

# TRANSFER PRICING AND SAFE HARBOURS

Veronika Solilová

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## Abstract

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Transfer prices are significant for both taxpayers and tax administrations because they determine in large part taxable profits of associated enterprises in different tax jurisdictions. Moreover, in the context of taxation, transfer prices must be complied with the arm's length principle. However, Multinational Enterprises have been faced daily by conflicting rules and approaches to applying the arm's length principle, burdensome documentation requirements, inconsistent audit standards and unpredictable competent authority outcomes. Therefore, the Committee on Fiscal Affairs launched another project on the administrative aspects of transfer pricing in 2010. On 16 May 2013 as a partial solution of this project was approved by the OECD Council *the Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Authorities*. The paper is focused on significant changes of newly approved chapter IV of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Authorities, further on analysis of practice in this area, on advantages and disadvantages of safe harbours for taxpayers and competent authorities with aim to suggest recommendations on use of safe harbours in the Czech Republic.

transfer pricing guidelines, the arm's length principle, safe harbours, multinational enterprises, transfer pricing, transfer pricing compliance issues

The role of multinational enterprises (hereinafter MNEs) in world trade has increased dramatically over the last 20 years. The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context. These issues arise primarily from the practical difficulty, for both MNEs and tax administrations, of determining the income and expenses of a company or a permanent establishment that is part of an MNE group that should be taken into account within a jurisdiction,

particularly where the MNE group's operations are highly integrated.

In applying the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in their transactions with each other. However, the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established had the group members been acting as independent enterprises operating in open markets. To ensure the correct application of the separate entity approach, OECD<sup>1</sup> member countries<sup>2</sup> have adopted

<sup>1</sup> The organisation for economic co-operation and development is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation.

<sup>2</sup> The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

the arm's length principle, under which the effect of special conditions on the levels of profits should be eliminated.

The arm's length principle is incorporated in the Art. 9 of the *OECD Model Tax Convention on Income and on Capital* (OECD Model Tax Convention), which forms the basis of the extensive network of bilateral income tax treaties between OECD member countries, and between OECD member and non-member countries. The same principle is also incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Nations.

In applying the arm's length principle, one of the most difficult issues that have arisen is how determine appropriate transfer prices<sup>3</sup> for tax purposes. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits of associated enterprises<sup>4</sup> in different tax jurisdictions. The Committee on Fiscal Affairs has issued a number of reports relating to transfer pricing issues of MNEs. The most important report is the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Authorities* (hereinafter *Transfer Pricing Guidelines*) which was published in 1995 and revised in 2010. These *Transfer Pricing Guidelines* focus on the application of the arm's length principle to evaluate the transfer pricing of associated enterprises, the analysis of the methods for evaluating whether the conditions of commercial and financial relations within MNEs satisfy the arm's length principle, discussion of the practical application of those methods and other transfer pricing compliance issues.

However, applying the arm's length principle can be a resource-intensive process, because it may impose a heavy administrative burden on taxpayers and tax administrations. It may require collection and analysis of data that may be difficult or costly to obtain and/or evaluate. Moreover, such compliance burdens may be disproportionate to the size of the taxpayer, its functions performed, and the transfer pricing risks assumed in its controlled

transactions. Furthermore, MNEs have been faced daily by conflicting rules and approaches to applying the arm's length principle, burdensome documentation requirements, inconsistent audit standards and unpredictable competent authority outcomes. Although *Transfer Pricing Guidelines*<sup>5</sup> emphasize that documentation requirements should be reasonable and should not impose on taxpayers costs and burdens disproportionate to the circumstances. Therefore, greater simplicity in transfer pricing administration and improving the efficiency and effectiveness of transfer pricing enforcement are really essential. These facts led OECD, namely the Committee on Fiscal Affairs to launch a project to improve the administrative aspects of transfer pricing and compliance issues in 2010.

The project started with a survey of the transfer pricing techniques that may be implemented by countries to optimise the use of taxpayers' and tax administrations' resources. The main findings from survey were released in 2011 and then in 2012 were updated, which present analysis of existing transfer pricing simplification measures (including safe harbours<sup>6</sup>) in existence in OECD and non-OECD member countries<sup>7</sup>. The key findings are as follows:

- 33 out of 41 respondent countries (more than 80%) have transfer pricing simplification measures in place.
- 75% of available simplification measures are directed to small and medium-sized enterprises (hereinafter SMEs), small transactions and low value adding intra-group services.
- Out of 33 respondent countries which have simplification measures, 16 countries have safe harbours.
- Of those 16 countries, 10 countries have simplified transfer pricing methods, safe harbour arm's length range/rate and safe harbour interest rates<sup>8</sup>.

The results of the survey were surprising. When the *Transfer Pricing Guidelines* were adopted in 1995 and further revised in 2010, the view on safe harbours was generally negative. It was suggested that safe harbours may not be compatible with the

3 Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises.

4 Associated enterprise is an enterprise that satisfies the conditions set forth in Article 9, sub-paragraphs 1a) and 1b) of the OECD Model Tax Convention. Under these conditions, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if "the same persons participate directly or indirectly in the management, control, or capital" of both enterprises.

5 OECD: *Transfer Pricing Guidelines*, para 3.80–3.83, 5.6–5.7 and 5.28.

6 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. For more details see p. 5 below.

7 Namely Argentina, Australia, Austria, Belgium, Canada, Chile, China, Colombia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Russia, Singapore, Slovak Republic, Slovenia, South Africa, Sweden, Switzerland, Turkey, the United Kingdom and the United States, as well as the European Union.

8 OECD: *Multi-country analysis of existing transfer pricing simplification measures*, 2011, 2012.

arm's length principle, and therefore safe harbours are not advisable and recommended. However, based on the results of the survey, this negative tone does not accurately reflect the practice of OECD and non-OECD member countries. Moreover, safe harbours were also explicitly endorsed in the EU Joint Transfer Pricing Forum (hereinafter EU JTPF) report "Transfer Pricing and Small and Medium-Sized Enterprises" as a means of providing a measure of simplification for SMEs as well as saving on administrative resources and reducing compliance burden<sup>9</sup>. Furthermore in other EU JTPF report "Guidelines on Low Value Adding Intra-Group Services" is also mentioned a safe harbour approach. Based on this approach low value adding services are valued by mark-up in the range of 3–10%, often around 5%<sup>10</sup>. Thus the Committee on Fiscal Affairs started to work on the review of the current guidance on safe harbours in Chapter IV of the Transfer Pricing Guidelines. On 6 June 2012, a discussion draft on safe harbours was released for public comments. The discussion draft included proposed revisions of the section E on safe harbours in Chapter IV of the Transfer Pricing Guidelines and associated sample memoranda of understanding for competent authorities to establish bilateral safe harbours, which was not introduced in current Chapter IV. Public comments on safe harbours were submitted by 35 private sector organizations, totaling 237 pages and presenting the importance of the proposal for the business community. During November 2012 Meeting received public comments were discussed and finally on 16 May 2013 the OECD Council approved the Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines as a partial solution of the project about administrative aspects and compliance issues of transfer pricing. In addition is important to mention that the current UN Transfer Pricing Manual also contain a comprehensive and pragmatic discussion of safe harbour provisions. Thus, policy-makers and tax administrations across developed and developing countries try to ensure a globally consistent approach of safe harbour provisions.

The paper is focused on significant changes of newly approved Chapter IV of the Transfer Pricing Guidelines, further on analysis of practice in this area, on advantages and disadvantages of safe harbours for taxpayers and competent authorities with aim to suggest recommendations on use of safe harbours in the Czech Republic.

## MATERIALS AND METHODS

The basic source of our research was previous and now revised section E on Safe Harbours in Chapter IV of the Transfer pricing Guidelines. The next source was public comments to discussion draft on

Safe Harbours. In addition, the last sources were the reports about multi-country analysis of existing transfer pricing simplification measures issued by OECD in 2011 and 2012.

Within the paper, the analysis and synthesis as scientific methods were used to introduction of (i) the main changes in section E on Safe Harbours, and (ii) advantages and disadvantages of safe harbours. Furthermore those methods were used in evaluation of the practice, public comments and experiences in this area. In addition, the others methods, namely induction and deduction were applied in the process of the suggestion of recommendations on use of safe harbours as a final result.

## RESULTS AND DISCUSSION

### 1. Main changes in understanding of safe harbours

New guidance on safe harbours includes a new, clearer, albeit narrow **definition of safe harbours** in subsection E.2, point 4.99 to 4.102 as follow: *A safe harbour 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 simple obligations, for example taxpayers can apply a simplified transfer pricing approach provided by the tax administration, or alternatively, a safe harbour exempts a defined category taxpayers or transactions from application of all or part of the general transfer pricing rules. Often, eligible taxpayers are relieved from burdensome compliance obligations – transfer pricing documentation requirements. Other alternative definition of safe harbour is possible, for example other administrative simplification measures that use presumptions (for details see point 4.102). In addition, a safe harbour is elective for taxpayers and binding on tax administrations.*

However, thin capitalization rules, advance pricing arrangements and other administrative simplification measures which do not directly involve determination of arm's length prices are not within the scope of the safe harbours discussion.

Tone of the **benefits of safe harbours** is slightly more positive as compared with guidance in the 1995 or in 2010. Safe harbours should be now appropriate at taxpayers and/or transactions which involve low transfer pricing risks and when they are adopted on a bilateral or multilateral basis. In this case the tax administrations can shift audit and examination resources from smaller taxpayers and less complex transactions to more complex, higher-risk cases. Safe harbours would result in a greater administrative simplicity for tax administrations, mainly due to minimal examination requirements with respect to the transfer prices of controlled

<sup>9</sup> EU JTPF: Transfer Pricing and Small and Medium-Sized Enterprises, 2011.

<sup>10</sup> EU JTPF: Guidelines on Low Value Adding Intra-Group Services, 2011.

transactions qualifying for the safe harbours. Moreover, taxpayers can file their tax returns with more certainty and with lower compliance burdens. Thus, according to the new guidance (point 4.103) the basic benefits of safe harbours are defined as follows:

- *Simplifying compliance and reducing compliance costs for eligible taxpayers in determining and documenting appropriate conditions for qualifying controlled transactions.* Especially in areas where transfer pricing risks are small, and the burden of compliance and documentation is disproportionate to the transfer pricing exposure.
- *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, and complied with, the safe harbour provisions.*
- *Permitting tax administrations to redirect their administrative resources from the examination of lower risk transaction to examinations of more complex or higher risk transactions and taxpayers.*

Nevertheless, there are also identified some **concerns** in subsection E.4 of the new guidance, for example 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 – ***divergence from the arm's length principle***. According to the new guidance, the degree of approximation could be improved by collecting, collating, and frequently updating a pool of information regarding prices and pricing developments of transactions between uncontrolled parties. But, such efforts could erode the administrative simplicity of the safe harbours. Furthermore, this potential disadvantage (divergence from the arm's length principle) can be eliminated by the option to either choose the safe harbour or general transfer pricing rules. However, in this regard, it is desirable to set detail conditions under which a taxpayer is eligible for the safe harbour.

Further concern identified in the safe harbour is the potential for creating inappropriate tax planning opportunities including double non-taxation of income, the potential for double taxation from the possible incompatibility of the safe harbours with the arm's length principle or with the practices of other countries – ***risk of double taxation or double non-taxation, and inappropriate tax planning***. In respect of double taxation, the higher risk is in case where safe harbours are adopted unilaterally. Moreover, if the safe harbour causes taxpayers to report income above arm's length level, the jurisdiction providing the safe harbour receives a benefit in the form of higher taxable

income, on the other hand, the other jurisdiction generates a loss in the form of less taxable income. Furthermore, the other jurisdiction can make a transfer pricing adjustment with the result that the taxpayer applying the safe harbour would face double taxation. In addition, the administrative burden saved by the jurisdiction providing the safe harbour would therefore be shifted to the other jurisdiction. Thus it is desirable to fully inform taxpayers applying the safe harbour about any eventual double taxation risks. In respect of double non-taxation or undertaxation, this situation can be identified, if unilateral safe harbour permits taxpayers to report income below arm's length level. Then there would be a high incentive to apply the safe harbour. On the other hand, the burden of undertaxation would be fall upon the jurisdiction providing the safe harbour and double non-taxation would be unavoidable and could result in distortions of investment and trade. Both problems (double taxation and double non-taxation) could be eliminated by bilateral or multilateral agreements<sup>11</sup>. In addition, for smaller taxpayers and/or less complex transactions would be considered this approach as transfer pricing simplification which could avoid some disadvantages of an unilateral safe harbour regime. In respect of possibility of inappropriate tax planning, safe harbours could provide taxpayers this opportunity. For instance, if safe harbours apply to simple or small transactions, then taxpayers can break own transactions up into parts to make them seem simple or small. Further, if safe harbours were based on an industry average, then taxpayers with better than average profitability, can shift the remaining percentages of profitability to a lower tax jurisdiction. However, as was mentioned above, this problem could be eliminated by bilateral or multilateral agreements. Especially, if the agreement is concluded with countries having similar tax rates, which eliminate the possibility that safe harbour provision itself would create opportunities for transfer pricing manipulation.

The last concern identified in the safe harbour is an equitable treatment of similarly situated taxpayers – ***equity and uniformity issues***. In this respect, it is desirable to set clearly and carefully designed criteria for differentiate those taxpayers or transactions eligible for the safe harbour provision. On the other hand in the new guidance is mentioned that the preferential tax treatment for specific category of taxpayers could create discrimination and competitive distortions. Moreover, the bilateral or multilateral agreements could also increase the potential of a divergence in tax treatment.

In addition, the new guidance is relatively innovative, as includes the possibility of **bilateral or multilateral agreements** establishing a safe

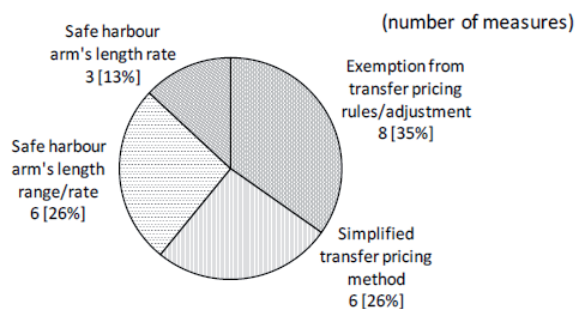
<sup>11</sup> See Annex I to Chapter IV of Transfer Pricing Guidelines, where is a sample of memoranda for establishing bilateral or multilateral safe harbours.



harbour contrary with the guidance in 1995 or in 2010. Thus the new guidance more reflects actual situation in OECD member countries or OECD non-member countries. As a few countries adopted safe harbours for dealing with common types of transfer pricing issues, mainly for low value adding services, SMEs or loans. Further, the general view of countries having adopted a bilateral agreement is that the bilateral agreement should be characterised as a “mutual agreement” under Art. 25 of the OECD Model Tax Convention and that “resolves difficulties or doubts arising as to the interpretation or application” of Art. 9 of the Treaty. In annex I to Chapter IV of Transfer Pricing Guidelines are presented three sample memoranda, one for low-risk distribution functions, one for low-risk manufacturing functions, and one for low-risk research and development functions. Competent authorities are free to modify, add or delete any provision of the sample agreement when concluding their own bilateral or multilateral agreements. However, there can be asked, whether such kind of distribution, manufacturing and research and development activities are really good candidates for a safe harbour?

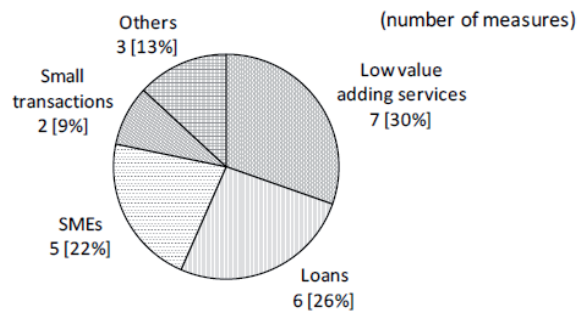
## 2. Safe harbours practice

The survey OECD on existing transfer pricing simplification measures presents that 33<sup>12</sup> out of 41 respondent countries have transfer pricing simplification measures, and especially 16 countries<sup>13</sup> of them (39% of respondent or 49% of respondent having simplification measures) have safe harbours in the total amount of 23. The types of safe harbours in place shows following graph 1.



1: *Types of safe harbours*

Source: OECD, Multi-country analysis of existing transfer pricing simplification measures, 2012.



2: *Scope of safe harbours*

Source: OECD, Multi-country analysis of existing transfer pricing simplification measures, 2012.

Almost 35% of safe harbours identified are exemption from transfer pricing rules/adjustments, simplified transfer pricing method and safe harbour arm's length range/rate are followed by 26%, and safe harbour interest rate (arm's length rate) is followed by 13%. When looking at taxpayers or transactions which are entitled to safe harbour benefits, 30% of safe harbours are directed at low value adding intra-group services, 26% of them are directed at loans, 22% are directed at SMEs, and 9% are directed at small transaction (for details see graph 2).

Further it is worth noting, that safe harbours such as simplified transfer pricing methods, safe harbour arm's length ranges/rates and safe harbour interest rates are optional. Due to this fact, there is no country reported double taxation cases related to the application of either own or another country's simplification measures. In addition, almost all optional safe harbours are directed at low value adding intra-group services and loans (for details see Tab. I).

The last key findings from the survey were related to the administrative practices and assessing the effectiveness of safe harbours. Majority of respondents using safe harbours generally evaluated safe harbours favourably and indicated them as simplification measures which alleviate compliance costs of taxpayers and tax administration, and increase certainty of taxpayers as well.

## 3. Public comments to guidance

Considering public comments to the discussion draft on the revision of the safe harbours section of the Transfer Pricing Guidelines<sup>14</sup>, the vast majority of commentators support the OECD's initiative to enable the simplification of transfer pricing issues through the extension of safe harbours

12 Namely Australia, Austria, Belgium, Canada, China, Colombia, Denmark, Estonia, Finland, France, Germany, Hungary, India, Ireland, Israel, Italy, Japan, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Russia, Singapore, Slovak Republic, Slovenia, Spain, South Africa, Sweden, Turkey, the United Kingdom and the United States.

13 Namely Australia, Austria, Columbia, Hungary, India, Ireland, Japan, Mexico, Netherlands, New Zealand, Russia, Singapore, Slovenia, South Africa, the United Kingdom and the United States.

14 OECD: The comments received with respect to the discussion draft on the revision of the safe harbours section of the Transfer Pricing Guidelines. 2012.

## I: Regime of safe harbours

| Countries     | Eligible taxpayers / transactions     | Type of safe harbours              | Option / Exclusion |
|---------------|---------------------------------------|------------------------------------|--------------------|
| Australia     | low value adding intra-group services | Safe harbour arm's length range    | Option             |
|               | Small transactions                    |                                    |                    |
| Austria       | low value adding intra-group services | Safe harbour arm's length range    |                    |
|               | Loans                                 | Simplified transfer pricing method |                    |
| Japan         | low value adding intra-group services | Simplified transfer pricing method |                    |
|               | Loans                                 |                                    |                    |
| Mexico        | Others                                | Safe harbour arm's length range    |                    |
| Netherlands   | low value adding intra-group services | Simplified transfer pricing method |                    |
| New Zealand   | low value adding intra-group services | Safe harbour arm's length range    |                    |
|               | Loans                                 | Simplified transfer pricing method |                    |
| Singapore     | low value adding intra-group services | Safe harbour arm's length rate     |                    |
| Slovenia      | Loans                                 | Safe harbour interest rate         |                    |
| South Africa  | Loans                                 | Safe harbour interest rate         |                    |
| United States | low value adding intra-group services | Simplified transfer pricing method |                    |
|               | Loans                                 | Safe harbour interest rate         |                    |

Source: OECD, Multi-country analysis of existing transfer pricing simplification measures, 2012.

and introduction of broad commonality between them. Selected public comments from PWC, TP Consortium, KPMG, Deloitte, Ernst & Young, Crowe Horwath, Confédération Fiscale Européenne and BDO were analysed and results are presented below with no intention to be exhaustive.

**In respect of purposes and benefits of safe harbours** commentators welcome the adoption of less stringent documentation requirements for eligible taxpayer or transactions or more generally the possibility to benefit from simplified administration and compliance processes. Commentators believe that 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 taxpayers, mainly for MNEs. The availability of safe harbours 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. Further, safe harbours may enable tax authorities to increase the efficiency of their yield from transfer pricing enquiries and provide taxpayers with much-desired certainty. However, commentators agreed 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. In this respect there can arise some risk, particularly 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 adjustment in consequence. On the other hand, well-designed, appropriate safe

harbours should not distort taxpayer behaviour, but should provide administrative certainty.

**Thus, safe harbours have the potential to significantly reduce the compliance burden of taxpayers and the resource dedication of tax authorities, provided they are well-designed in line with the arm's length principle and applied based on a careful evaluation of the facts and circumstances.** Furthermore, safe harbours could serve to simplify transfer pricing rules across jurisdictions, thereby aiding business competitiveness on regional and global scales. After that it will be achieve an effective outcome that preserves tax revenues and increase 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. However, revised guidance does not include any safe harbours related to a simplification of documentation. In commentators 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. But, taxpayers would still have the burden of answering any question or issue raised during an audit of such transactions, if such an audit nonetheless occurred.

Considering of taxpayers, benefits of safe harbours are potentially greatest for SMEs / small 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. Particularly, there are **two benefits for taxpayers in having bilateral safe harbours offered by tax**

**authorities: lower compliance costs and certainty.**

Mainly in the 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. Further, the process of conducting bilateral safe harbours starts with critical assumptions which, if met by the parties, would determine the pricing. From this point of view, the bilateral safe harbours can be considered as an alternative form of APA / simplified APA, if cover low risk transactions not to eligible for a normal APA and the costs of obtaining an APA may be prohibitive where the volume of transactions is low. In addition, multilateral agreements are likely to be the most useful to bigger MNEs. However, experience from APA shows that multilateral agreements are rarer and more labour intensive to conclude that bilateral equivalents. As such, the OECD's focus on providing bilateral sample memoranda of understanding is a practical one. In addition, bilateral (or multilateral) agreements clearly allow for the optimal compromise between certainty, compliance simplicity, risk management and fair allocation of taxing rights. However, unilateral rulings do provide benefits in that they are less time-consuming and simpler to manage. Moreover, the unilateral safe harbours have also a role to play for small transactions and SMEs for which a bilateral process may be overly costly. Furthermore, 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 taxpayers and tax authorities to achieve certainty, respectively, on tax burden and collections. On the other hand, 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. Further, based on general practice many tax authorities do 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. In this respect is essential, that the opportunity to apply for mutual agreement procedure (MAP) is not reduced in case a safe harbour. Therefore, all commentators agreed that safe harbours should be optional for taxpayers, because 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. Only such optional approach would achieve the desired compliance relief for taxpayers, and allow for sufficient flexibility, especially in case of unilateral safe harbours. However, bilateral safe harbours offer more protection against double taxation, and therefore have advantages over unilateral safe harbours.

**Considering of tax authorities, benefits of safe harbours are also identified in allowing a focus of resources on complex and high risk transfer pricing matters.** With better case selection and development, tax authorities may actually save costs and increase enforcement revenue. Further, use of bilateral or even multilateral agreements has the potential to significantly **decrease the number of transfer pricing disputes, audit and MAP cases.**

**In respect of the form and scope of safe harbours** commentators suggest that **safe harbours can be either qualitative or quantitative**, setting margins or de minimums thresholds below which a country's transfer pricing regulations would not apply. However, revised guidance does not consider quantitative safe harbours but only qualitative safe harbours. Therefore commentators suggest for establishing parameters around safe harbours that each tax jurisdiction could undertake to analyse 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 and attorneys in finalizing transfer pricing audits, and related costs (including external costs).
- Type of transaction and transfer pricing methodology used by the taxpayer.
- Taxpayer's filing position vs. final resolution of case.

Further, the above information shall be 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 areas which are better for investing both the tax authorities' and taxpayers' resources by implementing safe harbour rules.

Moreover, it is suggested to **design safe harbour provisions based on a sound evaluation of past experience with arm's length transfer pricing for a certain type of transaction/taxpayer** for elimination of the risk of divergence from the arm's length principle. Some commentators also suggest that the design of safe harbour provisions may need to take into account industry specificities and reflect industry comparability. However, this approach requires 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. Then, due to potentially influencing business and product cycles could be more reliable for certain types of transactions or industries a multi-year approach testing weighted average results. In addition, taxpayers should always have the option to apply arm's length



principle instead of any safe harbour. Therefore safe harbours **should be offered as an administrative simplification** rather than a move away from the arm's length principle.

Furthermore, commentators welcome that current guidance on safe harbours is applicable to less complex transactions, regardless of the size of the taxpayer concerned (thus also for MNEs), and then for **small transactions and routine or low value adding transactions**. Although some commentators believe that safe harbours should be designed in a way, that makes them available to eligible taxpayers, namely for SMEs. This approach is consistent with work done by the European Commission and EU JTPF on such enterprises.

Further, commentators recommend developing a list of example transactions which could normally be considered to be a low risk character and hence particularly suitable to be the subject of a unilateral or bilateral safe harbour arrangement. Commentators explicitly suggest to add to such list business support services, head office and shared service centre services (low-value adding services), including e.g., IT support services, payroll or bookkeeping services. Within MNEs these types of services are often centralized within one or multiple entities serving all group companies. Moreover, the inclusion of this type of 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 EU (EU JTPF Guidelines on low-value adding services). In addition, commentators note that other transactions, particularly thin capitalization is a key issue for taxpayers and one which would benefit from a safe harbour rule. In the end, commentators considered whether contract research and development is a good example of low risk activity in case of memoranda for understanding which is presented in guidance.

**In respect of risk of double taxation and abusive tax planning**, the commentators believe that safe harbours **should not be designed in a way that increases risks of unresolved double taxation**. Further, commentators suggest that for many tax authorities may be more comfortable to have 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. Moreover, 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. Or safe harbours can be put in place by a **progressive development** e.g., starting with small companies first in order to test the concept before expanding it to larger taxpayers.

In addition, 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. However, the safe harbours outcomes can never be exactly the same as with a full transfer pricing analysis.

#### 4. Advantages and disadvantages of safe harbours

Based on analysis of new guidance, public comments and safe harbour practice can be identified advantages and disadvantages of safe harbours with regard to the taxpayers and tax authorities.

For taxpayers and tax administrators mean safe harbours mainly simplified transfer pricing approach that can reduce compliance costs and administration costs. Further, it also means higher certainty for taxpayers and improved effectiveness of tax administration mainly by decreasing the number of transfer pricing disputes, audit and MAP cases for tax administrators. On the other hand, there are some disadvantages, namely an application for specific category of taxpayers or transactions which can create discriminations or some distortions e.g. trade or competitive; risk of double taxation or non-taxation; inappropriate tax planning and transfer pricing manipulation with results of lower tax revenues and so on (for details see Tab. II).

#### 5. Recommendations

In the beginning, there are mentioned common recommendations. Subsequently, there are mentioned recommendations for the Czech tax policy which has not used any safe harbours provisions.

Transfer pricing compliance and administration is often complex, time consuming and costly. Therefore, safe harbours can be considered as simplified measures, which could fulfil their benefits and advantages, provided that they are **properly and clearly designed with conditions in details** under which a taxpayer/transaction is eligible for safe harbour provision. Further, for elimination of negative impact on the tax revenues of the country implementing the safe harbour as well as on the countries whose associated enterprise engage in controlled transaction is recommended **to use bilateral form of the safe harbour or non-mandatory unilateral safe harbour**. Moreover is recommended to use a safe harbour provision mainly for **less complex transactions e.g., small transactions, routine with lower risks or low value adding transactions, and for SMEs**. This approach is consistent with work done by the European Commission and EU JTPF on such enterprises or transactions. However, it is questioned and left open whether also include business support services, head office and shared service centre services, which are usually centralized and serving all group companies. Specifically, the Confederation Fiscale Europeenne believes that tax authorities should



II: *Advantages and disadvantages safe harbours*

| Taxpayers  |   |
|--|---|
| Advantages   | Disadvantages   |
| Simplified transfer pricing approach   | Application only for defined category taxpayers or transactions. Potential discrimination and competitive, investment or trade distortions  |
| Non-obligation to apply a country's general transfer pricing rules   | It does not cover thin capitalization rules, simplification of documentation, business support services, head office or share service centre services as safe harbours  |
| More certainty that transfer prices will be accepted by the tax administrations  | Risk of double taxation from the possible incompatibility of the safe harbours with the arm's length principle or with the practices of other countries in case of mandatory unilateral form of safe harbours |
| Lower burdensome compliance obligations / costs  |   |
| Bilateral or multilateral form of safe harbours with the result of protection against double taxation  |   |
| Optional   |   |
| Potential tax planning opportunity   |   |
| Application of MAP is not reduced for safe harbours in the case of double taxation   |   |
| Tax authorities  |   |
| Advantages   | Disadvantages   |
| Transfers of administrative resources to the examinations of more complex and/or higher-risk cases   | Detail setting of safe harbour's conditions under which a transaction or taxpayer is eligible for safe harbour.   |
| Greater administrative simplicity for tax administrations  | Potential divergence from the arm's length principle providing that safe harbours are not optional  |
| Minimal examination requirements for control of transfer prices in the safe harbours   | Potential for inappropriate tax planning and transfer pricing manipulation with results of lower tax revenues   |
| Lower tax administration costs   | Risk of double non-taxation in case of unilateral form of safe harbours   |
| Limited audit or non-audit of safe harbours provided that taxpayer has met all conditions of the safe harbour provision.   | Potential to the oversimplification of characterization of the entity's functions and activities due to access safe harbours with the results of inconsistent with TP Guidelines                              |
| Bilateral or multilateral form of safe harbours  | Potential discrimination, competitive, investment or trade distortions  |
| Commonly used for low value adding services, SMEs and loans. Further suitable for low-risk transactions.   | Updating of information regarding prices and pricing developments of uncontrolled transactions for updating safe harbour's provisions – monitored going-forward approach                                      |
| Higher efficiency and effectiveness of the tax administration activities   |   |
| Potential to decrease the number of transfer pricing disputes, audit and MAP cases provided that the bilateral or multilateral form of safe harbour will be used |   |

Source: OECD, Multi-country analysis of existing transfer pricing simplification measures, 2012. OECD, The comments received with respect to the discussion draft on the revision of the safe harbours section of the transfer pricing guidelines, 2012. OECD, Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines, 2013. Own analysis and processing.

issue guidelines on 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 re-invoicing<sup>15</sup>.

In the end, it is recommended to set safe harbour provisions in that way which **allows tax authorities**

15 European Taxation: Opinion Statement of the CFE on the OECD Discussion Draft "Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines" Submitted to the OECD Centre for Tax Policy and Administration in September 2012, 2012.

**to challenge a taxpayer's use of the safe harbour** if that use is abusive or inconsistent with the purpose of the safe harbour. In this respect it is highly recommended to put safe harbours in place by a **progressive development**.

The Czech transfer pricing rules are generally introduced and published by the Czech Ministry of Finance in the form of decrees, which are considered as recommendations of the Ministry of Finance. Currently, there are effective 3 decrees, namely D-332<sup>16</sup>, D-333<sup>17</sup> and D-334<sup>18</sup>, which reflect the Transfer Pricing Guidelines. Further, there are set only 2 provisions in the tax law, particularly in the *Act No. 586/1992 Coll., on income taxes*, which include the definition of related/associated enterprises (in § 23/7) and the binding consideration over the transfer pricing policy used in related party transactions (in § 38nc). Unfortunately, the Czech tax policy has not used any safe harbour provisions, similarly as Argentina, Chile, Indonesia, Korea, Luxembourg, Malaysia and Switzerland. The main reason why the Czech Republic has not yet introduced any safe harbours is that the Czech tax law has not done any difference between taxpayers. All of them are obliged to refer and explain their transactions according to the arm's length principle and Transfer Pricing Guidelines to the tax authority. However, from 1 January 2013 is effective a new decree issued by the General Financial Directorate, namely GŘ D-10 *on Low Value Adding Intra-Group Services provided between associated enterprises*<sup>19</sup>, which reflect EU JTPF Guidelines on Low Value Adding Intra-Group Services. This decree GŘ D-10 can be considered as transfer pricing simplification measures, because if taxpayers met all conditions

set in this decree, after that is relieved from some transfer pricing documentation requirements.

In this respect it is recommended to consider whether the similar transfer pricing simplification measures in the form of **safe harbours introduce or not, particularly for SMEs or for transactions with low transfer pricing risks**. These other two areas seem to be the most suitable for establishing safe harbours and would be positive evaluated by taxpayers who bear burdensome compliance costs, e.g., transfer pricing compliance costs have a disproportionate effect on SMEs relative to the size of transactions, and can be a barrier to international expansion for such businesses. Further, in these areas the tax authorities can expend resources, which could be used in more complex and higher-risk cases and improved tax administrative effectiveness. However, before making a decision and establishing parameters around safe harbours, the Czech tax authorities should analyse their administration of transfer pricing transactions, particularly number of transfer pricing audits, number of hours spent and related costs, type of transaction and methodology used, and categorization of taxpayers. Based on the results of analysis is possible to indicate areas which are suitable for safe harbours provisions. Therefore, the further research will be covered this analysis with the indication of the suitable areas for safe harbours provisions and with the determination of specific safe harbours arm's length range. In the end is worth to note that tax authorities should always carefully weigh the benefits / advantages and concerns / disadvantages regarding safe harbours.

## SUMMARY

OECD has been focused on improving the administrative aspects of transfer pricing and compliance issues since 2010. The first finding from the survey were released in 2011 and then in 2012 were updated, which present analysis of existing transfer pricing simplification measures (including safe harbours) in existence in OECD and non-OECD member countries. Based on the results of the survey, the negative view on safe harbours does not accurately reflect the practice of OECD and non-OECD member countries and EU JTPF. Due to this fact, on 16 May 2013 the OECD Council approved the Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines as a partial solution of the project on the administrative aspects of transfer pricing.

New guidance on safe harbours includes a new, clearer definition of safe harbours with more positive tone. However, the new definition does not cover thin capitalization rules and advance pricing agreements. The most important benefits of safe harbours were identified as follows: simplifying

16 D-332 *Communication by the Ministry of Finance in respect of international standards application in taxation of transactions between associated enterprises – transfer pricing*. Available from: <http://cds.mfcr.cz/cps/rde/xchg/SID-3EA9846C-05B123CC/cds/xsl/167.html?year=0>.

17 D-333 *Communication by the Ministry of Finance in respect of s.38nc of Act no. 586/1992 Coll., on income taxes – binding consideration over the transfer pricing policy used in related party transactions*. Available from: <http://cds.mfcr.cz/cps/rde/xchg/SID-3EA9846C-05B123CC/cds/xsl/167.html?year=0>.

18 D-334 *Communication by the Ministry of Finance in respect of the scope of transfer pricing documentation*. Available from: <http://cds.mfcr.cz/cps/rde/xchg/SID-3EA9846C-05B123CC/cds/xsl/167.html?year=0>.

19 GŘ D-10 *to Low Value Adding Intra-Group Services provided between associated enterprises*. Available from: <http://cds.mfcr.cz/cps/rde/xchg/SID-3EA9846C-05B123CC/cds/xsl/167.html?year=0>.

compliance and reducing compliance costs; providing certainty; shifting administrative resources to examinations of more complex or higher risks transactions and taxpayers; minimal examination requirements and others. On the other hands there were identified some concerns, e.g., the possibility of divergence from the arm's length principle; risk of double taxation or double non-taxation; possibility of inappropriate tax planning; and equity and uniformity issues. However almost all concerns can be eliminated by both clearly and carefully designed criteria and conditions under which a taxpayer/transaction is eligible for safe harbours, and by bilateral or multilateral forms of safe harbours.

Furthermore, safe harbours practice shows that 49% of respondent having transfer pricing simplification measures have safe harbours provisions. The types of safe harbours used are following: exemption from transfer pricing rules; simplified transfer pricing method; safe harbour arm's length range/rate; and safe harbour interest rate. Further, all safe harbours used are optional and cover usually low value adding intra-group services, loans, SMEs and small transactions.

For taxpayers and tax administrators mean safe harbours mainly simplified transfer pricing approach that can reduce compliance costs and administration costs, increase certainty for taxpayers and improved effectiveness of tax administration mainly by decreasing the number of transfer pricing disputes, audit and MAP cases for tax administrators. On the other hand, there are some disadvantages, namely an application for specific category of taxpayers or transactions which can create discriminations or some distortions e.g. trade or competitive; risk of double taxation or non-taxation; inappropriate tax planning and transfer pricing manipulation with results of lower tax revenues.

At the end of the paper were made some recommendations for tax authorities who would like to introduce own safe harbours. They should properly and clearly designed conditions in details under which a taxpayer/transaction is eligible for safe harbour provision. Moreover this definition should allow tax authorities challenge a taxpayer's use of the safe harbour if that use is abusive or inconsistent with the purpose of the safe harbour. Further, they should use bilateral form of the safe harbour or non-mandatory unilateral safe harbour. In addition, safe harbour provisions should cover mainly less complex transactions e.g., small transactions, routine with lower risks or low value adding transactions, and SMEs. And the last recommendation is that the safe harbour's introduction should have progressive development.

From the general view, the Czech tax policy has not used any safe harbour provisions. However, from 1 January 2013 is effective a new decree GŘ D-10, which reflect EU JTPF Guidelines on Low Value Adding Intra-Group Services. This decree can be considered as transfer pricing simplification measures, because if taxpayers met all conditions set in this decree, after that is relieved from some transfer pricing documentation requirements. Therefore, there are two other areas which can be identified as suitable area for safe harbour provisions, namely SMEs and transactions with low transfer pricing risks. Mainly due to the fact that transfer pricing compliance costs have a disproportionate effect on SMEs relative to the size of transactions, and can be a barrier to international expansion for such businesses. Further, in these areas the tax authorities can expend resources, which could be used in more complex and higher-risk cases and improve tax administrative effectiveness. However, before making a decision and establishing parameters around safe harbours, the Czech tax authorities should analyse their administration of transfer pricing transactions and carefully weigh the benefits / advantages and concerns / disadvantages regarding safe harbours. Therefore, the further research will be covered this analysis with the aim to determinate a specific safe harbours arm's length range in the selected areas.

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#### Address

Ing. Veronika Solilová, Ph.D., Department of Accounting and Taxes, Mendel University in Brno, Zemědělská 1, 613 00 Brno, Czech Republic, e-mail: [Ritve@email.cz](mailto:Ritve@email.cz)