Safe harbours in transfer pricing (3/24/18)

The process of determining and administering arm’s length transfer pricing (TP) often takes a lot of effort, time and money. Safe harbour rules applicable in certain circumstances can ease some of those burdens and give the taxpayer more certainty.

What’s a safe harbour?

A safe harbour is a set of rules that a country passes into its national TP rules and that is automatically applied by its tax authority. A safe harbour usually allows the taxpayer to arrive at an arm’s length price in a specified way, for example:

- taking a simplified approach to TP analysis determined by the tax authority, a simplified TP method, a certain markup or markup range for a particular type of services (usually support services);
- releasing a certain category of taxpayers or type of transactions from all or some of the general TP rules.

A safe harbour usually applies to a certain category of taxpayers (e.g. those with revenue not exceeding a stated threshold) or to a certain type of transactions and releases the taxpayers from particular obligations that are otherwise imposed under the country’s general TP rules.

Advantages and disadvantages of safe harbours

Advantages of safe harbour rules include:

- A simplified assessment of the arm’s length price of a controlled transaction and reduced costs of determining and documenting fair conditions for qualifying controlled transactions;
- Confidence that a tax authority applying the safe harbour standard will accept the prices of controlled transactions without further review;
- A tax authority can shift its administrative resources from auditing low-risk transactions that qualify for a safe harbour to auditing taxpayers and transactions that are more complicated or involve a higher risk;
- Mitigating or eliminating the risk of litigation;
- A solution that helps increase foreign direct investment in the country that has adopted safe harbour rules.

It’s important to note that in assessing the arm’s length nature of a particular transaction, the safe harbour rules are not binding (place no restrictions) on any tax authority whose national TP rules don’t include this principle. This means that if the same TP audit of a controlled transaction is conducted by the customer’s and the supplier’s country of residence, there is a risk that the country where the safe harbour standard doesn’t operate can insist on doing a TP analysis under applicable general TP rules. Usually such a situation might arise where there is concern about possible shifting of profits and excessive reporting of taxable income in the country that offers a safe harbour.

Thus, while safe harbour rules seem to considerably relieve the taxpayer, this principle might have some adverse effects:

1. Adopting safe harbour rules in a particular country can create taxable income that doesn’t satisfy the arm’s length standard. Where a safe harbour provides for using a simplified TP method, that

method is unlikely to match the one that would be appropriate for the taxpayer's facts and circumstances under normal TP conditions.

2. Safe harbours can increase the risk of taxation in both countries or neither country if only one of the countries involved in the transaction adopts such rules. Taxpayers that have chosen safe harbours cannot usually bring the issue of double taxation before competent institutions where this is due to the use of safe harbours. Any relief from double taxation available to a taxpayer that has opted for the safe harbour treatment will be awarded abroad only if the taxpayer can prove that the result of using a safe harbour satisfies the arm's length standard.
3. Safe harbours can create tax planning opportunities.
4. A safe harbour tax treatment that creates advantages might discriminate against a particular category of taxpayers and distort competition. The adoption of safe harbours creates two distinct sets of rules: one requires an arm's length price, and the other demands compliance with a different and simplified set of conditions.