## CALL FOR INPUT ON TRANSFER PRICING ISSUES RELATED TO THE DESIGN OF THE SAFE-HARBOUR PROVISIONS AND OTHER COMPARABILITY CONSIDERATIONS

### BACKGROUND

1. The OECD and RFB jointly launched the "Transfer Pricing in Brazil" project in February 2018 to review and analyse the differences in the Brazilian transfer pricing rules as compared to the OECD standard. On 18 December 2019, the findings of the project were presented to the public with the publication of the Joint Report, *Transfer Pricing in Brazil: Towards Convergence with the OECD Standard*.[1] The Joint Report identifies two options for Brazil to converge with the OECD standard, while enhancing the positive attributes of its existing transfer pricing framework. Both options contemplate full adherence to the arm's length principle, which is at the core of the OECD standard, while seeking to preserve simplicity and certainty. In this regard, consideration will be given to incorporating targeted, carefully designed safe harbours in appropriate circumstances. Safe harbours, which constitute simplified approaches for determining or approximating the arm's length price or providing simplified guidance on compliance with otherwise complex and burdensome processes, can achieve important benefits in terms of simplicity and certainty, if properly designed (in line with the arm's length principle) and applied in appropriate circumstances (under specified eligibility criteria). They also reduce tax compliance costs for taxpayers and contribute to more efficient tax administration and tax certainty. Other measures and practices can also contribute to tax certainty in situations where safe harbours may not be an appropriate tool. Such measures and practices may include advance pricing arrangements (APAs), which also may provide a framework for achieving tax certainty in more complex and higher risk transactions.

2. The consideration of developing safe-harbour regimes strives to achieve the policy objectives of tax certainty and simplicity of compliance and administration that were originally intended with the adoption of the fixed margins approach in Brazil. The fixed margins approach, which is unilaterally applied by Brazil, was designed in a different economic reality, but is no longer sufficient to cope with the dynamic nature of economic activity, leading to losses of revenue through base erosion and profit-shifting practices that exploit these fixed margins, and also lead to double taxation. The development of safe harbours in line with the arm's length principle, designed according to the framework provided in the OECD Transfer Pricing Guidelines, that take into account the specificities of Brazil, could thus help to achieve the original policy intent without generating the same adverse consequences in terms of BEPS risks and double taxation.

3. To inform the work related to the development of safe harbours as well as other simplification measures and measures that can contribute to enhanced tax certainty, it is important to receive input from taxpayers and from other interested stakeholders. This input will help to understand the specific situations and needs of taxpayers, where issues may arise

[1] A brochure containing the key information of the report is also available in both English and Portuguese.

when performing comparability analysis and also where the design of safe harbours or other similar measures contributing towards tax certainty would be especially needed. This document therefore contains an open invitation to taxpayers and other interested stakeholders to contribute to the ongoing OECD/RFB project by providing their specific experience or comments on elements relevant to the development of safe-harbour regimes and other measures contributing to tax certainty in Brazil. To structure the input, a survey was designed, preceded by an introductory note providing the background and context of the questions.

4. Please note that this survey is strictly confidential; no individual or organisation-specific information will be disclosed. Results may only be made available in aggregated format. Comments may be submitted in both Portuguese and English.

5. Input can be provided by individual taxpayers, or on a more collective basis by industry bodies or by professional advisory firms. If you would like further information or would like to discuss the substantive issues please do not hesitate to contact TP.Brazil@oecd.org and Cotin.df.cosit@rfb.gov.br.

Please send your reply by email to the following address **by Friday 18 September 2020**:

E-mail: TP.Brazil@oecd.org and copied to Cotin.df.cosit@rfb.gov.br.

## INTRODUCTORY NOTE

6. Transfer pricing rules based on the arm's length principle require performing a comparability analysis, which involves identification of reliable data on comparable uncontrolled transactions (comparables). The typical process for identifying the commercial or financial relations between associated enterprises, and for identifying the conditions and economically relevant circumstances in connection to such relations, require a broad-based understanding of the industry sector in which the MNE operates as well as the factors affecting the performance of the business in that sector. More precisely, the economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between associated enterprises in order to accurately delineate the actual transaction can be broadly categorised as follows: (i) the contractual terms of the transaction; (ii) the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices; (iii) the characteristics of property transferred or services provided; (iv) the economic circumstances of the parties and of the market in which the parties operate; and (v) the business strategies pursued by the parties.

7. When taxpayers have to carry out the comparability analysis, they may encounter various challenges that may give rise to uncertainty and potential disputes with the tax administration(s) of one or more jurisdictions. These challenges may be further amplified in cases where there is an absence of internal comparables data and also a lack of external publicly available uncontrolled comparables data.

8. To address and overcome some of these challenges, various measures are foreseen in the OECD Transfer Pricing Guidelines,[2] which, if properly designed, may contribute to tax certainty, without jeopardising the achievement of the dual objective of transfer pricing rules, which is to secure the appropriate tax base in each jurisdiction and to avoid double taxation

[2] OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris, https://doi.org/10.1787/tpg-2017-en.

for cross-border transactions. Such measures may include safe-harbour regimes, rebuttable presumptions, and APAs.

9. A safe harbour in a transfer pricing regime is 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. The objective of safe harbours is to make available simplified approaches for determining or approximating the arm's length price or to provide simplified guidance on compliance with otherwise complex and burdensome processes, and thus contribute to reduced tax compliance costs for taxpayers, but also to more efficient tax administration and tax certainty. A safe harbour is generally an elective mechanism, meaning that taxpayers who meet the entry criteria are able to decide between application of the general transfer pricing rules or opting into the safe-harbour regime, in which case they would be exempted from the application of the general transfer pricing rules with respect to the activities covered by the safe-harbour regime.[3]

10. The OECD Guidelines recognise the benefits of well-designed safe harbours in Section E of Chapter IV,[4] as reproduced in the annex to this document. This guidance takes into account both the positive experience with safe-harbour regimes as well as the challenges experienced by various countries and provides the policy framework on which such measures should be designed. Such measures should be adopted only under appropriate circumstances, taking into account the concerns they may raise, with the objective of relieving some compliance burdens and to provide greater certainty for cases involving smaller taxpayers or less complex transactions. According to the OECD Guidelines, the "*appropriateness of safe harbours can be expected to be most apparent when they are directed at taxpayers and/or transactions which involve low transfer pricing risks and when they are adopted on a bilateral or multilateral basis*".[5]

11. The recommendations in favour of adopting safe harbours contained in the OECD Guidelines reflect the fact that a number of countries have adopted safe harbours and achieved positive results in doing so. This is why 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*".[6]

12. However, since the safe-harbour mechanism substitutes simpler obligations for those under the general transfer pricing regime, the availability of safe harbours for a given category of taxpayers or transactions may have adverse consequences if they are not properly designed. In this respect, the OECD Guidelines explain that the "*design of safe harbours requires careful attention to concerns about the degree of approximation to arm's length prices that would be permitted in determining transfer prices under safe harbour rules for eligible taxpayers, the potential for creating inappropriate tax planning opportunities including double non-taxation of income, equitable treatment of similarly situated taxpayers, and the potential for double taxation resulting from the possible incompatibility of the safe harbours with the arm's length principle or with the practices of other countries*".[7] Each of these four design

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[3] See paragraph 4.101 of the OECD Guidelines.
[4] It was approved by the Committee on Fiscal Affairs on 26 April 2013 and by the OECD Council on 16 May 2013. The Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C(95)126/FINAL] was amended on 16 May 2013 to take account of the revision of the report on safe harbours (available at: https://www.oecd.org/tax/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf), which replaced Section E on safe harbours in Chapter IV of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.
[5] See paragraph 4.98 of the OECD Guidelines.
[6] See paragraph 4.97 of the OECD Guidelines.
[7] See paragraph 4.99 of the OECD Guidelines.

considerations is further explained in the guidance (see annex), and also demonstrated in the following example.

13. Assume for instance that a country has adopted a safe-harbour regime to deal with a common type of related party transaction for which there is a lack of data on comparable uncontrolled transactions. Most of these transactions are carried out between entities that are part of MNE groups. The following steps have been carried out in the process of designing the safe harbour:

1) Careful analysis of the functional profile of the entities that carry out this type of transaction was conducted, which involve the analysis of the functions performed by these entities, the assets they use, and the risks they assume in carrying out those functions. The analysis has shown that approximately 80% of the taxpayers active in this sector present broadly the same type of functional profile – and were identified as Category A – while 20% of the taxpayers had a significantly different functional and risk profile. Among these remaining taxpayers, approximately half (10%) – identified as Category B – carried out significantly more simple functions, yet these functions were still significantly different from one to the other. The other half (10%) – identified as Category C – carried out significantly more complex functions and in doing so also used unique and valuable assets, and assumed additional economically significant risks. Based on this analysis, the eligibility criteria for the safe harbour were established, with the objectives of ensuring that only the taxpayers falling in Category A would be eligible to use this regime and of ensuring outcomes in line with the arm's length principle. Had the taxpayers in Category B been allowed to apply this regime, a potential risk of over-taxation would have arisen, and the risk of potential double taxation as a consequence. In contrast, there would be a risk of revenue losses if the taxpayers in Category C had been allowed to use this regime.

2) All the key elements of the comparability analysis for the taxpayers in Category A were examined to ensure that the outcomes of the safe-harbour regime would be in line with the arm's length principle and this led to the design of the remaining features of the safe-harbour regime. As a result, the specific method applicable under this regime has been determined as well as the approach to its application, the appropriate profit level indicator, and the profit margin, with a view to approximating the arm's-length outcomes for the taxpayers applying this regime in the most reliable way.

3) In the process of determining the appropriate method and the profit level indicator along with the applicable profit margin, the limited available data on comparable uncontrolled transactions was analysed. To ensure the reliability of this data, additional analysis was made of the data available to the tax administration based on the tax returns submitted by taxpayers engaged in uncontrolled transactions. In addition, the data available on comparable uncontrolled transactions carried out by taxpayers in other jurisdictions was analysed, taking into account the specificities of those other jurisdictions. Finally, consultations on the intended outcomes of the safe-harbour regime were carried out with the tax administrations of key trading partner jurisdictions potentially affected by the outcomes of this regime to ensure that any potential adverse outcomes are identified early and reflected in the design of the safe harbour.

14. As noted above, the objective of the safe-harbour regime is to provide for a standardised approach to determine or approximate the arm's length outcome for groups of taxpayers, or to provide simplified guidance on compliance with otherwise complex and burdensome processes, where it is reasonable to standardise these outcomes. Given the efforts necessary to design a safe harbour, it may not be the most effective instrument for taxpayers who are in significantly different situations from one another or whose circumstances are so unique and complex that it would not make the design of a standardised

approach feasible. As stated in the OECD Guidelines, "*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*".[8] For such cases, a complete transfer pricing analysis examining all the relevant aspects and specificities of the transaction tends to produce more appropriate results. This is mainly due to the fact that the unique and complex features of the transactions as well as important differences between such complex transactions do not make it possible to develop a reliable and standardised approach that could be equally relevant and applicable to other taxpayers.

15. For such unique or complex and higher-risk transactions, the OECD framework offers other mechanisms that are also capable of providing certainty and predictability for both taxpayers and tax administrations, and of reducing the risk of disputes – for example, APAs.

16. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. Similar policy objectives as those pursued by safe harbours could be achieved for those more complex and higher-risk transfer pricing matters through APAs, as in such cases there will rarely be two or more transactions that are sufficiently similar to justify the administrative efforts of designing a safe harbour regime. Instead, a framework for APAs can be designed to facilitate the smooth conclusion of APAs for a given sector/industry or specific types of more complex transactions. The framework for APAs can be used to cover more complex and higher-risk situations as the APA provides an opportunity for the refinement of the specific conditions relevant to different taxpayers to take into account the specific conditions, circumstances as well as other comparability factors, which would make it otherwise inappropriate to design and apply a safe-harbour regime.

17. One of the merits of a well-designed safe harbour is that for eligible taxpayers it can reduce the need to find uncontrolled comparables data and to perform a benchmarking study in every case. Safe harbours thus also prove useful in situations where comparables data is scarce by eliminating the difficulties arising from the absence of comparables data, especially as they can be designed by relying on information available to the tax administration in internal databases, which may not be available in the public domain.[9]

18. It may be the case that uncontrolled transactions from markets other than that of the tested party[10] can constitute reliable comparables, or may be accepted and used as the best available comparables in the absence of local market comparables. Where local comparables are not available, selection criteria often emphasise geographic proximity in the selection of foreign comparables. However, in some cases, it may be more relevant to consider selection criteria which focus on similarity of economic conditions between the foreign and local markets (either in general, or as it relates to the particular industry sector) rather than proximity. This alternative could however require comparability adjustments to be performed in order to account for the differences between the characteristics (including geographic) of the countries/regions concerned, including location savings and other local market features.

19. In light of the considerations above, the objective of this questionnaire is to identify the types of transactions for which there is potentially a need for safe harbours and invite taxpayers and other interested stakeholders to provide input regarding those needs, as well

[8] See paragraph 4.132 of the OECD Guidelines.
[9] See paragraph 3.36 of the OECD Guidelines. See also Section 4.1.1 of the PCT Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses.
[10] See paragraphs 3.18-3.19 of the OECD Guidelines for further information on the choice of the tested party.

as to provide further input that may be relevant for the design of safe harbours or APA frameworks for specific sectors and circumstances.

## SURVEY

The following survey seeks views on the circumstances in which future safe-harbour regimes and/or sector-specific APA frameworks should be developed in Brazil and to give stakeholders the opportunity to report specific needs based on experience in dealing with specific issues.

Contact for follow-up:

Name:

Affiliation:

E-mail address:

Telephone:

Please indicate whether you are responding to this survey:

☐As an individual

☐As a corporate taxpayer

☐ Other (e.g. advisory firm. law firm, business association, academic institution, NGOs, etc.)

If you are replying on behalf of others please specify what organisation or group of taxpayers you are representing.

**Identifying the needs for specific safe-harbour regimes**

1. Do you think the effort to design specific safe harbours is necessary and would it also be relevant for your business?

☐ Yes.

☐ No.

If yes, please provide a description of the types of transactions that you would find necessary to be covered by specific safe harbours and provide the reasons justifying the need for a safe harbour. When describing each category of specific transactions for which a safe-harbour regime should be developed, please describe the functional/risk profile of the entity that would benefit from the safe-harbour provision as well as the other comparability factors, which may be relevant for the purposes of safe-harbour design (contractual terms of the transactions; characteristics of property transferred or services provided; economic circumstances of the parties and of the market in which the parties operate; business strategies).

Would the relevant safe harbours apply to transactions that are covered by transfer pricing rules in other countries?

☐ Yes.

☐ No.

If yes, can you please provide the jurisdictions of the relevant counterparties (this information will help to prioritise potential bilateral dialogue to ensure acceptance of the safe-harbour regimes by the given jurisdictions).

If, yes, are you aware of how the arm's-length price is determined in the other country(ies)? If possible, provide details regarding the approach used by the counterparty of the transaction.

2. Designing safe harbours requires significant efforts, so it may be more appropriate and reasonable for a safe harbour to be designed to address situations where there are numerous taxpayers in the same circumstances. The specific parameters of a safe harbour would then apply to a larger number of taxpayers to justify the administrative efforts and make it relevant to more than a few transactions or MNEs (which could otherwise potentially be covered by APAs or APA frameworks). Are there other taxpayers that share the commonalities described in your transactions?

☐ Yes.

☐ No.

If yes, can you please identify any other taxpayers who are likely to benefit from the same type of safe harbour?

3. In each of the specific cases where you propose the development of a safe harbour, what transfer pricing method should be the most appropriate method in the given case? Please provide also details on the use of such method – e.g. profit level indicators (PLI) that you would suggest and based on what information.

4. Could you provide an economic analysis for your specific case to justify the approach proposed?

5. For which steps of the transfer pricing analysis do you consider that a safe harbour will be able to provide relief in your compliance efforts (e.g. safe harbour on the process – such as choice of the most appropriate method or safe harbours containing guidance on selecting comparables, or also providing guidance on appropriate application of the specific method and comparables)?

6. Would the safe harbours you propose correspond to the transfer pricing policies applied by your group members on the other side of the specific transaction?

7. For the transactions that would be covered by the safe harbours, are there situations for which you foresee a lack of comparables data? Please specify the reason, e.g. absence of internal comparables, lack of publicly available data or external comparables data, etc.

**Use of available comparables data**

8. If there are comparables data that you may use in your case, can you please provide details on what are the relevant local comparables data available in your specific case?

9. Do you have any concerns around the reliability of such data? If yes, could you explain why?

10. In the absence of local comparables data, does the application of comparability adjustments to foreign comparables data represent a challenge in your view? Would you welcome guidance on carrying out such comparability adjustments?

11. Which countries/regions are potential sources of relevant foreign comparables data in your specific case?

12. Do you consider that specific types of adjustments reflecting the difference between the relevant jurisdictions should be considered in that case – e.g. will location specific adjustments be necessary to reflect potential geographical differences in Brazil? If yes, could you specify which adjustments.

**Considerations for the use of sector-specific APAs**

13. Do you see a need for sector-specific APAs?

14. If you see a need for such a sector-specific APA framework, could you please provide the relevant details that would be helpful for the development of such an APA framework (e.g. industry sector, nature of transaction, details on comparability factors, selection and application of the most appropriate method, etc.)?

15. What would be the similarities and differences in your specific transactions compared to other enterprises operating in the same sector?

16. What should be the key set parameters of the APA framework that you propose and what should be the elements that should remain flexible to be determined in each specific case?

**Other measures**

17. Do you see a need for other simplification measures to enhance tax certainty? If yes, could you specify which measures.

# ANNEX. OECD GUIDANCE ON SAFE HARBOURS IN CHAPTER IV OF THE OECD TRANSFER PRICING GUIDELINES

## E. Safe harbours

### E.1. Introduction

4.95 Applying the arm's length principle can be a resource-intensive process. It may impose a heavy administrative burden on taxpayers and tax administrations that can be exacerbated by both complex rules and resulting compliance demands. These facts have led OECD member countries to consider whether and when safe harbour rules would be appropriate in the transfer pricing area.

4.96 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 on the tax revenues of the country implementing the safe harbour, as well as on the tax revenues of countries whose associated enterprises engage in controlled transactions with taxpayers electing a safe harbour. It was further suggested that safe harbours may not be compatible with the arm's length principle. Therefore, it was concluded that transfer pricing safe harbours are not generally advisable, and consequently the use of safe harbours was not recommended.

4.97 Despite these generally negative conclusions, a number of countries have adopted safe harbour rules. Those rules have generally been applied to smaller taxpayers and/or less complex transactions. 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.

4.98 The appropriateness of safe harbours can be expected to be most apparent when they are directed at taxpayers and/or transactions which involve low transfer pricing risks and when they are adopted on a bilateral or multilateral basis. It should be recognised that a safe harbour provision does not bind or limit in any way any tax administration other than the tax administration that has expressly adopted the safe harbour.

4.99 Although safe harbours primarily benefit taxpayers, by providing for a more optimal use of resources, they can benefit tax administrations as well. Tax administrations can shift audit and examination resources from smaller taxpayers and less complex transactions (which may typically be resolved in practice on a consistent basis as to both transfer pricing methodology and actual results) to more complex, higher-risk cases. At the same time, taxpayers can price eligible transactions and file their tax returns with more certainty and with lower compliance burdens. However, the design of safe harbours requires careful attention to concerns about the degree of approximation to arm's length prices that would be permitted in determining transfer prices under safe harbour rules for eligible taxpayers, the potential for creating inappropriate tax planning opportunities including double non-taxation of income, equitable treatment of similarly situated taxpayers, and the potential for double taxation resulting from the possible incompatibility of the safe harbours with the arm's length principle or with the practices of other countries.

4.100 The following discussion considers the benefits of, and concerns regarding, safe harbour provisions and provides guidance regarding the circumstances in which safe harbours may be applied in a transfer pricing system based on the arm's length principle.

## E.2. Definition and concept of safe harbours

4.101 Some of the difficulties that arise in applying the arm's length principle may be avoided by providing circumstances in which eligible taxpayers may elect to follow a simple set of prescribed transfer pricing rules in connection with clearly and carefully defined transactions, or may be exempted from the application of the general transfer pricing rules. In the former case, prices established under such rules would be automatically accepted by the tax administrations that have expressly adopted such rules. These elective provisions are often referred to as "safe harbours".

4.102 A safe harbour in a transfer pricing regime is 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, for example, 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. Often, eligible taxpayers complying with the safe harbour provision will be relieved from burdensome compliance obligations, including some or all associated transfer pricing documentation requirements.

4.103 For purposes of the discussion in this Section, safe harbours do not include administrative simplification measures which do not directly involve determination of arm's length prices, e.g. simplified, or exemption from, documentation requirements (in the absence of a pricing determination), and procedures whereby a tax administration and a taxpayer agree on transfer pricing in advance of the controlled transactions (advance pricing arrangements), which are discussed in Section F of this chapter. The discussion in this section also does not extend to tax provisions designed to prevent "excessive" debt in a foreign subsidiary ("thin capitalisation" rules).

4.104 Although they would not fully meet the foregoing description of a safe harbour, it may be the case that some countries adopt other administrative simplification measures that use presumptions to realise some of the benefits discussed in this Section. For example, a rebuttable presumption might be established under which a mandatory pricing target would be established by a tax authority, subject to a taxpayer's right to demonstrate that its transfer price is consistent with the arm's length principle. Under such a system, it would be essential that the taxpayer does not bear a higher burden to demonstrate its price is consistent with the arm's length principle than it would if no such system were in place. In any such system, it would be essential to permit resolution of cases of double taxation arising from application of the mandatory presumption through the mutual agreement process.

## E.3. Benefits of safe harbours

4.105 The basic benefits of safe harbours are as follows:

1. Simplifying compliance and reducing compliance costs for eligible taxpayers in determining and documenting appropriate conditions for qualifying controlled transactions;

2. Providing certainty to eligible taxpayers that the price charged or paid on qualifying controlled transactions will be accepted by the tax administrations that have adopted the safe harbour with a limited audit or without an audit beyond ensuring the taxpayer has met the eligibility conditions of, and complied with, the safe harbour provisions;

3. Permitting tax administrations to redirect their administrative resources from the examination of lower risk transactions to examinations of more complex or higher risk transactions and taxpayers.

### *E.3.1. Compliance relief*

4.106 Application of the arm's length principle may require collection and analysis of data that may be difficult or costly to obtain and/or evaluate. In certain cases, such compliance burdens may be disproportionate to the size of the taxpayer, its functions performed, and the transfer pricing risks inherent in its controlled transactions.

4.107 Properly designed safe harbours may significantly ease compliance burdens by eliminating data collection and associated documentation requirements in exchange for the taxpayer pricing qualifying transactions within the parameters set by the safe harbour. Especially in areas where transfer pricing risks are small, and the burden of compliance and documentation is disproportionate to the transfer pricing exposure, such a trade-off may be mutually advantageous to taxpayers and tax administrations. Under a safe harbour, taxpayers would be able to establish transfer prices which will not be challenged by tax administrations providing the safe harbour without being obligated to search for comparable transactions or expend resources to demonstrate transfer pricing compliance to such tax administrations.

### *E.3.2. Certainty*

4.108 Another advantage provided by a safe harbour is the certainty that the taxpayer's transfer prices will be accepted by the tax administration providing the safe harbour, provided they have met the eligibility conditions of, and complied with, the safe harbour provisions. The tax administration would accept, with limited or no scrutiny, transfer prices within the safe harbour parameters. Taxpayers could be provided with relevant parameters which would provide a transfer price deemed appropriate by the tax administration for the qualifying transaction.

### *E.3.3. Administrative simplicity*

4.109 A safe harbour would result in a degree of administrative simplicity for the tax administration. Although the eligibility of particular taxpayers or transactions for the safe harbour would need to be carefully evaluated, depending on the specific safe harbour provision, such evaluations would not necessarily have to be performed by auditors with transfer pricing expertise. Once eligibility for the safe harbour has been established, qualifying taxpayers would require minimal examination with respect to the transfer prices of controlled transactions qualifying for the safe harbour. This would enable tax administrations to secure tax revenues in low risk situations with a limited commitment of administrative resources and to concentrate their efforts on the examination of more complex or higher risk transactions and taxpayers. A safe harbour may also increase the level of compliance among small taxpayers that may otherwise believe their transfer pricing practices will escape scrutiny.

## E.4. Concerns over safe harbours

4.110 The availability of safe harbours for a given category of taxpayers or transactions may have adverse consequences. These concerns stem from the fact that:

1. The implementation of a safe harbour in a given country may lead to taxable income being reported that is not in accordance with the arm's length principle;

2. Safe harbours may increase the risk of double taxation or double non-taxation when adopted unilaterally;

3. Safe harbours potentially open avenues for inappropriate tax planning, and

4. Safe harbours may raise issues of equity and uniformity.

### *E.4.1. Divergence from the arm's length principle*

4.111 Where a safe harbour provides a simplified transfer pricing approach, it 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. For example, a safe harbour might require the use of a particular method when the taxpayer could otherwise have determined that another method was the most appropriate method under the facts and circumstances. Such an occurrence could be considered as inconsistent with the arm's length principle, which requires the use of the most appropriate method.

4.112 Safe harbours involve a trade-off between strict compliance with the arm's length principle and administrability. They are not tailored to fit exactly the varying facts and circumstances of individual taxpayers and transactions. The degree of approximation of prices determined under the safe harbour with prices determined in accordance with the arm's length principle could be improved by collecting, collating, and frequently updating a pool of information regarding prices and pricing developments in respect of the relevant types of transactions between uncontrolled parties of the relevant nature. However, 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.

4.113 Any potential disadvantages to taxpayers from safe harbours diverging from arm's length pricing are avoided when taxpayers have the option to either elect the safe harbour or price transactions in accordance with the arm's length principle. With such an approach, taxpayers that believe the safe harbour would require them to report an amount of income exceeding the arm's length amount could apply the general transfer pricing rules. While such an approach can limit the divergence from arm's length pricing under a safe harbour regime, it would also limit the administrative benefits of the safe harbour to the tax administration. Moreover, tax administrations would need to consider the potential loss of tax revenue from such an approach where taxpayers will pay tax only on the lesser of the safe harbour amount or the arm's length amount. Countries may also be concerned over the ability of taxpayers to opt in and out of a safe harbour, depending on whether the use of the safe harbour is favourable to the taxpayer in a particular year. Countries may be able to gain greater comfort regarding this risk by controlling the conditions under which a taxpayer can be eligible for the safe harbour, for example by requiring taxpayers to notify the tax authority in advance of using the safe harbour or to commit to its use for a certain number of years.

### *E.4.2. Risk of double taxation, double non-taxation, and mutual agreement concerns*

4.114 One major concern raised by a safe harbour is that it may increase the risk of double taxation. If a tax administration sets safe harbour parameters at levels either above or below arm's length prices in order to increase reported profits in its country, it may induce taxpayers to modify the prices that they would otherwise have charged or paid to controlled parties, in order to avoid transfer pricing scrutiny in the safe harbour country. The concern of possible overstatement of taxable income in the country providing the safe harbour is greater where that country imposes significant penalties for understatement of tax or failure to meet documentation requirements, with the result that there may be added incentives to ensure that the transfer pricing is accepted in that country without further review.

4.115 If the safe harbour causes taxpayers to report income above arm's length levels, it would work to the benefit of the tax administration providing the safe harbour, as more taxable income would be reported by such domestic taxpayers. On the other hand, the safe harbour may lead to less taxable income being reported in the tax jurisdiction of the foreign associated enterprise that is the other party to the transaction. The other tax administrations may then challenge prices derived from the application of a safe harbour, with the result that the taxpayer would face the prospect of double taxation. Accordingly, any administrative benefits gained by the tax administration of the safe harbour country would potentially be obtained at the expense of other countries which, in order to protect their own tax base, would have to determine systematically whether the prices or results permitted under the safe harbour are consistent with what would be obtained by the application of their own transfer pricing rules. The administrative burden saved by the country offering the safe harbour would therefore be shifted to the foreign jurisdictions.

4.116 In cases involving smaller taxpayers or less complex transactions, the benefits of safe harbours may outweigh the problems raised by such provisions. Provided the safe harbour is elective, taxpayers may consider that a moderate level of double taxation, if any arises because of the safe harbour, is an acceptable price to be paid in order to obtain relief from the necessity of complying with complex transfer pricing rules. One may argue that the taxpayer is capable of making its own decision in electing the safe harbour as to whether the possibility of double taxation is acceptable or not.

4.117 Where safe harbours are adopted unilaterally, care should be taken in setting safe harbour parameters to avoid double taxation, and the country adopting the safe harbour should generally be prepared to consider modification of the safe-harbour outcome in individual cases under mutual agreement procedures to mitigate the risk of double taxation. At a minimum, in order to ensure that taxpayers make decisions on a fully informed basis, the country offering the safe harbour would need to make it explicit in advance whether or not it would attempt to alleviate any eventual double taxation resulting from the use of the safe harbour. Obviously, if a safe harbour is not elective and if the country in question refuses to consider double tax relief, the risk of double taxation arising from the safe harbour would be unacceptably high and inconsistent with double tax relief provisions of treaties.

4.118 On the other hand, if a unilateral safe harbour permits taxpayers to report income below arm's length levels in the country providing the safe harbour, taxpayers would have an incentive to elect application of the safe harbour. In such a case, 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. While the burden of under-taxation in such situations would fall exclusively upon the country adopting the safe harbour provision, and should not adversely affect the ability of other countries to tax arm's length amounts of income, double non-taxation would be unavoidable and could result in distortions of investment and trade.

4.119 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 harbour 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 the countries. Such agreements could be published in advance and taxpayers could consistently report results in each of the affected countries in accordance with the agreement.

4.120 The rigor of having two or more countries with potentially divergent interests agree to such a safe harbour should serve to limit some of the arbitrariness that otherwise might characterise a unilateral safe harbour and would largely eliminate safe harbour-created double taxation and double non-taxation concerns. Particularly for some smaller taxpayers and/or less complex transactions, creation of bilateral or multilateral safe harbours by competent authority agreement may provide a worthwhile approach to transfer pricing simplification that would avoid some of the potential pitfalls of unilateral safe harbour regimes.

4.121 The Annex I to Chapter IV of these Guidelines contains sample memoranda of understanding that country competent authorities might use to establish bilateral or multilateral safe harbours in appropriate situations for common classes of transfer pricing cases. The use of these sample memoranda of understanding should not be considered as either mandatory or prescriptive in establishing bilateral or multilateral safe harbours. Rather, they are intended to provide a possible framework for adaptation to the particular needs of the tax authorities of the countries concerned.

#### *E.4.3. Possibility of opening avenues for tax planning*

4.122 Safe harbours may also provide taxpayers with tax planning opportunities. 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, if safe harbours apply to "simple" or "small" transactions, taxpayers may be tempted to break transactions up into parts to make them seem simple or small.

4.123 If a safe harbour were based on an industry average, tax planning opportunities might exist for taxpayers with better than average profitability. For example, a cost-efficient company selling at the arm's length price may be earning a mark-up of 15% on controlled sales. If a country adopts a safe harbour requiring a 10% mark-up, the company might have an incentive to comply with the safe harbour and shift the remaining 5% to a lower tax jurisdiction. Consequently, taxable income would be shifted out of the country. When applied on a large scale, this could mean significant revenue loss for the country offering the safe harbour.

4.124 This concern may largely be avoided by the solution noted in paragraph 4.119 of adopting safe harbours on a bilateral or multilateral basis, thus limiting application of safe harbours to transactions involving countries with similar transfer pricing concerns. In adopting bilateral and multilateral safe harbours, tax administrations would need to be aware that the establishment of an extensive network of such arrangements could potentially encourage "safe harbour shopping" via the routing of transactions through territories with more favourable safe harbours and take appropriate steps to avoid that possibility. Similarly, countries adopting bilateral safe harbours would be well advised to target fairly narrow ranges of acceptable results and to require consistent reporting of income in each country that is a party to the safe harbour arrangement. Treaty exchange of information provisions could be used by countries where necessary to confirm the use of consistent reporting under such a bilateral safe harbour.

4.125 Whether a country is prepared to possibly suffer some erosion of its own tax base in implementing a safe harbour is for that country to decide. The basic trade-off in making such a policy decision is between the certainty and administrative simplicity of the safe harbour for taxpayers and tax administrations on the one hand, and the possibility of tax revenue erosion on the other.

#### *E.4.4. Equity and uniformity issues*

4.126 Safe harbours may raise equity and uniformity issues. By implementing a safe harbour, one would create two distinct sets of rules in the transfer pricing area. Clearly and carefully designed criteria are required to differentiate those taxpayers or transactions eligible for the safe harbour to minimise the possibility of similar and possibly competing taxpayers finding themselves on opposite sides of the safe harbour threshold or, conversely, of allowing application of the safe harbour to unintended taxpayers or transactions. Insufficiently precise criteria could result in similar taxpayers receiving different tax treatment: one being permitted to meet the safe harbour rules and thus to be relieved from general transfer pricing compliance provisions, and the other being obliged to price its transactions in conformity with the general transfer pricing compliance provisions. Preferential tax treatment under safe harbour regimes for a specific category of taxpayers could potentially entail discrimination and competitive distortions. The adoption of bilateral or multilateral safe harbours could, in some circumstances, increase the potential of a divergence in tax treatment, not merely between different but similar taxpayers but also between similar transactions carried out by the same taxpayer with associated enterprises in different jurisdictions.

### E.5. Recommendations on use of safe harbours

4.127 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.

4.128 Safe harbour provisions may raise issues such as potentially having perverse effects on the pricing decisions of enterprises engaged in controlled transactions and a negative impact on the tax revenues of the country implementing the safe harbour as well as on the countries whose associated enterprises engage in controlled transactions with taxpayers electing a safe harbour. Further, unilateral safe harbours may lead to the potential for double taxation or double non-taxation.

4.129 However, in cases involving smaller taxpayers or less complex transactions, the benefits of safe harbours may outweigh the problems raised by such provisions. Making such safe harbours elective to taxpayers can further limit the divergence from arm's length pricing. Where countries adopt safe harbours, willingness to modify safe-harbour outcomes in mutual agreement proceedings to limit the potential risk of double taxation is advisable.

4.130 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.

4.131 It should be clearly recognised that a safe harbour, whether adopted on a unilateral or bilateral basis, is in no way binding on or precedential for countries which have not themselves adopted the safe harbour.

4.132 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 under the provisions of these Guidelines.

4.133 Country tax administrations should carefully weigh the benefits of and concerns regarding safe harbours, making use of such provisions where they deem it appropriate.