DISCUSSION DRAFT

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

AND

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

6 June to 14 September 2012

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
CENTRE FOR TAX POLICY AND ADMINISTRATION

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Public discussion draft

Working Party No. 6 of the OECD Committee on Fiscal Affairs has released a discussion draft on safe harbours as part of its project to improve the administrative aspects of transfer pricing. This project started with a **survey of the transfer pricing simplification measures** in existence in OECD and non-OECD countries and led WP6 to review the current guidance on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("TPG").

The current guidance in the TPG has a somewhat negative tone regarding transfer pricing safe harbours. This negative tone does not accurately reflect the practice of OECD member countries, a number of which have adopted transfer pricing safe harbour provisions. Also, the current guidance is largely silent with regard to the possibility of a bilateral agreement establishing a safe harbour, even though some countries have favourable experience with such bilateral agreements.

This discussion draft includes proposed revisions of the section on safe harbours in Chapter IV of the TPG and associated sample memoranda of understanding for competent authorities to establish bilateral safe harbours.

This document is an interim draft prepared by Working Party No. 6. It should be recognised that it is not necessarily a consensus document and it does not necessarily reflect the final view of the OECD and its member countries. One or another country may not be in full agreement with one or more of its provisions. Due to its interim nature, the Committee on Fiscal Affairs has not yet considered the draft.

Interested parties are invited to send comments on this discussion draft **before 14 September**. Comments should be sent in Word format to Mr. Joe Andrus, Head, Transfer Pricing Unit (joe.andrus@oecd.org). Unless otherwise requested at the time of submission, comments received may be posted on the OECD website.

Depending on the nature of the comments received, there may be a public consultation on the matters in this discussion draft during the week of 5 November 2012. Participants in the public consultation will be drawn primarily from those providing timely written comments.

PROPOSED REVISION OF THE SECTION ON SAFE HARBOURS IN CHAPTER IV OF THE TPG

The existing language of paragraphs 4.93 through 4.122 would be removed and replaced with the following language.

E. Safe harbours

E.1 Introduction

1. 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.

2. 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.

3. Despite these generally negative conclusions, a number of countries have adopted safe harbour rules. Those rules have generally been applied to smaller taxpayers and less complex transactions. 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. 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 those tax administrations that have expressly adopted the safe harbour.

5. 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 scarce 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.

6. 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

7. 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. Prices established under such rules would be automatically accepted by the tax administrations that have expressly adopted such rules. Such elective provisions are often referred to as "safe harbours".

8. 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.

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

10. 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).

E.3 Benefits of safe harbours

11. 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

12. 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 complexity may be disproportionate to the size of the taxpayer, its functions performed, and the transfer pricing risks inherent in its controlled transactions.

13. 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

14. 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. Qualifying taxpayers would have the assurance that they would not be subject to an audit or reassessment in connection with their transfer prices provided they have met the eligibility conditions of, and complied with, the safe harbour provisions. 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

15. 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

16. 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

17. 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 application of a profit method when the taxpayer could otherwise have determined that the comparable uncontrolled price or 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.

18. 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.

19. 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

20. 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.

21. 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.

22. 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.

23. Where safe harbours are adopted unilaterally, 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.

24. 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.

25. It is important to observe that the problems of non-arm's length results and potential double taxation and double non-taxation arising under safe harbours could be largely eliminated if safe harbours were adopted on a bilateral or multilateral basis by means of competent authority agreements between countries. Under such a procedure, two or more countries could, by agreement, define a category of taxpayers and/or transactions to which a safe 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 their 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.

26. 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 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.

27. The Annex 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

28. 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, as safe harbours are generally applicable to “simple” or “small” transactions, taxpayers may be tempted to break transactions up into parts to make them seem simple or small.

29. 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 percent on controlled sales. If a country adopts a safe harbour requiring a 10 percent mark up, the company might have an incentive to comply with the safe harbour and shift the remaining 5 percent 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.

30. This concern may be avoided, on the one hand, by the solution noted in paragraph 25 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. Tax administrations would need to be aware that the establishment of an extensive network of bilateral or multilateral safe harbours 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.

31. Whether a country is prepared possibly to 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

32. 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

33. 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.

34. 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.

35. 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.

36. 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.

37. 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.

38. 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.

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

SAMPLE MEMORANDA OF UNDERSTANDING FOR COMPETENT AUTHORITIES TO ESTABLISH BILATERAL SAFE HARBOURS

A. Introduction

40. WP6 has been working on developing sample Memoranda of Understanding (MOUs) for use by Competent Authorities in negotiating bilateral safe harbours for common categories of transfer pricing cases involving low risk distribution functions, low risk manufacturing functions, and low risk research and development functions. It is intended that these sample MOUs will be published on the OECD website and ultimately be included as an Annex to the Transfer Pricing Guidelines with the intention of providing countries with a tool to adapt and use in addressing, on a bilateral safe harbour basis, important classes of transfer pricing cases that now take up a great deal of time and effort when processed on a case by case basis. Competent authorities are of course free to modify, add or delete any provision of the sample agreement when concluding their own bilateral agreements.

B. Reasons for Concluding a Bilateral Safe Harbour MOU

41. One of the potential problems arising from the use of unilateral transfer pricing safe harbours is that they may increase the risk of double taxation and double non-taxation. This can occur if the country granting the unilateral safe harbour shades the safe harbour towards the high end of an acceptable arm's length profit range, while a treaty partner on the other end of the transaction disagrees with the assertion that the defined safe harbour profit level reflects arm's length dealing. Some business commentators contend that there is a tendency for safe harbour profit ranges to increase over time, exacerbating this potential problem. It is also sometimes suggested that unilateral safe harbours can tend to force taxpayers into reporting higher than arm's length levels of income, and to incur some resulting double taxation, as the price to be paid for administrative convenience and simplicity. Finally, unilateral safe harbours can, at times, provide a windfall to taxpayers whose specific facts might suggest that income above the safe harbour level would be more consistent with arm's length dealing.

42. These double tax and windfall issues would likely be quite pronounced in connection with safe harbours directed at some of the most common types of transfer pricing transactions. Transactions such as sales of goods to a local distribution affiliate for resale on a limited risk basis in the local market, contract manufacturing arrangements, and contract research arrangements could clearly raise these issues. It is perhaps for this reason that few countries, if any, have developed functioning safe harbours for dealing with these common types of transfer pricing issues.

43. Distribution margins and manufacturing mark-ups can sometimes be quite consistent across geographies and across many industries. Therefore guidance on normal settlement ranges for these types of cases could have the effect of reducing the number of transfer pricing audits and reducing competent authority dockets and other transfer pricing controversy by a substantial margin if reasonable ranges of results could be agreed bilaterally and published.

44. These types of cases could potentially be addressed through bilateral MOUs adopted and publicised by competent authorities. Some countries have adopted such arrangements on a bilateral basis. The general view of such countries is that treaty provisions based on Article 25(3) of the OECD Model Tax Convention provide sufficient authority to support a bilateral competent authority agreement on a safe harbour rule that would apply to numerous similarly situated taxpayers. Article 25(3) provides: "The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention." A competent authority agreement on a bilateral transfer pricing safe harbour should properly be characterised as a "mutual agreement" that "resolves difficulties or doubts arising as to the interpretation or application" of Article 9 of the Treaty.

45. Although nothing would prevent the countries' competent authorities from adopting safe harbour provisions under Article 25(3) on a multilateral basis if the conditions and circumstances so allow, the types of transactions described above are such that a bilateral agreement will often be the most appropriate approach.

46. If such MOUs existed, qualifying taxpayers would be able to manage their financial results to fall within the agreed safe harbour range, secure in the understanding that those results would be accepted in both (or all) countries agreeing to the MOU concerned. A commonly cited precedent for this type of approach is the agreement between the United States and Mexico regarding safe harbour profit ranges for maquiladora operations.

47. A bilateral approach to the development of safe harbours would have a number of advantages over unilateral transfer pricing safe harbours:

- A bilateral approach executed through competent authority MOUs could increase the likelihood that safe harbour provisions do not result in double taxation or double non-taxation.
- Bilateral safe harbours could be tailored to the economics of a particular market and circumstances, and thus be compatible with the arm's length principle.
- Bilateral safe harbours could be entered into on a selective basis with countries having similar tax rates, thus minimising the possibility that the safe harbour provision itself would create opportunities for transfer pricing manipulation and providing a means for limiting the application of the safe harbour to situations where transfer pricing risk is quite low.
- If the relevant countries desire, bilateral safe harbours could initially be limited to small taxpayers and small transactions in order to limit exposures to government tax revenue that might otherwise be created by the safe harbour.
- Safe harbours adopted by means of a competent authority MOU could be reviewed and modified from time to time by competent authority agreement, thus assuring that the provisions stay up to date and reflect developments in the broader economy.
- For developing countries with serious resource constraints, bilateral MOUs entered into with a number of treaty partners could provide a means of protecting the local tax base in common transfer pricing fact patterns without an inordinate enforcement effort.

48. The following elements may be of relevance in the negotiation and conclusion of an MOU.

1. Description of and criteria to be fulfilled by the qualifying enterprises. These could include:

    a. A description of the functions required to be performed (or to be disallowed) as a condition to application of the safe harbour;

    b. The risks to be assumed by the participating enterprises as a condition to application of the safe harbour;

    c. The mix of assets permitted to be used by the participating enterprises as a condition of application of the safe harbour;

    d. A description of classes of entities excluded from the safe harbour provision (by virtue of size, industry, etc.).

2. Description of the qualifying transactions covered by the MOU;
3. Determination of the arm's length range of tested party compensation;
4. The years to which the MOU applies;
5. Statement that the MOU is binding on both of the tax administrations involved;
6. Reporting and monitoring procedures for the MOU;
7. Documentation and information to be maintained by the participating enterprises:
8. A mechanism for resolving disputes;

49. Set forth in the Exhibits hereto are proposed draft MOUs for three types of transactions: (i) performance of low risk manufacturing services; (ii) performance of low risk distribution services; and (iii) performance of low risk contract research and development services. It is proposed that these three sample agreements be added to the TPG as part of the Annex to Chapter IV. Comments of all interested parties on the specific provisions of these draft agreements are requested.

EXHIBIT 1: DRAFT SAMPLE MOU ON LOW RISK MANUFACTURING SERVICES

Preamble

50. The Competent Authorities of [State A] and [State B] have reached an understanding relating to the arm's length remuneration applicable to low risk manufacturing services performed by a Qualifying Enterprise resident in [State A] on behalf of an associated enterprise resident in [State B], and by a Qualifying Enterprise resident in [State B] on behalf of an associated enterprise resident in [State A] in the circumstances described herein. The purpose of this memorandum of understanding is to provide legal certainty to Qualifying Enterprises by establishing specific procedures to comply with the transfer pricing rules in [State A] and [State B] and to eliminate double taxation.

51. This memorandum of understanding is entered into under authority of Article [25] of the [Tax Treaty] (the "Treaty") between [State A] and [State B]. It implements the principles of Article [9] of the Treaty in the circumstances described herein. It applies to tax years of Qualifying Enterprises ending in calendar years [20__] through [20__].

Qualifying Enterprise

52. For purposes of this memorandum of understanding, a Qualifying Enterprise must have each of the characteristics described in this paragraph.

(a) The Qualifying Enterprise shall be a resident of a Contracting State for purposes of the Treaty and shall conduct business operations exclusively in such State.

(b) The predominant business activity of the Qualifying Enterprise shall be either the performance of manufacturing services in its State of residence on behalf of an associated enterprise (within the meaning of Article [9] of the Treaty) resident in the other Contracting State, or alternatively, the production of manufactured products for sale to such associated enterprise.

(c) The Qualifying Enterprise shall have entered into a written agreement with the associated enterprise, prior to the commencement of the relevant taxable year of the Qualifying Enterprise, pursuant to which the associated enterprise assumes the principal business risks associated with the manufacturing activities of the Qualifying Enterprise and agrees to compensate the Qualifying Enterprise for its manufacturing activities at levels consistent with this memorandum of understanding.

(d) Annual research, development, and product engineering expense of the Qualifying Enterprise shall, in the aggregate, be less than [___] percent of its net sales revenue.

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

(f) The Qualifying Enterprise shall not retain title to finished products after they leave its factory, shall not bear any transportation or freight expense with respect to such finished products, and shall not bear any risk of loss with respect to damage or loss of finished products in transit.

(g) The Qualifying Enterprise shall not engage in managerial, legal, accounting, or personnel management functions other than those directly related to the performance of its manufacturing activities.

(h) At least [___] percent of the assets of the Qualifying Enterprise shall consist of manufacturing plant and equipment, raw material inventory, and work in process inventory, calculated on the basis of the average of assets held on the last day of each of the four quarterly periods during the relevant taxable year of the Qualifying Enterprise.

(i) The finished product inventory of the Qualifying Enterprise shall not exceed [___] percent of the annual net sales of the Qualifying Enterprise, calculated on an average asset basis in the manner described in paragraph (h) above.

53. A Qualifying Enterprise may not:

(a) Conduct its principal operations in any of the following industries: [__________].

(b) Have annual net sales in excess of [________________].

(c) Have total assets in excess of [________________].

(d) Derive more than [____] percent of its net revenues from transactions other than Qualifying Transactions.

(e) Have undergone a transfer pricing audit in either [State A] or [State B] within the past [___] years which resulted in adjustments in excess of [________________].

Qualifying Transactions

54. For purposes of this memorandum of understanding, a Qualifying Transaction shall be (i) the rendering of manufacturing services by the Qualifying Enterprise on behalf of an associated enterprise resident in the other Contracting State and / or (ii) the sale of manufactured products produced by the Qualifying Enterprise to an associated enterprise resident in the other Contracting State, in each case without the interposition of other transactions or parties.

Determination of the Taxable Income of the Qualifying Enterprise

55. In the event a Qualifying Enterprise elects to apply the provisions of this memorandum of understanding:

(a) In the event the Qualifying Enterprise holds title to raw materials and work in process inventory related to the Qualifying Transactions, the net income before tax of the Qualifying Enterprise with respect to its Qualifying Transactions for the taxable year shall be in the range of [equal to] [__ to ___] percent of the total costs of the Qualifying Enterprise, excluding from the base for computing the profit percentage only net interest expense, currency gain or loss, and any non-recurring costs.

(b) In the event the associated enterprise holds title to raw materials and work in process inventory related to the Qualifying Transactions, the net income before tax of the Qualifying Enterprise with respect to the Qualifying Transactions for the taxable year shall be in the range of [equal to] [___ to ___] percent of the total costs of the Qualifying Enterprise, excluding from the base for computing the profit percentage only net interest expense, currency gain or loss, and any non-recurring costs.

(c) Accounting terms utilised in this memorandum of understanding shall be defined in accordance with generally accepted financial accounting principles in the residence country of the Qualifying Enterprise.

56. Each of [State A] and [State B] agree that compensation for Qualifying Transactions calculated in accordance with this memorandum of understanding shall be deemed to constitute an arm's length level of compensation for purposes of applying the transfer pricing rules of such State and the provisions of Article [9] of the Treaty.

Permanent Establishment

57. The Competent Authorities of [State A] and [State B] agree that the associated enterprise which is party to a Qualifying Transaction shall not be deemed to have a permanent establishment in the country of residence of the Qualifying Enterprise by virtue of the performance of low risk manufacturing services on its behalf by the Qualifying Enterprise or by virtue of such associated enterprise taking title to products produced by the Qualifying Enterprise in the country of residence of the Qualifying Enterprise.

Election and Reporting Requirements

58. A Qualifying Enterprise and the relevant associated enterprise may elect to apply the provisions of this memorandum of understanding consistently in [State A] and [State B] by filing a notice with [______________] of [State A] and [______________] of [State B] no later than the due date for their respective tax returns covering the Qualifying Transactions.

59. The required notice shall include:

- An affirmative statement that the taxpayers intend to apply and be bound by this memorandum of understanding;

- An affirmative statement that income and expense from Qualifying Transactions will be reported on a consistent basis in [State A] and [State B] in accordance with this agreement;

- A narrative description of the Qualifying Transactions;

- Identification of each of the associated enterprises that are parties to the Qualifying Transactions;

- Audited financial statements of the Qualifying Enterprise for the relevant year and sufficient additional financial and accounting information to demonstrate the status of the Qualifying Enterprise as a Qualifying Enterprise;

- A detailed calculation of the income of the Qualifying Enterprise from Qualifying Transactions applying the principles of this memorandum of understanding;

- A statement that the electing enterprise will respond within 60 days to any request of the tax authority of its residence country for information deemed necessary by such tax authority to verify qualification of the enterprise for treatment under this memorandum of understanding;

60. Satisfaction of the election and reporting requirements of this memorandum of understanding, and reporting income calculated in accordance with its terms in a timely filed tax return for the year, shall relieve the Qualifying Enterprise and its relevant associated enterprise from the obligation to comply with the otherwise applicable transfer pricing documentation requirements of State A and State B with respect to the Qualifying Transactions.

61. A Qualifying Enterprise and its relevant associated enterprise not electing treatment of their Qualifying Transactions under this memorandum of understanding shall be subject to the application of

the transfer pricing and documentation rules of [State A] and [State B] as if this memorandum of understanding were not in force.

62. All disputes with regard to the application of this memorandum of understanding shall be referred to the competent authorities of [State A] and [State B] for resolution by mutual agreement.

63. The competent authorities of [State A] and [State B] may exchange information where necessary to carry out this agreement under the provisions of [Article 26] of the Treaty.

Termination of the Agreement

64. Either State A or State B may terminate this memorandum of understanding at any time upon written notice to the competent authority of the other Contracting State and publication of such notice. Such termination will have effect for taxable years of Qualifying Enterprises beginning after the last day of the calendar year in which delivery and publication of such notice of termination occurs.

EXHIBIT 2: DRAFT SAMPLE MOU ON LOW RISK DISTRIBUTION SERVICES

Preamble

65. The Competent Authorities of [State A] and [State B] have reached an understanding relating to the arm's length remuneration applicable to low risk distribution services performed by a Qualifying Enterprise resident in [State A] on behalf of an associated enterprise resident in [State B], and by a Qualifying Enterprise resident in [State B] on behalf of an associated enterprise resident in [State A] in the circumstances described herein. The purpose of this memorandum of understanding is to provide legal certainty to Qualifying Enterprises by establishing specific procedures to comply with the transfer pricing rules in [State A] and [State B] and to eliminate double taxation.

66. This memorandum of understanding is entered into under authority of Article [25] of the [Tax Treaty] (the "Treaty") between [State A] and [State B]. It implements the principles of Article [9] of the Treaty in the circumstances described herein. It applies to tax years of Qualifying Enterprises ending in calendar years [20__] through [20__].

Qualifying Enterprise

67. For purposes of this memorandum of understanding, a Qualifying Enterprise must have each of the characteristics described in this paragraph.

(a) The Qualifying Enterprise shall be a resident of a Contracting State for purposes of the Treaty and shall conduct business operations exclusively in such State.

(b) The predominant business activity of the Qualifying Enterprise shall be either the performance of marketing and distribution services in its State of residence on behalf of an associated enterprise (within the meaning of Article [9] of the Treaty) resident in the other Contracting State, or alternatively, the purchase by the Qualifying Enterprise of products from an associated enterprise resident in the other Contracting State for resale to unrelated customers in its country of residence.

(c) The Qualifying Enterprise shall have entered into a written agreement with the associated enterprise, prior to the commencement of the relevant taxable year of the Qualifying Enterprise, pursuant to which the associated enterprise assumes the principal business risks associated with the marketing and distribution activities of the Qualifying Enterprise and agrees to assure that the Qualifying Enterprise is compensated for its marketing and distribution activities at levels consistent with this memorandum of understanding.

(d) Annual research, development, and product engineering expense of the Qualifying Enterprise shall, in the aggregate, be less than [___] percent of its net sales revenue.

(e) The Qualifying Enterprise shall not engage in manufacturing or assembly functions with regard to the products it markets and distributes.

(f) The total marketing and advertising expense of the Qualifying Enterprise shall not exceed [________] percent of its net sales.

(g) The Qualifying Enterprise shall not engage in managerial, legal, accounting, or personnel management functions other than those directly related to the performance of its marketing and distribution activities.

(h) The finished product inventory of the Qualifying Enterprise shall not exceed [___] percent of the annual net sales of the Qualifying Enterprise, calculated on the basis of the average inventory held on the last day of each of the four quarterly periods during the relevant taxable year of the Qualifying Enterprise.

68. A Qualifying Enterprise may not:

(a) Conduct its principal operations in any of the following industries: [__________].

(b) Have annual net sales in excess of [________________].

(c) Have total assets in excess of [________________].

(d) Derive more than [____] percent of its net revenues from transactions other than Qualifying Transactions.

(e) Have undergone a transfer pricing audit in either [State A] or [State B] within the past [___] years which resulted in adjustments in excess of [________________].

Qualifying Transactions

69. For purposes of this memorandum of understanding, a Qualifying Transaction shall be (i) the rendering of marketing and distribution services by the Qualifying Enterprise on behalf of an associated enterprise resident in the other Contracting State and / or (ii) the sale of products to unrelated customers purchased by the Qualifying Enterprise from an associated enterprise resident in the other Contracting State, in each case without the interposition of other transactions or parties.

Determination of the Taxable Income of the Qualifying Enterprise

70. In the event a Qualifying Enterprise elects to apply the provisions of this memorandum of understanding:

(a) The net income before tax of the Qualifying Enterprise with respect to its Qualifying Transactions for the taxable year shall be in the range of [equal to] [__ to ___] percent of the total net sales of the Qualifying Enterprise.

(b) Accounting terms utilised in this memorandum of understanding shall be defined in accordance with generally accepted financial accounting principles in the residence country of the Qualifying Enterprise.

71. Each of [State A] and [State B] agree that compensation for Qualifying Transactions calculated in accordance with this memorandum of understanding shall be deemed to constitute an arm's length level of compensation for purposes of applying the transfer pricing rules of such State and the provisions of Article [9] of the Treaty.

Permanent Establishment

72. The Competent Authorities of [State A] and [State B] agree that the associated enterprise that is party to a Qualifying Transaction shall not be deemed to have a permanent establishment in the country of residence of the Qualifying Enterprise by virtue of the performance of low risk marketing and distribution services on its behalf by the Qualifying Enterprise or by virtue of the Qualifying Enterprise purchasing products from such associated enterprise in Qualifying Transactions for resale to unrelated customers.

Election and Reporting Requirements

73. A Qualifying Enterprise and the relevant associated enterprise may elect to apply the provisions of this memorandum of understanding consistently in [State A] and [State B] by filing a

notice with [______________] of [State A] and [____________] of [State B] no later than the due date for their respective tax return covering the Qualifying Transactions.

74. The required notice shall include:

- An affirmative statement that the taxpayers intend to apply and be bound by this memorandum of understanding;
- An affirmative statement that income and expense from Qualifying Transactions will be reported on a consistent basis in [State A] and [State B] in accordance with this agreement;
- A narrative description of the Qualifying Transactions;
- Identification of each of the associated enterprises that are parties to the Qualifying Transactions;
- Audited financial statements of the Qualifying Enterprise for the relevant year and sufficient additional financial and accounting information to demonstrate the status of the Qualifying Enterprise as a Qualifying Enterprise;
- A detailed calculation of the income of the Qualifying Enterprise from Qualifying Transactions applying the principles of this memorandum of understanding;
- A statement that the electing enterprise will respond within 60 days to any request of the tax authority of its residence country for information deemed necessary by such tax authority to verify qualification of the enterprise for treatment under this memorandum of understanding;

75. Satisfaction of the election and reporting requirements of this memorandum of understanding, and reporting income calculated in accordance with its terms in a timely filed tax return for the year, shall relieve the Qualifying Enterprise and its relevant associated enterprise from the obligation to comply with the otherwise applicable transfer pricing documentation requirements of State A and State B with respect to the Qualifying Transactions.

76. A Qualifying Enterprise and its relevant associated enterprise not electing treatment of their Qualifying Transactions under this memorandum of understanding shall be subject to the application of the transfer pricing and documentation rules of [State A] and [State B] as if this memorandum of understanding were not in force.

77. All disputes with regard to the application of this memorandum of understanding shall be referred to the competent authorities of [State A] and [State B] for resolution by mutual agreement.

78. The competent authorities of [State A] and [State B] may exchange information where necessary to carry out this agreement under the provisions of [Article 26] of the Treaty.

Termination of the Agreement

79. Either State A or State B may terminate this memorandum of understanding at any time upon written notice to the competent authority of the other Contracting State and publication of such notice. Such termination will have effect for taxable years of Qualifying Enterprises beginning after the last day of the calendar year in which delivery and publication of such notice of termination occurs.

EXHIBIT 3: DRAFT SAMPLE MOU ON LOW RISK RESEARCH AND DEVELOPMENT SERVICES

Preamble

80. The Competent Authorities of [State A] and [State B] have reached an understanding relating to the arm's length remuneration applicable to low risk research and development services performed by a Qualifying Enterprise resident in [State A] on behalf of an associated enterprise resident in [State B], and by a Qualifying Enterprise resident in [State B] on behalf of an associated enterprise resident in [State A] in the circumstances described herein. The purpose of this memorandum of understanding is to provide legal certainty to Qualifying Enterprises by establishing specific procedures to comply with the transfer pricing rules in [State A] and [State B] and to eliminate double taxation.

81. This memorandum of understanding is entered into under authority of Article [25] of the [Tax Treaty] (the "Treaty") between [State A] and [State B]. It implements the principles of Article [9] of the Treaty in the circumstances described herein. It applies to tax years of Qualifying Enterprises ending in calendar years [20__] through [20__].

Qualifying Enterprise

82. For purposes of this memorandum of understanding, a Qualifying Enterprise must have each of the characteristics described in this paragraph.

(a) The Qualifying Enterprise shall be a resident of a Contracting State for purposes of the Treaty and shall conduct business operations exclusively in such State.

(b) The predominant business activity of the Qualifying Enterprise shall be the performance of research and development services in its State of residence on behalf of an associated enterprise (within the meaning of Article [9] of the Treaty) resident in the other Contracting State.

(c) The Qualifying Enterprise shall have entered into a written agreement with the associated enterprise, prior to the commencement of the relevant taxable year of the Qualifying Enterprise, pursuant to which: (i) the associated enterprise assumes the principal business risks associated with the research and development services of the Qualifying Enterprise, including the risk that the research and development will not be successful; (ii) the Qualifying Enterprise agrees that all interests in intangibles developed through its research and development services shall belong to the associated enterprise; and (iii) the associated enterprise agrees to compensate the Qualifying Enterprise for its research and development services at levels consistent with this memorandum of understanding.

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

(e) The Qualifying Enterprise shall not utilise proprietary patents, know-how, trade secrets, or other intangibles in performing its research and development services other than those made available to it by the associated enterprise.

(f) The Qualifying Enterprise shall not engage in managerial, legal, accounting, or personnel management functions other than those directly related to the performance of its research and development services.

(g) The research and development programme carried out by the Qualified Enterprise shall be designed, directed and controlled by the associated enterprise.

83. A Qualifying Enterprise may not:

(a) Conduct its principal operations in any of the following industries: [___________].

(b) Have annual payroll and other operating expenses in excess of [_________________].

(c) Have total assets in excess of [_________________].

(d) Derive more than [____] percent of its net revenues from transactions other than Qualifying Transactions.

(e) Have undergone a transfer pricing audit in either [State A] or [State B] within the past [___] years which resulted in adjustments in excess of [_________________].

Qualifying Transactions

84. For purposes of this memorandum of understanding, a Qualifying Transaction shall be the rendering of research and development services by the Qualifying Enterprise on behalf of an associated enterprise resident in the other Contracting State without the interposition of other transactions or parties.

Determination of the Taxable Income of the Qualifying Enterprise

85. In the event a Qualifying Enterprise elects to apply the provisions of this memorandum of understanding:

(a) The net income before tax of the Qualifying Enterprise with respect to its Qualifying Transactions for the taxable year shall be in the range of [equal to] [__ to ___] percent of the total costs of the Qualifying Enterprise incurred in performing research and development services, excluding from the base for computing the profit percentage only net interest expense, currency gain or loss, and any non-recurring costs.

(b) Accounting terms utilised in this memorandum of understanding shall be defined in accordance with generally accepted financial accounting principles in the residence country of the Qualifying Enterprise.

86. Each of [State A] and [State B] agree that compensation for Qualifying Transactions calculated in accordance with this memorandum of understanding shall be deemed to constitute an arm’s length level of compensation for purposes of applying the transfer pricing rules of such State and the provisions of Article [9] of the Treaty.

Permanent Establishment

87. The Competent Authorities of [State A] and [State B] agree that the associated enterprise that is party to a Qualifying Transaction shall not be deemed to have a permanent establishment in the country of residence of the Qualifying Enterprise by virtue of the performance of low risk research and development services on its behalf by the Qualifying Enterprise.

Election and Reporting Requirements

88. A Qualifying Enterprise and the relevant associated enterprise may elect to apply the provisions of this memorandum of understanding consistently in [State A] and [State B] by filing a

notice with [______________] of [State A] and [_______________] of [State B] no later than the due date for their respective tax returns covering the Qualifying Transactions.

89. The required notice shall include: An affirmative statement that the taxpayers intend to apply and be bound by this memorandum of understanding;

- An affirmative statement that income and expense from Qualifying Transactions will be reported on a consistent basis in [State A] and [State B] in accordance with this agreement;
- A narrative description of the Qualifying Transactions;
- Identification of each of the associated enterprises that are parties to the Qualifying Transactions;
- Audited financial statements of the Qualifying Enterprise for the relevant year and sufficient additional financial and accounting information to demonstrate the status of the Qualifying Enterprise as a Qualifying Enterprise;
- A detailed calculation of the income of the Qualifying Enterprise from Qualifying Transactions applying the principles of this memorandum of understanding;
- A statement that the electing enterprise will respond within 60 days to any request of the tax authority of its residence country for information deemed necessary by such tax authority to verify qualification of the enterprise for treatment under this memorandum of understanding;

90. Satisfaction of the election and reporting requirements of this memorandum of understanding, and reporting income calculated in accordance with its terms in a timely filed tax return for the year, shall relieve the Qualifying Enterprise and its relevant associated enterprise from the obligation to comply with the otherwise applicable transfer pricing documentation requirements of State A and State B with respect to the Qualifying Transactions.

91. A Qualifying Enterprise and its relevant associated enterprise not electing treatment of their Qualifying Transactions under this memorandum of understanding shall be subject to the application of the transfer pricing and documentation rules of [State A] and [State B] as if this memorandum of understanding were not in force.

92. All disputes with regard to the application of this memorandum of understanding shall be referred to the competent authorities of [State A] and [State B] for resolution by mutual agreement.

93. The competent authorities of [State A] and [State B] may exchange information where necessary to carry out this agreement under the provisions of [Article 26] of the Treaty.

Termination of the Agreement

94. Either State A or State B may terminate this memorandum of understanding at any time upon written notice to the competent authority of the other Contracting State and publication of such notice. Such termination will have effect for taxable years of Qualifying Enterprises beginning after the last day of the calendar year in which delivery and publication of such notice of termination occurs.