD add these three sample agreements to transfer pricing Guidelines as an Annex to Chapter IV. The drafters request commentary as to the specific provisions of these three draft agreements.

As transfer pricing practitioners, we respond to the OECD’s request that we comment on the specifics of the MOU proposal. Note the foregoing:
1. The MOU proposal should provide a quantified definition of “low-risk,” whether to manufacturing services, distribution services, or contract research and development services.
2. The MOU proposal should address functional analysis issues that pertain to manufacturing services, distribution services, or contract research and development services.

Draft Sample MOU – Low Risk Manufacturing Services

The draft MOU begins with a statement of authorization. The Competent Authorities of State A and State B have reached an understanding relating to the “arm’s length remuneration,” which term the MOU fails to define, where these services are applicable to “low
risk manufacturing services,” a term the MOU fails to define as to the performance of such services. Such low risk manufacturing services are to be performed by the following:

- A Qualifying Enterprise in State A on behalf of an associated enterprise resident in State B, and by
- A Qualifying Enterprise in State B on behalf of an associated enterprise resident in State A,

in the circumstances described herein.

The MOU contains a “purpose” clause: The purpose of this memorandum of understanding is to provide the “legal certainty” to the Qualifying Enterprises. The MOU establishes specific procedures that are designed to comply with the transfer pricing rules in State A and in State B. The MOU expresses a broad-based purpose; that of eliminating double taxation.xiii

The MOU itself provides a treaty basis predicated on the understanding that the competent authorities have reached. The basis for the memorandum of understanding is pursuant to Article 25 of the Tax Treaty between State A and State B. The MOU implements the principles of Article 9 of the Treaty in the circumstances described herein. The MOU applies to the tax years of the Qualifying Enterprises that end in calendar years from 20xx to 20yy.xiv

**Qualifying Enterprise**

The MOU specifies that the Qualifying Enterprise must meet all of the following nine characteristics:xv

a. The residency test and the exclusivity test narrow the scope of the “Qualifying Enterprise.” The Qualifying Enterprise must be a resident of a Contracting State for purposes of the Treaty. The Qualifying Enterprise must conduct its business operations exclusively in such State.

b. The “Qualified Enterprise” must meet a scope of the activities requirement. The first portion of this test relies on the “predominance” of the business activity of the Qualifying Enterprise. However, the MOU fails to define the characteristics than would define the predominant purpose of that activity. The MOU refers to “manufacturing services” but the MOU fails to define such “manufacturing” term. Thus, terminology creates uncertainty as to whether “manufacturing” encompasses such activities such as production, repairs, assembly and the like. The MOU sets forth two alternative conditions as to whether the predominant business activity of the Qualifying Enterprise meets the “performance of manufacturing services” test:

i. The performance of manufacturing services takes place the State of residence on behalf of an associated enterprise, within the meaning of Article 9 of the Treaty resident in the other Contracting State, or alternatively,

ii. The production of manufactured products for sale to such an associated enterprise.
c. The Qualifying Enterprise is to have entered into a written agreement with the associated enterprise that meets the following three parameters:
   i. The Qualifying Enterprise and its associated enterprise are to enter into this agreement prior to the commencement of the relevant tax year of the Qualifying Enterprise.
   ii. This agreement is to specify that the associated enterprise assumes the business risks that are associated with the manufacturing activities of the Qualifying Enterprise.
   iii. The associated enterprise must agree to compensate the Qualifying Enterprise for its manufacturing activities at levels that are consistent with the MOU.

d. The MOU limits the scope the Qualifying Enterprise activities: The annual research, development, and product engineering expense of the Qualified Enterprise are, in the aggregate, must be less than XX percent of the net sales revenue of the Qualifying Enterprise.

e. The MOU precludes certain functions on the part of the Qualifying Enterprise. The Qualifying Enterprise is precluded from engaging in advertising, marketing, or distribution functions, in credit and collection functions, or in warranty administrative functions with regard to the products the Qualifying Enterprise manufactures. It is our view, as transfer pricing practitioners, that this parameter would cause the putative Qualifying Enterprise with extreme audit difficulties.

f. The MOU establishes three strict title passage requirements:
   i. The MOU prohibits the Qualifying Enterprise from retaining title to the finished goods after the goods leave the factory.
   ii. The Qualifying Enterprise is not to bear any transportation expenses or freight expense as to these finished products.
   iii. The Qualifying Enterprise is not to bear any risk of losses as to damages or loss of finished products in transit.

As transfer pricing practitioners, it our view that the title provisions are unduly restrictive in applying the Qualifying Enterprise formulation.

g. The MOU precludes the Qualifying Enterprise from engaging in the following functions other than those activities that are directly related to the performance of its manufacturing functions:
   i. Managerial functions
   ii. Legal functions
   iii. Accounting functions
   iv. Personnel management functions

As transfer pricing practitioners, it our view that the title provisions are unduly restrictive in applying the Qualifying Enterprise formulation.

h. The MOU restricts the assets of the Qualifying Enterprise. The MOU provides that at least XX percent of the assets of the Qualifying Enterprise are to consist of the following assets:
   i. Manufacturing plant and equipment
ii. Raw material inventory

iii. Work in process inventory

The putative Qualifying Enterprise is to determine this calculation on the basis of the average of the assets held on the last day of each of the four quarterly periods during the relevant taxable year of the Qualifying Enterprise.

1. The MOU limits the percentage of product inventory on the part of the Qualifying Enterprise. This finished product inventory cannot exceed XX percent of the annual net sales of the Qualifying Enterprise. The Qualifying Enterprise is to calculate the percentage based on an average asset basis, determined in accordance with paragraph h, above.

A putative Qualifying Enterprise is prohibited from engaging in the following five activities:

- a. Conducting its principal operations in any one of the following specified industries____.
- b. Have annual sales that are in excess of the following___.
- c. Have total assets that are in excess of the following___.
- d. Derive more than ___percent of its net revenues from transactions other than from Qualifying Transactions.
- e. Have undergone a transfer pricing audit in either State A or in State B within the past ___years which have resulted in adjustments in excess of $____.

### Qualifying Transactions

The MOU specifies two activities of a Qualifying Transaction:

1. A Qualifying Transaction is to render the manufacturing services on behalf of an associated enterprise that is resident in the other Contracting State;
2. The sale of manufactured products produced by the Qualifying State to an associated enterprise resident in other Contracting State;

in each case without the interposition of other transactions or parties.

### Determination of the Taxable Income of the Qualifying Enterprise

The following conditions apply if a Qualifying Enterprise elects to apply the MOU provisions:

- a. The Qualifying Enterprise might hold title to the raw materials and to work in process inventory that relate to the Qualifying Transactions. In that event, the net income, before tax, of the Qualifying Enterprise that pertains to the Qualifying Transactions for the taxable year are to be in the range of, or equal to, ___ to ____ percent of the total costs for the Qualifying Enterprise. This net cost computation excludes net interest expense, currency gain or loss, and non-recurring costs in computing the Qualifying Enterprise computation.
b. The MOU addresses title passage attributable to the associated enterprise. Such an associated enterprise might hold title to raw materials and work in process inventory that are related to the Qualifying Transactions. In such a title passage situation, the net income, before tax, of the Qualifying Enterprise as to the Qualifying Transactions for the taxable year must be in the range of, or equal to ___ to ___ percent of the total costs of the Qualifying Enterprise. This net cost computation excludes net interest expense, currency gain or loss, and non-recurring costs in computing the Qualifying Enterprise computation.

c. The MOU, in utilizing accounting terms, is to apply these accounting terms in accordance with general accepted accounting principles established in the residence country of the Qualifying Enterprise.

Each of State A and State B agree that the countries involved are to determine the compensation for Qualified Transactions under the MOU as arm’s length for purposes of applying the transfer pricing rules of such State and the provisions of Article 9 of the Treaty.xix

**Permanent Establishment**

The MOU would override the applicable permanent establishment provisions. Such a permanent establishment clause might make the MOU untenable. The permanent establishment clause provides that the competent authorities of State A and State B agree that the associated enterprise which is a party to a Qualifying Transaction “shall not be deemed to be a permanent establishment in the country of residence of the Qualifying Enterprise” in two respects:xx

1. By virtue of the performance of low risk manufacturing services on its behalf by the Qualifying Enterprise, or
2. By virtue of such associated enterprise by taking title to products produced by the Qualifying Enterprise in the country of residence of the Qualifying Enterprise.

**Election and Reporting Requirements**

The country participants in the MOU are to elect the MOU process by filing an applicable notice to each government.xxx The Qualifying Enterprise and the relevant associated enterprise are to elect the MOU provisions in State A and in State B by filing a notice with the applicable officials in each state no later than the due date for the respective tax returns covering the Qualifying Transactions.xxxi As transfer pricing practitioners, it is our view that the tax authorities might demand notice at the beginning of the period rather than at the end.

The MOU notice is to include the following seven items:

1. An affirmative statement that the taxpayers intend to apply the MOU and are bound by the MOU.
2. An affirmative statement that the Qualifying Enterprise and its associated enterprise will report the income and expense on a consistent basis in State A and State B in accordance with this agreement.
3. The MOU is to provide a “narrative description” of the Qualifying Transactions. The MOU fails to define “narrative description.”
4. The MOU is to identify each associated enterprise that is a party to the Qualifying Transactions.
5. The MOU is to provide audited financial statements pertaining to the Qualifying Enterprise for the relevant year; and to provide sufficient additional financial and accounting information to demonstrate the status of the Qualifying Enterprise as being a Qualified Enterprise.
6. The MOU is to provide a detailed calculation of the income of the Qualifying Transactions applying the principles of the MOU.
7. The agreement must provide that the electing enterprise will respond within 60 days to a request by the tax authority of the residence country. That country’s tax authority can request information to verify qualification of the enterprise for treatment under the MOU.

The Qualifying Enterprise and its relevant associated enterprise have the obligation to comply with the otherwise applicable transfer pricing documentation requirements applicable to State A and State B with respect to the Qualifying Documentation. The Qualifying Enterprise and its relevant enterprise can satisfy the election and reporting requirements of the MOU and the reporting income calculated accordance with its terms and timely tax returns for the year.\textsuperscript{xxiii}

The Qualifying Enterprise and its relevant associated enterprise might not elect MOU treatment of its Qualifying Transactions. In the event of such non-election, the parties are subject to the application of the transfer pricing and documentation rules of State A and State B as if the MOU were not in force.\textsuperscript{xxiv}

The MOU contains a joint resolution clause. The controlled participants are to refer all disputes in regard to the MOU to the competent authorities of State A and State B for resolution by mutual agreement.\textsuperscript{xxv}

The MOU contains an exchange of information clause. The competent authorities of State A and State B can exchange information where necessary to carry out this Agreement under the provisions of Article 26 of the Treaty.\textsuperscript{xxvi}

Termination of the Agreement

The MOU contains a termination provision. Either State A or State B can terminate the MOU at any time upon written notice to the competent authority of the other Contracting State and publication of such notice. Such termination comes into effect for taxable years of the Qualifying Enterprises, beginning after the last day of the calendar year in which the delivery and the publication of such notice of termination occurs.\textsuperscript{xxvii}

Draft Sample MOU on Low Risk Distribution Services
The draft MOU begins with a statement of authorization. The Competent Authorities of State A and State B have reached an understanding relating to the “arm’s length remuneration,” which term the MOU fails to define, where these services are applicable to “low risk distribution services,” another term the MOU fails to define as to the performance of such services. Such low risk distribution services are to be performed by the following:

- A Qualifying Enterprise in State A on behalf of an associated enterprise resident in State B, and by
- A Qualifying Enterprise in State B on behalf of an associated enterprise resident in State A,

in the circumstances described herein.

The MOU contains a “purpose” clause: The purpose of this memorandum of understanding is to provide the “legal certainty” to the Qualifying Enterprises. The MOU establishes specific procedures that are designed to comply with the transfer pricing rules in State A and in State B. The MOU expresses a broad-based purpose; that of eliminating double taxation.xxviii

The MOU itself provides a treaty basis predicated on the understanding that the competent authorities have reached. The basis for the memorandum of understanding is pursuant to Article 25 of the Tax Treaty between State A and State B. The MOU implements the principles of Article 9 of the Treaty in the circumstances described herein. The MOU applies to the tax years of the Qualifying Enterprises that end in calendar years from 20xx to 20yy.xxx

**Qualifying Enterprise**

The MOU specifies that the Qualifying Enterprise must meet all of the following eight characteristics.xxx

a. The residency test and the exclusivity test narrow the scope of the “Qualifying Enterprise.” The Qualifying Enterprise must be a resident of a Contracting State for purposes of the Treaty. The Qualifying Enterprise must conduct its business operations exclusively in such State.

b. The “Qualified Enterprise” must meet a scope of the activities requirement. The first portion of this test relies on the “predominance” of the business activity of the Qualifying Enterprise. However, the MOU fails to define the characteristics than would define the predominant purpose of that activity. The MOU refers to “distribution services,” but the MOU fails to define such “distribution” term. Thus, terminology creates uncertainty as to whether “distribution” encompasses such activities such as resale services or wholesale services and the like. The MOU sets forth two alternative conditions as to whether the predominant business activity of the Qualifying Enterprise meets the “performance of distribution services” test:

i. The performance of distribution services takes place the State of residence on behalf of an associated enterprise, within the meaning
of Article 9 of the Treaty resident in the other Contracting State, or alternatively,

ii. The production of products for resale to such associated enterprise.

c. The Qualifying Enterprise is to have entered into a written agreement with the associated enterprise that meets the following three parameters:

i. The Qualifying Enterprise and its associated enterprise are to enter into this agreement prior to the commencement of the relevant tax year of the Qualifying Enterprise.

ii. This agreement is to specify that the associated enterprise assumes the business risks that are associated with the marketing and distribution activities of the Qualifying Enterprise.

iii. The associated enterprise must agree to compensate the Qualifying Enterprise for its manufacturing activities as levels that are consistent with the MOU.

d. The MOU limits the scope the Qualifying Enterprise activities: The annual research, development, and product engineering expense of the Qualified Enterprise, in the aggregate, must be less than XX percent of the net sales revenue of the Qualifying Enterprise.

e. The MOU provides that the Qualifying Enterprise is not to engage in manufacturing or in assembly functions with regard to the products the Qualifying Enterprise markets and distributes. As transfer pricing practitioners, we are concerned that the term “assembly functions” is often an item of dispute, and we suggest that the OECD define assembly functions in terms of time spent or functions.

f. The MOU limits the total marketing and advertising expenses of the Qualifying Expenses. Marketing and advertising expenses cannot exceed ___ percent of its net sales.

g. The MOU precludes the Qualifying Enterprise from engaging in the following functions other than those activities that are directly related to the performance of its marketing and distribution functions:

i. Managerial functions

ii. Legal functions

iii. Accounting functions

iv. Personnel management functions

As transfer pricing practitioners, it our view that the low risk distribution provisions are unduly restrictive in applying the Qualifying Enterprise formulation.

h. The MOU restricts the assets of the Qualifying Enterprise. The MOU provides that at least XX percent of the finished product inventory are to consist of the average inventory of the Qualifying Enterprise held on the last day of each of
the four quarterly periods during the relevant taxable year of the Qualifying Enterprise.

A putative Qualifying Enterprise is prohibited from engaging in the following five activities:

1. Conducting its principal operations in any one of the following specified industries.
2. Have annual sales that are in excess of the following.
3. Have total assets that are in excess of the following.
4. Derive more than percent of its net revenues from transactions other than from Qualifying Transactions.
5. Have undergone a transfer pricing audit in either State A or in State B within the past years which have resulted in adjustments in excess of $.

Qualifying Transactions

The MOU specifies two activities of a Qualifying Transaction:

1. A Qualifying Transaction is to render the marketing and distribution services on behalf of an associated enterprise that is resident in the other Contracting State;
2. The sale of manufactured products produced by the Qualifying State to an unrelated customer in an associated enterprise resident in other Contracting State; in each case without the interposition of other transactions or parties.

Determination of the Taxable Income of the Qualifying Enterprise

Two conditions apply in the event that a Qualifying Enterprise elects to apply the MOU:

1. The net income, before tax, of the Qualifying Enterprise as to the Qualifying Transactions for the taxable year are to be in the range of or equal to percent of the total net sales of the Qualifying Enterprise.
2. The MOU, in utilizing accounting terms, are to apply these accounting terms in accordance with general accepted accounting principles established in the residence country of the Qualifying Enterprise.

Each of State A and State B agree that the countries involved are to determine the compensation for Qualified Transactions under the MOU as arm’s length for purposes of the applying the transfer pricing rules of such State and the provisions of Article 9 of the Treaty.

Permanent Establishment

The MOU would override the applicable permanent establishment provisions. Such a permanent establishment clause might make the MOU untenable. The permanent establishment clause provides that the competent authorities of State A and State B agree that the associated enterprise which is a party to a Qualifying Transaction “shall not be deemed to
be a permanent establishment in the country of residence of the Qualifying Enterprise” in two respects:xxxv

1. By virtue of the performance of low risk manufacturing services on its behalf by the Qualifying Enterprise, or
2. By virtue of such associated enterprise by taking title to products produced by the Qualifying Enterprise in the country of residence of the Qualifying Enterprise.

**Election and Reporting Requirements**

The country participants in the MOU are to elect the MOU process by filing an applicable notice to each government.xxxvi The Qualifying Enterprise and the relevant associated enterprise are to elect the MOU provisions in State A and in State B by filing a notice with the applicable officials in each state no later than the due date for the respective tax returns covering the Qualifying Transactions. As transfer pricing practitioners, it is our view that the tax authorities might demand notice at the beginning of the period rather than at the end of the period.

The MOU notice is to include the following seven items:xxxvii

1. An affirmative statement that the taxpayers intend to apply the MOU and are bound by the MOU.
2. An affirmative statement that the Qualifying Enterprise and its associated enterprise will report the income and expense on a consistent basis in State A and State B in accordance with this agreement.
3. The MOU is to provide a “narrative description” of the Qualifying Transactions. The MOU fails to define “narrative description.”
4. The MOU is to identify each associated enterprise that is a party to the Qualifying Transactions.
5. The MOU is to provide audited financial statements pertaining to the Qualifying Enterprise for the relevant year; and to provide sufficient additional financial and accounting information to demonstrate the status of the Qualifying Enterprise as being a Qualified Enterprise.
6. The MOU is to provide a detailed calculation of the income of the Qualifying Transactions applying the principles of the MOU.
7. The agreement must provide that the electing enterprise will respond within 60 days to a request by the tax authority of the residence country. That country’s tax authority can request information to verify qualification of the enterprise for treatment under the MOU.

The Qualifying Enterprise and its relevant associated enterprise have the obligation to comply with the otherwise applicable transfer pricing documentation requirements applicable to State A and State B with respect to the Qualifying Documentation. The Qualifying Enterprise and its relevant enterprise can satisfy the election and reporting requirements of the MOU and the reporting income calculated accordance with its terms and timely tax returns for the year.xxxviii
The Qualifying Enterprise and its relevant associated enterprise might not elect MOU treatment of its Qualifying Transactions. In the event of such non-election, the parties are subject to the application of the transfer pricing and documentation rules of State A and State B as if the MOU were not in force. xxxix

The MOU contains a joint resolution clause. The controlled participants are to refer all disputes in regard to the MOU to the competent authorities of State A and State B for resolution by mutual agreement. xli

The MOU contains an exchange of information clause. The competent authorities of State A and State B can exchange information where necessary to carry out this Agreement under the provisions of Article 26 of the Treaty. xlii

**Termination of the Agreement**

The MOU contains a termination provision. Either State A or State B can terminate the MOU at any time upon written notice to the competent authority of the other Contracting State and publication of such notice. Such termination comes into effect for taxable years of the Qualifying Enterprises, beginning after the last day of the calendar year in which the delivery and the publication of such notice of termination occurs. xliii

**Draft Sample MOU on Low Risk Research and Development Services**

The draft MOU begins with a statement of authorization. The Competent Authorities of State A and State B have reached an understanding relating to the “arm’s length remuneration,” which term the MOU fails to define, where these services are applicable to “low risk research and development service,” a term the MOU fails to define as to the performance of such services. Such research and development services are to be performed by the following:

- A Qualifying Enterprise in State A on behalf of an associated enterprise resident in State B, and by
- A Qualifying Enterprise in State B on behalf of an associated enterprise resident in State A,

in the circumstances described herein.

The MOU contains a “purpose” clause: The purpose of this memorandum of understanding is to provide the “legal certainty” to the Qualifying Enterprises. The MOU establishes specific procedures that are designed to comply with the transfer pricing rules in State A and in State B. The MOU expresses a broad-based purpose; that of eliminating double taxation. xliii

The MOU itself provides a treaty basis predicated on the understanding that the competent authorities have reached. The basis for the memorandum of understanding is pursuant to Article 25 of the Tax Treaty between State A and State B. The MOU implements the
principles of Article 9 of the Treaty in the circumstances described herein. The MOU applies to the tax years of the Qualifying Enterprises that end in calendar years from 20xx to 20yy.\textsuperscript{xliv}

**Qualifying Enterprise**

The MOU specifies that the Qualifying Enterprise must meet all of the following nine characteristics:\textsuperscript{xlv}

a. The residency test and the exclusivity test narrow the scope of the “Qualifying Enterprise.” The Qualifying Enterprise must be a resident of a Contracting State for purposes of the Treaty. The Qualifying Enterprise must conduct its business operations exclusively in such State.

b. The “Qualified Enterprise” must meet a scope of the activities requirement. The first portion of this test relies on the “predominance” of the business activity of the Qualifying Enterprise. However, the MOU fails to define the characteristics than would define the predominant purpose of that activity. The MOU refers to “research and development services,” but the MOU fails to define such “research and development” term. Thus, terminology creates uncertainty as to whether “research and development” encompasses such activities such as exploration, engineering studies and the like.

c. The Qualifying Enterprise is to have entered into a written agreement with the associated enterprise that meets the following three parameters:
   
   i. The Qualifying Enterprise and its associated enterprise are to assume the principal business risks associated with the research and development services of the Qualifying Enterprise, including the risk that the research and development might not be successful.
   
   ii. This agreement is to specify that the associated enterprise agrees that all interests in the intangibles developed through its research activities shall belong to the associated enterprise.
   
   iii. The associated enterprise must agree to compensate the Qualifying Enterprise for its manufacturing activities at levels that are consistent with the MOU.

d. The MOU precludes Qualifying Enterprise activities: The prohibited activities are the product manufacturing and assembly functions, together with the following: advertising, marketing and distribution functions, credit and collection functions, or warranty administration functions of the Qualifying Enterprise. It is our view, as transfer pricing practitioners, that this parameter would cause the putative Qualifying Enterprise with extreme audit difficulties.

e. The MOU precludes the Qualifying Enterprise from engaging in the following activities: The Qualifying Enterprise is prohibited from using proprietary patents, know-how, trade secrets, or other intangibles in performing its research and development services other than those made available to it by the associated enterprise. It is our view, as transfer pricing practitioners, that
this parameter would cause the putative Qualifying Enterprise with extreme audit difficulties.

f. The MOU precludes the Qualifying Enterprise from engaging in the following functions other than those activities that are directly related to the performance of its research and development functions:
   i. Managerial functions
   ii. Legal functions
   iii. Accounting functions
   iv. Personnel management functions

As transfer pricing practitioners, it our view that the title provisions are unduly restrictive in applying the Qualifying Enterprise formulation.

g. The MOU restricts the research and development program for the Qualifying Enterprise. The research and development program carried out by the Qualifying Enterprise must be designed by, directed, and controlled by the associated enterprise.

A putative Qualifying Enterprise is prohibited from engaging in the following five activities:

   a. Conducting its principal operations in any one of the following specified industries.
   b. Have annual sales that are in excess of the following.
   c. Have total assets that are in excess of the following.
   d. Derive more than percent of its net revenues from transactions other than from Qualifying Transactions.
   e. Have undergone a transfer pricing audit in either State A or in State B within the past years which have resulted in adjustments in excess of $.

Qualifying Transactions

The MOU specifies an activity of a Qualifying Transaction. Such a Qualifying Transaction must be the rendering of research and development services by the Qualifying Enterprise taken in behalf of an associated enterprise that is resident in the other Contracting State without interposition of other transactions or parties.

Determination of the Taxable Income of the Qualifying Enterprise

Two conditions apply in the event that a Qualifying Enterprise elects to apply the MOU:

   a. The net income, before tax, of the Qualifying Enterprise as to the Qualifying Transactions for the taxable year are to be in the range of or equal to to percent of the total net sales of the Qualifying Enterprise.
   b. The MOU, in utilizing accounting terms, are to apply these accounting terms in accordance with general accepted accounting principles established in the residence country of the Qualifying Enterprise.
Each of State A and State B agree that the countries involved are to determine the compensation for Qualified Transactions under the MOU as arm’s length for purposes of the applying the transfer pricing rules of such State and the provisions of Article 9 of the Treaty.

**Permanent Establishment**

The MOU would override the applicable permanent establishment provisions. Such a permanent establishment clause might make the MOU untenable. The permanent establishment clause provides that the competent authorities of State A and State B agree that the associated enterprise which is a party to a Qualifying Transaction “shall not be deemed to be a permanent establishment in the country of residence of the Qualifying Enterprise” by virtue of the performance of low risk research and development services on behalf of the Qualifying Enterprise.

**Election and Reporting Requirements**

The country participants in the MOU are to elect the MOU process by filing an applicable notice to each government. The Qualifying Enterprise and the relevant associated enterprise are to elect the MOU provisions in State A and in State B by filing a notice with the applicable officials in each state no later than the due date for the respective tax returns covering the Qualifying Transactions. As transfer pricing practitioners, it is our view that the tax authorities might demand notice at the beginning of the period rather than at the end of the period.

The MOU notice is to include the following seven items:

1. An affirmative statement that the taxpayers intend to apply the MOU and are bound by the MOU.
2. An affirmative statement that enterprise and its associated enterprise will report the income and expense on a consistent basis in State A and State B in accordance with this agreement.
3. The MOU is to provide a “narrative description” of the Qualifying Transactions. The MOU fails to define “narrative description.”
4. The MOU is to identify each associated enterprise that is a party to the Qualifying Transactions.
5. The MOU is to provide audited financial statements pertaining to the Qualifying Enterprise for the relevant year; and to provide sufficient additional financial and accounting information to demonstrate the status of the Qualifying Enterprise as being a Qualified Enterprise.
6. The MOU is to provide a detailed calculation of the income of the Qualifying Transactions applying the principles of the MOU.
7. The agreement must provide that the electing enterprise will respond within 60 days to a request by the tax authority of the residence country. That country’s tax
authority can request information to verify qualification of the enterprise for
treatment under the MOU.

The Qualifying Enterprise and its relevant associated enterprise have the obligation to
comply with the otherwise applicable transfer pricing documentation requirements applicable
to State A and State B with respect to the Qualifying Documentation. The Qualifying Enterprise
and its relevant enterprise can satisfy the election and reporting requirements of the MOU and
the reporting income calculated accordance with its terms and timely tax returns for the year.iii

The Qualifying Enterprise and its relevant associated enterprise might not elect MOU
treatment of its Qualifying Transactions. In the event of such non-election, the parties are
subject to the application of the transfer pricing and documentation rules of State A and State B
as if the MOU were not in force. iv

The MOU contains a joint resolution clause. The controlled participants are to refer all
disputes in regard to the MOU of the competent authorities of State A and State B for
resolution by mutual agreement.v

The MOU contains an exchange of information clause. The competent authorities of
State A and State B can exchange information where necessary to carry out this Agreement
under the provisions of Article 26 of the Treaty.vi

**Termination of the Agreement**

The MOU contains a termination provision. Either State A or State B can terminate the
MOU at any time upon written notice to the competent authority of the other Contracting
State and publication of such notice. Such termination comes into effect for taxable years of the
Qualifying Enterprises, beginning after the last day of the calendar year in which the delivery
and the publication of such notice of termination occurs.vii

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iii Proposed revision 40

iv Proposed revision 41

v Proposed revision 42

vi Proposed revision 43

vii Proposed revision 44

viii Proposed revision 45

ix Proposed revision 46

x Proposed revision 47

xi Proposed revision 48

xii Proposed revision 49

xiii Proposed revision 50
September 15, 2010

Mr. Joe Andrus  
Head of Transfer Pricing Unit  
Organisation for Economic Co-operation and Development (“OECD”)  
Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris  
Cedex 16  
France

Dear Mr. Andrus,

True Partners Consulting, in cooperation with its global network of affiliates (collectively “True Partners International” or “TPI”), welcomes the opportunity to provide commentary to the OECD with respect to its undertaking of a possible revision of Chapters IV of the Transfer Pricing Guidelines (“TPG”) concerning Safe Harbours.

Safe Harbours are clearly a very important topic within the transfer pricing realm and therefore we welcome the OECD’s initiative to revisit the appropriateness of utilizing a safe harbour pricing model; and possibly constructing a rationale for employing such safe harbours in certain situations. In the following sections, we share our ideas for the development of more cohesive international guidance.

Best Regards,

Michael Heckel, Rölfs RP Rechtsanwaltsgesellschaft GmbH (Germany)  
Les Secular, True Partners Consulting (UK) LLP  
Daniel Falk, True Partners Consulting LLC (U.S.)  
James Chang, True Partners Consulting International (China) Co., Ltd.  
Hervé Bidaud, Artemtax International (France)  
Kay H. Lee, Sungjhee Accounting Corporation (Korea)  
Natalia Operti, Studio Manzoni Pagliero Vanz e Associati (Italy)  
Michal Majdanski, BT&A Group (Poland)
A) Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines – Comments from TPC

There are numerous benefits to implementing a safe Harbour for certain countries and certain transactions (i.e. those that are nominal in size and routine in scope). The currently applicable Transfer Pricing Guidelines (“Guidelines”) cite compliance relief and certainty for taxpayers and administrative simplicity for both tax payers and tax administrations, as being the impetus for incorporating safe harbors for certain taxpayers. While the proposed revision on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines further elaborates upon the benefits of supporting the use of safe Harbours, they do not add any additional benefits for undergoing this transformation (albeit on a limited basis). All that is being referenced in the proposal is an expanded/detailed explanation of these three reasons – which were previously implied. The authors of the currently applicable Guidelines state that “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. Therefore, we believe that there are no new considerations to further ponder.

With respect to the paragraphs relating to the “Concerns over Safe Harbours”, the authors of the proposed Guidelines once again do not bring any additional reasons for the argument against applying safe harbours. Again, they do provide more of the previously implied detail for their argument. In our opinion, the three most compelling arguments, as they relate to mitigating the potential detriments, include (a) focusing on the necessity for these safe harbor regimes to be multilateral; (b) making companies commit to a predetermined period – to apply the safe harbour instead of the arm’s length principle; and (c) factoring in the additional revenue that governments will earn from small taxpayers who were previously noncompliant, but due to the administrative ease of the safe harbour will either fall under scrutiny, or conform to the safe harbour rules.

Multilateral Regimes

In the proposed Guidelines there is much clout given to the success of safe harbours being contingent on multilateral agreements. However, many tax authorities, in our experience will elect to apply “rules” that will generate more taxable income to their jurisdiction. If a particular regime, especially those in mature markets, elects to apply a safe harbour, it will generally set the parameters to ensure that it does not erode its tax base. If the goal is for all taxable income to be accounted for, then the other country will not accept a price that is below arm’s length. If domicile companies are more prone to perform a particular function they would set up the safe harbour to ensure that that particular function receives the higher degree of remuneration. Getting tax authorities to agree on a position, whereby they will have to sacrifice income (on the aggregate), and accept what could potentially be ‘below arm’s length pricing’ will be a difficult
Moreover, multilateral safe harbours do have some history of success as well. As the new Guidelines point out, the success of the Maquiladora program lends credence to the proponents of instituting a safe harbour. However, we still believe, its advisability on a broad basis should remain unchanged.

**Electing in-and-out of the safe harbour**

Granting taxpayers the option to elect either the safe harbour or the arm’s length price can be harmful to local tax authorities. Companies with significant resources will utilize this election as a tax planning opportunity and select the option that results in a lower tax base. This will result in an erosion of the local tax base, and can potentially result in double non-taxation. The proposed Guideline revision recognizes this shortcoming. The recommendation to curtail the subjective nature of this election is to force companies to commit to the Safe Harbour for a predetermined period of time. There are several problems with this approach. If the period is too short, companies can forecast well enough to render their commitment meaningless and opt in-and-out based on the minimum commitment requirement. If the period is too long companies will not elect the safe harbour, out of the fear of the lengthy commitment - and the advantages of the safe harbour will be lost on most. Additionally, skilled taxpayers can potentially create situations which alleviate a company’s commitment to a particular election. For example, restructuring operations or renaming the organization, whereby the company can take the position that the facts and circumstances surrounding the election of a particular election has changed.

**Inclusion of previously noncompliant taxpayers into the pool**

The size of the small taxpayers who were previously noncompliant due to the lack of resources and high administrative costs that will now become compliant is low. Furthermore, the addition of these taxpayers will, in all likelihood, not offset the revenue lost by those taxpayers who are now paying the lesser of the arm’s length price or the safe harbour. On the aggregate, the tax planning opportunities utilized to reduce the tax base will probably not be filled by this minor infusion of tax revenue.

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1 However, such a case does exist in the United States, whereby the Applicable Federal Rate (“AFR”) Safe Harbour, for U.S. Dollar denominated intercompany loans is an example of a unilaterally instituted non-arms length safe harbour. During periods of low interest rates (e.g. recessions) the U.S. government will accept a price which is below arm’s length – without even gauging the creditworthiness of the borrowing party. Furthermore, the Services Cost Method under Regulation 1.482-9(b), was previously referred to as the “cost safe harbor” (when it was referenced under Regulation 1.482-2(b)(3)) and is another example of a unilateral safe harbour whereby the U.S. Treasury accepts a below arm’s length price; for ease of administration.
Memoranda of Understanding

The Memoranda of Understanding (“MOU”) lists a number of previously considered advantages to instituting the safe harbour, and describes the taxpayers which it would service best. If a safe harbour were to be applied by a particular regime, the circumstances listed in the MOU would probably have to be germane to those facts. However, in light of the detriments of the Safe Harbour, making a broad recommendation should not be considered.

With respect to the MOU Exhibit 1, while we do not agree that a generic template should exist for low risk manufacturing, we pose the following questions and offer the following considerations for your review:

Paragraph 53 states that a “Qualifying Enterprise” may not … have Annual Net Sales of __ nor may they have total assets of __. If the taxpayer has already elected the safe harbour from years past, and has committed to a period of X, would they be grandfathered in to the election? Or would they be removed due to their lack of qualification? What is to stop the taxpayer from creating another Legal Entity to pick up the excess slack and thus keeping the manufacturer in compliance? If the Safe Harbour earns a markup on their costs, and the markup is the “Safe Harbour”, why do levels of sales and assets, respectively, disqualify the company? Volume is a key variable in the equation of profitability (especially when the manufacturer does not own significant process intangibles). The business purpose and tax considerations may be at odds with one another. If a company wants to establish a low risk manufacturing operation, they may consider limiting their manufacturing in countries offering the safe harbour and shifting a portion of their production elsewhere – thus lowering the number of jobs and income from manufacturing operations in the domicile facility.

Furthermore, companies seeking to break their commitment to their multi-year safe harbour commitment may need to just intentionally increase production and thus become disqualified from their safe harbour commitment. If once again, the Safe Harbour offers a better tax answer, this particular company may shift production to another plant in order to once again qualify for the Safe Harbour. Such “planning” techniques need to be considered when setting the threshold for sales and assets in a particular tax year.
True Partners Consulting LLC and its affiliates assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader’s particular situation. This memorandum is a summary discussion and is limited to the described facts. The conclusions and recommendations contained in this memorandum are based on our understanding of the facts, assumptions, information, and documents referenced herein and current tax laws and published tax authorities in effect as of the date of this memorandum, all of which are subject to change. If the facts and assumptions are incorrect or change or if the relevant tax laws change, the conclusions and recommendations would likewise be subject to change. True Partners Consulting LLC assumes no obligation to update the memorandum for any future changes in tax law, regulations, or other interpretations and does not intend to do so. Only the specific tax issues and tax consequences described herein are covered by this memorandum, and any other federal, state, or local laws of any kind are expressly outside the scope of this memorandum.

We are required by regulation to inform you that any tax advice contained in this communication (or in any attachment) is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of: (i) avoiding U.S. federal, state, or local tax penalties or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed in this communication (or any attachment).
August 28, 2012

VIA EMAIL AND REGULAR MAIL

Mr. Joe Andrus
Head, Transfer Pricing Unit
OECD, 2, rue Andre Pascal
75775 Paris /Cedex 16
France
(joe.andrus@oecd.org)

Re. Comments on Proposed Revision of the Section on Safe Harbors in Chapter IV of the OECD Transfer Pricing Guidelines

Dear Mr. Andrus:

This letter responds to the OECD’s invitation to send comments on the discussion draft regarding safe harbors released on June 6, 2012, by Working Party No. 6 of the OECD Committee on Fiscal Affairs (the “Discussion Draft”). The Discussion Draft contains proposed revisions to the section on safe harbors in Chapter IV of the 2010 OECD Transfer Pricing Guidelines (“TPGs”) and associated draft sample memoranda of understanding (“MOUs”) for possible use by competent authorities in establishing bilateral safe harbors for contract manufacturing, limited-risk distribution, and research and development (“R&D”) services, respectively. The report was issued in connection with an ongoing OECD project focused on broader efforts to simplify the administration of transfer pricing (the “Project”).

USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and regulatory coherence. Its members include U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

General Comments

We commend the OECD for initiating the Project and welcome the revised tone and the new bilateral approach to safe harbors in the Discussion Draft. No doubt, the proposed revisions to Chapter IV represent a significant improvement over the existing
safe harbor provisions in the TPGs, reversing decades of firm tax authority opposition to the safe harbor concept. With relatively minor revisions and clarifications, we are optimistic that the OECD’s final changes to Chapter IV will enhance compliance, provide new certainty, and minimize the potential for double taxation, to the benefit of both taxpayers and tax authorities.

Notwithstanding this progress, USCIB members urge the OECD to continue working on the Project. Safe harbors represent only a partial solution to the larger transfer pricing compliance issues faced daily by multinational companies -- conflicting substantive rules, burdensome documentation requirements, inconsistent audit standards, arbitrary penalty assessments, and unpredictable competent authority outcomes. Greater simplicity in transfer pricing administration will remain essential even after the Discussion Draft is finalized. For that reason, we hope that the OECD (i) will continue work on the other work streams that comprise the Project (e.g., obtaining consensus on the treatment of headquarters expenses, harmonizing documentation requirements, conforming and limiting the application of penalty regimes, and strengthening advance pricing agreement (“APA”) and other alternative dispute resolution processes), and (ii) will continue to look proactively for ways to improve the efficiency and effectiveness of global transfer pricing enforcement.

To that end, although the Discussion Draft surely offers a more balanced view about the “benefits” and “concerns” of safe harbors than do the TPGs, the stated concerns remain unnecessarily skeptical. While the principal benefits derive directly from the safe harbor concept (i.e., simplifying taxpayer compliance, ensuring greater taxpayer certainty, and freeing up tax authorities to focus on higher-risk transactions), the principal concerns apply as much to the arm’s-length standard generally as to safe harbors specifically (i.e., the challenges of precisely determining an arm’s-length result, the risk of double taxation, and potential inconsistencies in taxpayer treatment). Rather than exacerbating these concerns, safe harbors should help to resolve them, especially with some of the refinements proposed in the Discussion Draft, such as (i) making safe harbors elective, (ii) requiring disclosure of taxpayer elections and either fixed-term elections or tax authority review of changed elections, (iii) subjecting unilateral safe harbors to competent authority resolution, and (iv) encouraging the negotiation of bilateral safe harbors in the form of MOUs. Arguably, the Discussion Draft changes the tone in the TPGs only from decidedly (not “somewhat”\(^2\)) negative to “neutral,” when, in fact, the advantages of safe harbors clearly outweigh the disadvantages for taxpayers and tax authorities alike. The final report should emphasize to a greater extent (i) the potential administrative and likely revenue benefits of safe harbors to tax authorities (see discussion below on paragraph 34), and (ii) the very real possibility of developing safe harbor provisions that are compatible with the arm’s length standard.

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1 See BIAC comments in support of the Project, dated June 30, 2011. USCIB materially participated in those comments.

2 The introduction to the Discussion Draft contends that the “current guidance in the TPG has a somewhat negative tone regarding transfer pricing safe harbors.” In our view, this characterization greatly understates the degree of antipathy in the TPGs regarding safe harbors.
Comments on Recommendations on Use of Safe Harbors

USCIB supports the recommendations in paragraphs 33-39 of the Discussion Draft, with two exceptions. First, paragraph 38 provides that safe harbors are not workable for “more complex and higher risk” transfer pricing matters. While that is undoubtedly true for most restructurings, intangible property transfers, and other non-routine intercompany transactions, a large gap remains between these highly complex transactions and cases involving smaller taxpayers and the simplest transactions, which the Discussion Draft deems uniquely suitable for safe harbors. The final report could be more open to more complex safe harbors, especially if agreed to in a bilateral setting. For example, if two countries develop experience in negotiating bilateral APAs on a more complex issue and as a result of that experience resolve cases in an agreed fashion, the two countries should be encouraged to enter an MOU reflecting that experience.

Second, paragraph 34 contends that safe harbors may have “perverse effects” on taxpayer pricing decisions and a “negative impact” on revenues for tax authorities. Neither contention is supported by statistics or other evidence, and both reflect (i) a continuing misunderstanding of taxpayer motives in supporting safe harbors, and (ii) an incorrect assumption that safe harbors are inherently incompatible with the arm’s-length standard. In supporting safe harbors, taxpayers are looking primarily for simplicity and certainty at minimum compliance cost for high-volume, non-unique transactions. For these transactions, most taxpayers are willing to exchange the opportunity for personalized tax planning for reasonable, certain profit benchmarks.

On the revenue issue, safe harbors have the potential of reducing costs and raising revenues in a variety of ways. Perhaps most obviously, safe harbors will allow tax authorities to focus more resources on higher-risk, higher-value transactions. With better case selection and development, tax authorities may actually save costs and increase enforcement revenue. At the same time, safe harbors may improve compliance by small- and medium-sized companies, many of which currently escape audit and/or lack the resources and expertise needed to apply the arm’s-length standard on a case-by-case basis. Finally, bilateral safe harbors, e.g., in the form of MOUs, have a unique ability to diminish double non-taxation, helping to ensure that income is subject to tax in one jurisdiction.

Comments on Sample MOUs

USCIB supports the MOU concept enthusiastically. The process resolves virtually every “concern” identified in the Discussion Draft and has the potential of reducing dramatically the time and resources devoted by taxpayers and tax authorities to monitor compliance with the thousands of routine intercompany transactions that occur every year within the typical large company. In addition, as noted above, the process may allow some tax authorities to apply the knowledge gained over the past 20 years of experience with bilateral APAs and other transfer pricing processes to develop safe harbors for more complex and/or contentious transactions, such as headquarter
allocations and routine at-risk distribution and manufacturing activities that cross industries and/or geographies. Realizing the full potential of the MOU concept is more likely to be stymied by tax authority reluctance to embrace the idea than by perceived limits about the scope of possible covered transactions.

In commenting on the MOUs, we recognize that they are only draft samples and that any executed MOU will likely depart from the terms and conditions proposed in the drafts. Accordingly, we refrain below from “wordsmithing” the documents in favor of focusing on key issues common to all three MOUs. We certainly appreciate the time and effort that went into drafting the samples for the Discussion Draft.

To start, we’d like to highlight a few features in the sample MOUs that we hope would be adopted in any actual MOU:

- That taxpayer results satisfying an MOU benchmark would be accepted as arm’s length by both (or all) counties agreeing to the MOU (para 46).
- That any safe harbor would be tailored to the economics of a particular market and circumstances, and thus be compatible with the arm’s-length standard (para 47).
- That all safe harbors would be elective, rather than mandatory (para 55, 70, 85)
- That the associated enterprise which is party to a Qualifying Transaction would not be deemed to have a permanent establishment in the country of residence of the Qualifying Enterprise by virtue of its relationship with the Qualifying Enterprise or the activities of the associated enterprise that occur in the State of the Qualifying Enterprise consistent with the activities envisaged by the MOU (para 57, 72, 87).
- That satisfaction of the election and reporting requirements contained in a MOU would satisfy the documentation requirements of both (or all) countries agreeing to the MOU (para 60, 75, 90).
- That termination of an MOU would have only prospective effect (para 64, 79, 94).

On the other hand, certain provisions in the sample MOUs deserve “constructive” comment. Most problematic are the criteria set forth in the MOUs to determine eligible taxpayers and transactions. These criteria seem overly restrictive and would effectively disqualify most multinationals from taking advantage of the MOUs as drafted:

- The Discussion Draft provides that safe harbors should apply to “smaller taxpayers or less complex transactions” (para 35). The draft MOUs are limited, however, to Qualifying Enterprises with (i) limited functions (i.e., a
single “predominant” low-risk function), and (ii) income and assets below thresholds to be negotiated in individual MOUs. Paragraph 35 of the Discussion Draft is written in the disjunctive; that is, safe harbors are most appropriate for smaller taxpayers “or” less complex transactions (emphasis added). As drafted, the MOUs conflate the alternative thresholds, requiring both smaller taxpayers and simpler transactions. We see no reason why a larger taxpayer engaged predominantly in a Qualifying Transaction should not be eligible for an otherwise available safe harbor simply because of the taxpayer’s absolute size or the volume of its covered transactions.

The MOUs seem to prevent a single Qualifying Enterprise from entering into contracts covering multiple transactions with multiple associated enterprises. For example, an MNE group sells multiple products in a given jurisdiction. Those products are manufactured by different entities in different jurisdictions, but the group wishes to distribute the products through a single low-risk Qualifying Enterprise in a given jurisdiction. The draft MOU does not seem to cover this because the predominant business activity of the Qualifying Enterprise is required to be the performance of marketing or distribution activities in its State of residence on behalf of an associated enterprise resident in the other Contracting State. Thus, if a low-risk distributor markets products with equal value that are manufactured in three different jurisdictions, then none of those activities would qualify for the safe harbor because none of them would be the predominant business activity. Obviously, relationships with different entities in different jurisdictions would require separate contracts and multiple or multilateral MOUs, but there does not seem to be a reason to exclude this common case if it otherwise qualified for the safe harbor.³

• In the same vein, why limit safe harbors to Qualifying Enterprises with only one “predominant business activity” or that conduct business “exclusively” in one country⁴ (para 52(a) and (b), 67(a) and (b), 82(a) and (b))? Taxpayers often combine functions within individual entities and use single entities to operate across borders through branches and permanent establishments, especially within defined territories (e.g., North America, Asia Pacific, and Europe and the Middle East). Few (if any) taxpayers create separate entities for each function performed in every country. As drafted, the MOUs would require the typical multinational to create a plethora of limited-risk entities for no purpose other than to satisfy the MOU eligibility criteria. As with transfer pricing generally, the proper focus should be on functions, not formal entity

³ Another reason not to exclude this case is that it might encourage the formation of “base companies”, so that there is a single entity that purchases from the manufacturing companies and sells to the distribution companies.

⁴ To be clear, we are not arguing that the foreign activities of the Qualifying Enterprise should be eligible for the safe harbor, only that the activities of the Qualifying Enterprise in the safe harbor country should be eligible if it otherwise satisfies the relevant criteria.
structure. Taxpayers routinely segment business operations by function and would have no problem isolating Qualifying Transactions for purposes of testing eligibility for and compliance with a safe harbor. This expansion would also reduce the risk of taxpayers inadvertently failing to qualify for the safe harbor or the ability of taxpayers to opt out of a prior election by deliberately failing a qualifying test.

- On a related point, the Discussion Draft notes favorably that MOU-based safe harbors are capable of being tailored to fit the economics of a particular market and circumstances (para 47). We wholly agree and would argue further that the eligibility criteria in agreed MOUs should take into account the characteristics of the most appropriate transfer pricing method. For example, if the most reliable set of comparables in a jurisdiction performs both low-risk manufacturing and distribution, then the safe harbor should allow combined testing – a relaxation of the single “predominant activity” test. On the other hand, if it is clear from the comparability analysis that size or volume correlates with profitability, it may be appropriate to include a size or volume limit in a specific MOU (or allow an adjustment in the safe harbor benchmark to account for differences in size and/or volume).

- In addition, the MOUs contain a provision that denies eligibility to a taxpayer that has been the subject of a transfer pricing audit adjustment of an undetermined size within an undetermined period (para 53(e), 68(e), 83(e)). We understand the basic rationale for such a provision, but regard the proposed language as both overbroad and counter-productive. As drafted, the prohibition applies to any transfer pricing adjustment, even if unrelated to the business activity covered by the MOU. It also seems to contemplate a fixed-dollar adjustment threshold, which if it is to have any meaningful effect will disqualify larger taxpayers, for whom any adjustment is likely to exceed the absolute amount.\footnote{The same problem exists in most transfer pricing penalty regimes, with the triggering dollar thresholds set so low that virtually any adjustment triggers a potential penalty for larger taxpayers. See, e.g., I.R.C. §6662(e).} At the same time, it is not clear why a taxpayer that otherwise qualifies for a safe harbor should not be encouraged to adopt the safe harbor and become compliant at least with respect to the covered transaction. Perhaps a better test would state the prohibition in relative terms, be limited to the covered transactions, and/or apply only if penalties had been assessed in an audit.

Apart from the eligibility criteria, certain definitional and interpretive issues require elaboration:

- The application of each MOU depends on a number of critical, but ill-defined terms (e.g., “predominant,” “manufacturing,” and “marketing and distribution”) that if not correctly interpreted could cause significant
difficulties for both taxpayers and tax authorities. This definitional problem is compounded by cliff-like operative tests (e.g., “shall” and “shall not”) that if applied strictly could cause a taxpayer to be deemed after-the-fact not to have been eligible for the safe harbor, to the considerable detriment of the taxpayer. To illustrate, the MOU for marketing and distribution provides that a low-risk distributor “shall not engage in manufacturing or assembly functions” (para 67(e)). If it engages in such activity, it would be ineligible for the safe harbor. From experience, however, we know that characterizing an activity as manufacturing or distribution can be problematic. For example, is packaging and/or labeling part of distribution or manufacturing?

The definitions of covered and prohibited activities need to be extremely clear. If an entity turns out not to have been eligible for a safe harbor, it should have applied the regular transfer pricing rules, including the documentation rules. Because the entity believed that it qualified for the safe harbor, it will not have been required to prepare documentation (see para 60, 75, 90). The absence of documentation could lead to the imposition of significant penalties, in addition to transfer pricing adjustments. Tax authorities can similarly be ill-served by uncertain definitions and uncompromising operative language. For example, if a tax authority requires taxpayers to elect a safe harbor for a minimum number of years, a taxpayer could effectively revoke its election in the middle of the term by intentionally failing a “shall not” prohibition.

Another issue with the “cliff effect” of the qualifications is the administrative difficulty of policing these absolute prohibitions. A multinational group may set up a Qualifying Enterprise with the advice of tax personnel and provide guidance on how the Qualifying Enterprise should operate, but ensuring that the guidance is followed in 100 percent of the cases may prove difficult. An inadvertent violation of one of the “shall not” prohibitions could have devastating consequences for the multinational group.

One response to the above problem on the part of taxpayers may be to limit their use of safe harbors. If a taxpayer has doubts about whether or not it qualifies for a safe harbor, it may choose to resolve those doubts in favor of not qualifying, in which case it would not elect to apply the safe harbor, thus limiting the utility of these rules. Of course, the best way to avoid the problem in the first place is for tax authorities to draft clear guidance in the actual MOUs. Another possible way to deal with these “uncertain” cases would be to institute some form of expedited ruling process, e.g., a streamlined or fast-track APA process.

In closing, we have a few MOU-specific comments:

- The MOUs for low-risk manufacturing and distribution, respectively, recognize that a Qualifying Enterprise may function solely as a service
provider or may engage in buy-sell transactions with related parties (i.e., toll vs. contract manufacturers; commission agents vs. buy-sell distributors). At the same time, a number of the proposed eligibility criteria are based on undetermined “percentage of sales” (para 52(d) and (h) for manufacturers and para 67(d), (f), and (h) for distributors). These criteria reflect buy-sell arrangements and need to be revised to fit toll manufacturers and non-buy-sell distributors.

- The MOU for R&D services prohibits a Qualifying Enterprise from “utilis[ing] proprietary patents, know how, trade secrets, or other intangibles in performing [R&D] services other than those made available to it by the associated enterprise” (para 82(e)). In light of the recent OECD discussion draft on intangibles,⁶ it seems unlikely that any on-going research center would not have some intangibles, including know how, goodwill, going concern, and possibly workforce in place (which may or may not be an intangible⁷). The rule effectively disqualifies any research center that previously performed any at-risk R&D from electing the safe harbor, and it seems inconsistent with the other sample MOUs, which permit a certain level of R&D for low-risk manufacturers and distributors. It also ignores the fact that virtually every R&D services comparable will likely develop, invest in, and otherwise utilize some limited amount of proprietary intangible property in performing its services. Some de minimis amount of intangibles ownership should be allowed, subject to the comments above about vague definitions and the unduly harsh effects of “shall not” language.

- Paragraph 82(g) provides that the research should be designed, directed, and controlled by the associated enterprise. Is this intended to be consistent with paragraph 9.26 of the existing Transfer Pricing Guidelines?

Conclusion

The Discussion Draft and accompanying sample MOUs represent a significant step forward in (i) providing taxpayers with simplicity and certainty in transfer pricing compliance and (ii) freeing up tax authorities to focus on the largest, most complex, and highest value cases. If embraced by tax authorities, the MOU concept has the potential to rival the APA process and mandatory arbitration in improving the efficiency and effectiveness of transfer pricing enforcement. If anything, the Discussion Draft, perhaps because of lingering tax authority suspicion about the “tails I win, heads you lose” historical view about safe harbors (especially elective safe harbors), remains unnecessarily cautious about the application and scope of safe harbors. In finalizing the Discussion Draft, USCIB members would encourage the OECD to focus on the common ground that exists between taxpayers and tax authorities in identifying more practical and

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⁷ Id. at para24, 25.
administrable transfer pricing policies and practices. To that end, safe harbors are a critical component of the broader goal to simplify transfer pricing administration for the benefit of both taxpayers and tax authorities.

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Thank you again for the opportunity to comment on this important topic. We would welcome further consultation on the Discussion Draft specifically and the Project generally and would be pleased to respond to any comments or questions that you may have on this submission.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business
Dear Mr. Andrus,

We have read the discussion draft - proposed revision of the section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines and the draft sample memoranda of understanding for competent authorities to establish bilateral safe harbours (hereinafter referred to as: “Draft”) – and welcome the opportunity to provide our comments.

VNO-NCW would like to emphasize that it fully supports all efforts leading to transfer pricing simplification measures. Further clarification and alignment on the use of Safe harbours is one of them. We have some concerns on the following topics mentioned in this Draft.

- The choice of transfer pricing method: when setting safe harbour targets it is recommended that tax authorities acknowledge that transfer pricing methods applied by tax payers may differ. Any safe harbours set therefore should acknowledge the existence of various transfer pricing methods to come to a certain result. The application of a safe harbour rule therefore should aim to test the result and should not prescribe the use of a specific transfer pricing method for the price setting.

- Margins differ amongst industries: the Draft ignores / does not address that there are various types of industries which all have their specific profitability levels. We recommend acknowledging that arm’s length
safe harbour margins need to take into account the differences between various industries.

- Safe harbours reflecting functionality: Multinational Enterprises should have the flexibility to decide how to best operate their business. Where there are well known standard operating models, we recommend to acknowledge the existence of these when setting safe harbours. A simple example would be the widely used standard operating models of contract manufacturing and toll manufacturing: when safe harbours are being set in this area, it would be good to have them for both operating models. Otherwise, the safe harbours for one might have to be translated into safe harbours for the other - which would negate the simplification effect which was the intention of the safe harbour in the first place.

- The use of safe harbours only results in a simplification / decrease of the administrative burden if all countries embrace the implementation of safe harbours in local law in a consistent and aligned way. Otherwise the use of safe harbours will most likely result in more double taxation issues rather than less. Without an OECD wide implementation we recommend to use the clarifications on this topic as a guide to bilateral or multilateral Advanced Pricing Agreements.

Yours sincerely,

J.M. Lammers
Subject: Draft of a proposed revision of the section on safe harbours in chapter IV of the OECD transfer pricing guidelines

Dear Mr. Andrus,

WTS is pleased to provide you with comments regarding the OECD draft of a proposed revision of the section on safe harbours in chapter IV of the OECD transfer pricing guidelines.

Overall it is a positive development that the OECD adapts its guidelines to the practice of several of its member countries. In some of the OECD member countries safe harbours are already a vital part of the transfer pricing practice and the OECD transfer pricing guidelines should reflect that development. We embrace the draft of the OECD as it steers in the right direction. Nevertheless there are some issues within the draft that we want to comment on.

- Definitions

Our experience in Germany shows that such safe harbours do only work with clear definitions, a list of the transactions covered, and a fixed threshold. Without these conditions, safe harbours could even be used against tax payers. Therefore it is necessary to clearly define small taxpayers and less complex transactions. WTS asks the OECD to list less complex transactions for which safe harbours should be available. Such a list of less complex transactions could include amongst others low value contract manufacturing/processing activities, low value sales activities of sales agents/limited risk distributors, and low value contract R&D activities, or HQ services.

Furthermore a fixed threshold would be necessary for the characterization of small taxpayers. To prevent incentives for the TP policy of the enterprises this threshold should be made contingent to a figure relatively independent of the transfer pricing policy of the tax payer (e.g. number of the employees, total assets). Without this
information the OECD transfer pricing guidelines could remain ineffective considering safe harbours.

In this context WTS wants to note that it is also necessary to specify the bandwidths within the exhibits of the draft for the same reason.

- **Potential changes on tax revenue**

In several chapters of the draft the OECD fears that the tax payer will only pay tax on the lesser side of the safe harbor amount or the arm’s length amount. WTS states that this risk can be minimized through clear definitions concerning eligible transactions and enterprises. When using safe harbours for less complex transactions there should only be a marginal difference if any between the safe harbour amount and the arm’s length amount. Besides with such definitions the risk of abuse should not be higher than regarding other regulatory framework. Therefore WTS does not expect the problem of significant tax revenue losses if the safe harbours are implemented the right way. Also the risk of “safe harbour shopping” explained in paragraph 30 could get minimized in this manner.

- **Recognition by tax administrations and risk of double taxation**

Within the discussion draft the OECD explains in paragraph 21 that there could be a risk of double taxation arising from unilateral safe harbours as the safe harbour amount could be a higher than the arm’s length amount. Therefore the taxable income in the country without the safe harbour could be lower than the arm’s length amount which could lead to double taxation. Even if the risk of differences between the safer harbour amount and the arm’s length amount can be minimized by means of well-defined safe harbours (as described above) the risk of double taxation is severe. Therefore WTS asks the OECD to instruct its member countries through the transfer pricing guidelines to accept safe harbour amounts that fulfill certain OECD standards, and to provide clear standards concerning safe harbours.

- **Safe harbours considering administrative simplification measures**

It appears that the draft does not include safe harbour rules regarding administrative simplification measures. For many small taxpayers or companies with less complex transactions it would be a huge relief to have guidelines concerning such safe harbours as well. Documentation requirements in many countries are extensive and in many cases penalties can be imposed for not having a proper transfer pricing documentation. Therefore safe harbours considering administrative simplification measures should be a part of this draft.

WTS would appreciate any administrative simplification measures. When setting administrative simplification measures the following points should be recognized:

- The administrative simplification measures should be set sufficiently high to be efficient.
• The administrative simplification measures should be contingent on the amount of total transactions of a single entity. This prevents incentives to “switch” volumes between transactions. The benefit of the simplification measure should then incur at the single entity level only.

• The administrative simplification measures should be set on (average) multiple period data in order to allow entities to benefit from the administrative simplification measures, even when there are deviations in single periods.

To prevent incentives on the TP policy of the enterprises administrative simplification measures should be made contingent to a figure relatively independent of the transfer pricing policy of the tax payer (e.g. number of employees, total assets).

In case of further questions please do not hesitate to contact us.

Kind regards,

WTS Steuerberatungsgesellschaft mbH

Dr. Arwed Crüger                  Andreas Riedl
Partner                          Consultant Transfer Pricing
Head of Transfer Pricing