TAX MANAGEMENT

TRANSFER PRICING

REPORT

Short Cuts for Small Fry: Why the IRS Should Reconsider Transfer Pricing Safe Harbors for Small Taxpayers, Transactions

The author makes the case for reconsideration of a safe harbor for relatively small firms and transactions, addressing the reasons the IRS has resisted the idea in the past and finding those objections surmountable today.

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It is time to seriously consider safe harbor transfer pricing rules for small taxpayers and transactions. Why, and why now? Revenue, resources, and respect.

The Internal Revenue Commissioner and the Assistant Commissioner (International) have declared that transfer pricing is one of the highest IRS priorities in terms of revenue and enforcement. Transfer pricing has attracted front page attention for many years, including Bill Clinton's famous declaration, during his 1992 Presidential bid, that transfer pricing was an evil that accounted for $45 billion of lost revenue.[1] The 1990 and 1992 Pickle House Ways & Means Committee hearings (focusing on the electronics, automotive, and motorcycle industries) were followed by critical amendments to the Section 6662(e) penalty regime and revamped Section 482 regulations. Under the amended Section 6662(e), the only way to avoid 20 percent and 40 percent penalties in the event of a transfer pricing adjustment above certain thresholds is to have maintained extensive contemporaneous documentation demonstrating a reasonable attempt to comply with the arm's-length standard and the Section 482 rules.

A. The Lead-Up

The objective of the contemporaneous documentation approach was to force taxpayers to formulate and assess transfer pricing methods up front *and* to use that analysis to improve the aim of IRS transfer pricing examinations. The IRS reinforced this hammer through directives to the field in 2003 and 2005 and related revisions to the Internal Revenue Manual,[2] which mandated that IRS examiners seek Section 6662(e) documentation as a kick-off document request in every ex-

[1] This also was an example of the often misleading characterization of transfer pricing as a technique for avoiding taxes rather than an inherent requirement of cross-border activity. See D. Falk, "Misrepresentation of Transfer Pricing in the Mainstream Media," 19 *Transfer Pricing Report* 829, 11/18/10.

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[2] IRM Exhibit 4.46.3-6 (3/1/06).

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amination of business entities with cross-border relationships.[3]

Foreign tax authorities gradually followed suit, adding their own variations, and efforts to stem the proliferation of reporting requirements or move toward standardization have been limited.[4]

As a result, a large global industry is now dedicated to the preparation of contemporaneous documentation, ranging from the Big Four accounting firms down to ''do it yourself'' software, and enormous internal and external resources are devoted to this endeavor.

One seldom sees a final documentation study that does not confirm that the transactions covered by the analysis were being conducted at arm's length in satisfaction of the Section 482 requirements.[5] This high apparent compliance level results partly from the flexibility of the Section 482 standards, and partly from the fact that Section 6662(e) did accomplish a key objective: taxpayers *do* now think proactively about transfer pricing and in most cases try to comply.

At the same time, IRS examiners have been intensely auditing those transfer pricing situations that are not protected by advance pricing agreements, to the extent IRS resources permit. These situations often involve big-ticket items for major multinational corporations, and the potential for transfer pricing mischief together with the revenue at stake makes these audits both appropriate and worthwhile from a governance perspective. Increasingly, though, the taxpayers caught up in this fire are small to medium-sized businesses, which almost never have APAs.

The special small business taxpayer APA procedure that has been offered by the APA Program since 1996 is a noteworthy effort to make APAs attractive to small taxpayers. See section 9 of Rev. Proc. 2006-9, 2006-1 C.B. 278, and Notice 98-65, 1998-2 C.B. 803. Small business taxpayer APAs currently account for about 10 percent of all APAs, but have apparently not lived up to their potential.[6]

As for transfer pricing studies, many small firms will not even have prepared contemporaneous documentation in the first place due to cost, ignorance, or appropriate application of the statutory minima; in other cases, IRS examiners may consider the documented analysis inadequate and press aggressive positions. (The existence of adequate documentation never means that its results will be accepted by the IRS, only that if there is an adjustment by the IRS, no penalty will be imposed.) The increasing audit activity is predictable, given cookie-cutter studies and the quest for revenue. Recent IRS hiring of additional international examiners, economists, and Competent Authority personnel supports this effort, albeit with protestations that the need still outstrips available resources.

Laudably, one of the objectives of the recent restructuring of the IRS Large Business and International division is to improve the quality and consistency of transfer pricing examinations across the country, since to date the experience and judgment of examiners varies widely. Defense against a transfer pricing audit adjustment is not a matter of finding supportive case law, but rather involves factual and economic analysis of the taxpayer group's entire cross-border business, as well as expensive professional assistance.

What is everyone trying to show? Whether the transactions satisfy the amorphous arm's-length standard. This article is not intended to take on the debate about the appropriateness of the arm's-length standard; there are significant and respectable views on both sides. Rather, the point is that it is a flexible and fairly subjective standard, since there are few truly close comparables available for most transactions, and it is common practice to determine a range of acceptable results. Just as taxpayers usually can find a way to show that their own transfer pricing satisfies the standard, IRS examiners can find a way to show that it fails. The stage is set for frequent audit adjustments and continuing debates.

And the endgame? To encourage taxpayers to be reasonable about their transfer pricing and to enable the IRS to collect an appropriate amount of revenue. The cost, however, is extensive and expensive documentation and controversy.[7] Although there are also positives, in that increased attention to transfer pricing improves compliance and articulated analysis facilitates audits, the cost/benefit analysis for small taxpayers and transactions is debatable. Logically, one would expect the IRS's limited resources to be more effectively deployed by focusing on large taxpayers rather than on small taxpayers.

Indeed, it may be that the IRS in fact already sharpens its focus in this manner, while trying to communicate that all taxpayers—small and large—must abide by the transfer pricing rules. But since obviously it is not feasible for the IRS to audit most small taxpayers, and since small taxpayers may have trouble understanding or complying with the intricacies of the current rules, or simply sidestep them through ignorance or design, there must be considerable amounts of revenue left on the table.

B. Argument for a Safe Harbor

This article submits that the desired objectives could be achieved—at considerably less resource and time cost, with considerably less friction and business distraction, and with enhanced revenue flow as well as respect for tax administration—by establishing simple and acceptable pricing mechanisms for most kinds of

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[3] See 11 *Transfer Pricing Report* 827, 2/5/03; 14 *Transfer Pricing Report* 154, 6/22/05.

[4] Examples are the Pacific Association of Tax Administrators' revised transfer pricing documentation package issued in 2003 (11 *Transfer Pricing Report* 955, 3/19/03) and the European Commission's transfer pricing documentation code of conduct, proposed in 2005 and issued in 2006 (15 *Transfer Pricing Report* 165, 7/5/06).

[5] Durst, Michael C., ''Making Transfer Pricing Work for Developing Countries,'' 129 *Tax Notes* 1109 (12/6/10). The author states that ''contemporaneous documentation has become an empty ritual, perhaps giving a veneer of legitimacy to arm's length transfer pricing but serving no other apparent purpose.''

[6] See the IRS's 2010 report to Congress on the APA Program, IRS Announcement 2010-21, 2010-5 I.R.B. 551 (4/12/10), which stated, ''[O]ur experience is that such cases require nearly the same level of resources and the same commitment of time as non-SBT cases.''

[7] Although APAs have managed to minimize controversy from the beginning, they primarily serve large taxpayers, at considerable cost. The Appeals Office, together with the Competent Authority process, also play important roles in ultimately resolving transfer pricing cases, but at the cost of working through additional administrative levels.

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transactions undertaken by relatively small taxpayers or for relatively small transactions per se. Such mechanisms are referred to below as safe harbors. That does not mean that the target returns are not arm's-length, or that they are somehow outside of the equitable application of Section 482—only that the range of results is preset to facilitate compliance.[8]

When the Section 482 regulations were modernized in 1994, the IRS expressly rejected the inclusion of safe harbors, primarily because of concern about potential misuse or abuse. Of note, however, the 1993 temporary regulations *had* included a small-taxpayer safe harbor. Although that safe harbor was dropped in the final regulations, there remains a placeholder at Regs. §1.482-1(h), ''Small Taxpayer Safe Harbor,'' and the preamble to the final regulations requested comments on safe harbor approaches that would not suffer from various cited deficiencies.

The intervening decades provide experience—both with transfer pricing itself and with the results of the road chosen by the IRS—suggesting that safe harbors *would* be viable and desirable now, for all parties. This article takes a fresh look at the original considerations from the perspective of today's transfer pricing environment and puts forth ideas for a workable and productive safe harbor approach. Indeed, development of some such system seems essential to put transfer pricing in its proper place in the business lives of taxpayers and to achieve the compliance objectives of LB&I on a principled and efficient basis. There are many moving parts and competing considerations involved in designing a suitable safe harbor approach, and it may take guts to accept the ''rough justice'' aspect. The idea is to start the dialogue.[9]

C. Prior Consideration of Safe Harbors

Safe harbor concepts are not new in transfer pricing. The current Section 482 regulations contain a safe harbor for intercompany interest rates based on applicable federal rates[10] as well as the safe harbor-like ''services cost method'' for intercompany services, which grew out of the cost-only safe harbor in the 1968 regulations,[11] and the 80-120 exceptions to the periodic adjustment/commensurate-with-income rules for intangibles.[12] Indeed, compliance with the requirements for qualified cost sharing arrangements under Regs. §1.482-7T effectively operates as a safe harbor against the requirement to price intercompany licenses of intangibles, though the IRS has steadfastly refused to characterize it as such.[13] The taxpayer community has urged consideration of broader transfer pricing safe harbors on various occasions but, after consideration, the IRS has spurned the idea. Several key surfacings of the concept are summarized below.

An early manifestation of the government view was set forth by Stanley S. Surrey, Assistant Secretary of the Treasury for Tax Policy, in his seminal article on transfer pricing.[14] He states:

> A typical suggestion is that the Regulations should supply a ''mechanical safe haven'' in the area of the pricing of goods. Much as this solution appeals as blissful to our tax administration as to the taxpayers who suggest it, we have not taken this route. The reason is that no satisfactory device has yet been suggested or worked out. . . . The ''safe haven'' here will, therefore, have to lie in a sensible, reasonable administration of the Regulations themselves.[15]

A safe harbor can take various forms. At one extreme, satisfaction of specified requirements can lead to complete exemption from certain substantive or procedural requirements.[16] More typically, a safe harbor applies a simplified set of rules to achieve compliance, if the taxpayer meets the threshold qualifications.[17] The rules can be provided by statute, regulation, administrative guidance, or administrative practice.

1. Section 482 White Paper

In 1988, Treasury and the IRS completed a major study of transfer pricing issues that culminated in the Section 482 white paper.[18] Chapter 9 (''The Need for Certainty: Are Safe Harbors the Solution?'') was devoted to consideration of potential safe harbors. It reviewed various proposed types of safe harbors, including pricing based on industry norms, minimum U.S. profit levels, profit split mechanisms, an ''insubstantial tax benefit test'' (available where the foreign tax rate is

[8] To quote again from the Durst article: ''Required minimum margins and markups . . . can properly be described not as a departure from the arm's-length approach but as an application of it.''

[9] Durst urges consideration of safe harbors in the more macro context of establishing a simplified approach to transfer pricing in developing countries. Durst would dispense with contemporaneous documentation in favor of government-prescribed minimum margins or markups for broad categories of situations. The system would cover companies whose sales or operating expenses were below certain levels (for example, $1 billion sales or $200 million operating expenses) and that do not perform R&D other than where ownership of resulting intangibles is clearly assigned to the parent company. The program would be mandatory, subject to discretionary exceptions for startup situations. Location savings would be addressed by competent authorities on a country-wide basis. APAs could be used to handle problematic bilateral situations or certain permitted exceptions. See 29 *Tax Notes* 1109 (12/6/10).

[10] Regs. §1.482-2(a)(2)(iii).

[11] Regs. §1.482-9(b) (2009), §1.482-2(b)(3) (1968).

[12] Regs. §1.482-4(f)(2)(ii).

[13] See Lewis and Kochman, ''Option Wars: Upping the Ante for Cost Sharing Arrangements,'' 31 *Tax Management International Journal* 547, 11/8/02; and ''The Final Word on Stock Options in Cost Sharing Agreements?'' 32 *Tax Management International Journal* 651, 12/12/03. See also the IRS's action on decision regarding *Xilinx Inc. v. Comr.*, 2010-33 I.R.B. 1 (8/16/10).

[14] ''Treasury's Need To Curb Tax Avoidance in Foreign Business Through Use of 482,'' 28 *Journal of Taxation* 75 (February 1968).

[15] See also General Accounting Office, *Report by the Comptroller General to the Chairman, House Committee on Ways and Means*, ''IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations'' (1981).

[16] See for example, the U.K. exemption of small or medium-sized enterprises from the transfer pricing arm's-length rule, discussed below.

[17] Some non-transfer pricing examples include estimated tax safe harbors, Section 401(k) safe harbor plans, Section 530 worker classification rules, hobby loss presumptions under Section 183(d), and theft loss determinations for Ponzi scheme victims under Rev. Proc. 2009-20, 2009-14 I.R.B. 749, 4/6/09.

[18] Treasury, IRS, ''A Study of Intercompany Pricing,'' Notice 88-123, 1988-2 C.B. 458 (10/18/88).

close to the U.S. tax rate), and burden-of-proof shifting. The white paper's conclusions were:

■ Historical experience with safe harbors indicates that they generally result in unwarranted windfalls for taxpayers, without significant benefits for the government.

■ In the highly factual Section 482 context, no one safe harbor or combination of safe harbors has yet been proposed that would be useful but not potentially abusive.

■ While the possibility that useful safe harbors could be developed is not categorically rejected, additional Section 482 safe harbors are not recommended at the present time.

The white paper's attitude appears to have relied on one key premise—that safe harbors ''all have one common element that makes them both attractive to the taxpayer and potentially troublesome to the government: they generally would serve only to reduce tax liability.'' That is, under a concept of adverse selection, the only taxpayers who would use a safe harbor are those for whom it ''would produce a lower tax liability than the appropriate normative rule''; taxpayers in the converse situation would apply the normative rule. While conceding that reduction of administrative costs or the need for certainty might encourage some taxpayers to use a safe harbor ''in marginal situations even if application of the normal rule would result in a tax savings,'' the clear implication of the white paper is that those situations would be few and far between and, in general, ''the only benefit a safe harbor offers from the Service's perspective is a saving of administrative costs.''

The white paper did not offer statistical support for its conclusions. It commented that the 1968 absolute safe harbor interest rates in Regs. §1.482-2(a)(2)(ii) of between 4 percent and 6 percent ultimately needed to be replaced by a variable rate tracking the federal rates under Section 1274(d), and that the 1968 safe harbor for tangible property rentals (a formula based primarily on depreciable basis and useful life) was repealed in 1988 because of its over-generosity and not replaced. Extrapolating from this, the white paper described the government's experience as being that safe harbors generally have treated amounts as arm's-length that tended to differ from market rates, exacerbated by the types of property that have created transfer pricing problems under Section 482:

> In any event, the fundamental deficiencies of safe harbors are not resolved by continually reviewing and revising the rates, or by intentionally setting the safe harbor on the conservative side for protection of the revenue. . . . If safe harbors are set at non-market rates, they will be used only by taxpayers that will benefit by making or receiving payments at those rates.

These comments reflected, among other things, an impression that safe harbors tend to be non-market. This perception also may have been due to the white paper's focus on high-profit intangibles. For example, regarding the type of safe harbor suggested below, the white paper dispensed with ''pricing based on industry norms'' on the basis that it is contrary to the legislative history of the 1986 legislative changes to Section 482, which added the commensurate-with-income rule. The white paper opined:

> Industry norms generally do not reflect arm's length prices for highly profitable intangibles. Accordingly, any safe harbors based on industry norms or statistics would permit transfer prices that would be far different from the arm's length standard in the most significant cases.

As to the somewhat related minimum-U.S.-profit approach (for example, 50 percent of system profit), the white paper felt it would be inconsistent with the case-by-case factual determination that is necessary to measure the economic contribution made by each of the related parties. Moreover, it was felt that such a requirement would be objectionable to other countries when intangibles were developed outside the United States.

Practitioners disagreed with the white paper's conclusions. The American Bar Association, for example, in comments dated July 11, 1989, said:

> We believe that the white paper has an unnecessarily negative attitude towards safe harbors. By emphasizing perfection and the collection of every last dollar of possible revenue, the white paper fails to recognize the benefit to the government of simpler mechanisms and a more administrable system.

At the time, the ABA was interested in a rebuttable, profit split-type safe harbor. The New York City Bar Taxation Section wrote on April 24, 1989:

> Essentially, safe harbors are rejected because they always operate to reduce tax liability and never to increase it. This ignores the fact that safe harbors provide an element of certainty in areas where there may not be a ''right'' answer and thus can play an important role in encouraging taxpayer compliance, thereby increasing tax revenue. . . . We believe the Treasury and the Internal Revenue Service should seriously consider the adoption of safe harbors, particularly in cases involving transfers of intangibles in non-tax haven situations.

2. 1992 Proposed Regulations

The first set of regulations emanating from the white paper was proposed in 1992. Although this set included the first taste of today's comparable profits method (then known as the comparable profit interval, or CPI), a principal focus was the pricing of intangibles and the commensurate-with-income rule. The regulatory preamble solicited comments on broad use of a safe harbor CPI to provide certainty in the pricing of intangible transactions. An example given was application of published rates of return on assets (for example, the 11 percent average ratio for U.S. publicly held companies from 1980 to 1989).

The preamble was tilted against such a safe harbor, saying it ''raises significant issues that may outweigh the benefits of simplicity and certainty,'' and effectively doomed the effort by raising almost insoluble questions, including comparison with wider variations of returns observed in the marketplace, differences in assets held by different taxpayers, shifting of assets among related taxpayers, differences in debt-to-equity ratios relative to the country-wide average embodied in the total asset numbers, need for industry-specific intervals, and adjustments to book values to correct distortions in reported asset values.

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3. 1993 Temporary Regulations

Notwithstanding the concerns evinced in the 1992 preamble, the 1993 temporary rules *did* contain a small taxpayer safe harbor, found in Regs. §1.482-1T(f)(1).[19] The safe harbor was not limited to intangibles transactions, but would have been broadly applicable to any kind of related-party situation if either the U.S. party or the foreign counterparty had less than $10 million of gross receipts for the year in issue (for each party, measured as an aggregate of U.S. or foreign affiliates, respectively).

The operative mechanism of the safe harbor was that the U.S. taxpayer must determine its aggregate taxable income from all controlled transactions by applying "the appropriate profit level indicator that the Commissioner provides in applicable revenue procedures." The election into the safe harbor would be made with a timely filed tax return and would be permanent, requiring the consent of the IRS Commissioner to revoke or discontinue it. A limited anti-abuse rule was included, potentially applicable in the case of a taxpayer moving in and out of eligible status.

4. 1994 Final Regulations

Ultimately, however, the IRS backed away from the 1993 approach. In declining to include a safe harbor provision in the 1994 final regulations, the preamble explained:

> This provision [the safe harbor in the 1993 proposed regulations] was never implemented because the IRS did not issue the profit level indicators required to apply the provisions of the safe harbor. There are three reasons why this provision was not included. *First, treaty partners had expressed concern that the safe harbor might cause taxpayers to overreport their U.S. taxable income and underreport their foreign taxable income.* They requested that the safe harbor provide that electing taxpayers be required to report an amount of profit in the United States that was *less than* that expected under a strict application of the arm's length standard.[20] Such an approach was not acceptable. *Second, it would have been necessary to add a number of anti-abuse provisions in order to eliminate the possibility of inappropriate use of the provision by large taxpayers.* Commenters had already expressed concern that the existing restrictions were excessively complex and burdensome given the level of sophistication of its intended beneficiaries. *The final concern was that both taxpayers and the IRS might give undue weight to the published measures of profitability in cases not governed by the safe harbor.* It was not possible to address these problems consistently with the overall objective of alleviating the compliance burden for small taxpayers. *Moreover, the concern regarding the compliance burden of small taxpayers has been addressed to some extent by the regulations under section 6662(e), which provide that one of the factors to be taken into account in determining whether a taxpayer reasonably applied a method to determine its transfer prices is the taxpayer's experience and knowledge.* Comment is requested on alternative approaches to the small taxpayer safe harbor that would not suffer from the deficiencies noted above. [Emphasis added.]

5. OECD 1995 Consideration of Safe Harbors

Around the same time, the Organization for Economic Cooperation and Development in its 1995 transfer pricing guidelines considered the use of safe harbors as well. However, the organization ultimately recommended against the adoption of safe harbors, concluding that the problems of safe harbor approaches outweighed their potential benefits. The negative considerations included:

- The safe harbor may displace a more appropriate method in specific cases, such as a CUP or other transactional method, or sacrifice accuracy—and thus be inconsistent with the arm's-length method.
- Safe harbors are likely to be arbitrary, and sufficient refinement to satisfy the arm's-length standard would impose burdens on the tax authority.
- Shifting income to the safe harbor jurisdiction to satisfy the safe harbor could undermine compliance in the foreign jurisdiction, and also lead to the prospect of double taxation.
- Competent authority support from the safe harbor jurisdiction should be made unavailable as a consequence of the election, so that relief could be obtained only by the taxpayer convincing the other country that its results were arm's-length.
- Foreign tax authorities may find it necessary to audit more extensively situations where a safe harbor was elected abroad to avoid revenue loss, thus shifting administrative burden to such countries.
- Tax planning opportunities might be created—for example, for relatively profitable companies—including shifts to low-tax countries or tax havens.
- Equity and uniformity concerns.

The OECD summarized its conclusions as follows in section 4, paragraphs 120-122:

> The foregoing analysis suggests that while safe harbours could accomplish a number of objectives relating to the compliance with and administration of transfer pricing provisions, they raise fundamental problems. They could potentially have perverse effects on the pricing decisions of enterprises engaged in controlled transactions. They may also have 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. More importantly, safe harbours are generally not compatible with the enforcement of transfer prices consistent with the arm's length principle.
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> . . . While more flexible administrative practices toward smaller taxpayers are not a substitute for a formal safe harbour, they may achieve, to a lesser extent, the same objectives pursued by safe harbours.

[19] The safe harbor from the 1993 regulations appears in the Text section of this Special Report.

[20] See, for example, the 1993 task force report by the OECD Committee on Fiscal Affairs, commenting on the safe harbor in the temporary IRS regulations, which recommended that the IRS PLIs "be chosen with a view to providing the taxpayer with a result that is more likely to be favorable than that which would be achieved under a strict application of the arm's length standard," presumably to avoid excessive income shifting to the United States.

D. A Rebuttal to Asserted Deficiencies

This section comments on the deficiencies identified by the IRS and the OECD in their 1994-95 commentaries, from a vantage point almost 20 years later.

1. Treaty Partners' Concern with Overreporting of U.S. Income

A clear theme in the cited deficiencies was that income might be shifted to the safe harbor country to the detriment of the counterpart country, either in terms of loss of revenue or heightened monitoring activity to prevent abuses. This concern arguably has abated.

First, one must note that this type of concern existed, on a larger scale, even without a safe harbor, since treaty partners' concern with potential overreporting of U.S. income applied generally to the 1994 regulations' CPM, especially when combined with the new penalty structure. There was a general perception that where the U.S. affiliate was the tested party, application of CPM would effectively guarantee it a certain level of profitability. Indeed, the IRS's eventual widespread use of CPM, together with its typical rejection of loss comparables and the general use of an interquartile range, has effectively resulted in positive target profit margins for the U.S. affiliate.

However, CPM is no longer novel or unique to the United States. The similar concept in the 1995 OECD guidelines, the transactional net margin method, has become widely utilized worldwide. Although the OECD guidelines noted that the method was one-sided and designated it, along with profit split, as a method of last resort, the 2010 update of the OECD guidelines removed the last-resort modifier and now put TNMM approximately on a par with other transfer pricing methods.[21] Likewise, penalty regimes on a par with Section 6662(e) have proliferated.

Second, the initial perception of the IRS as an aggressive transfer pricing adjuster, along with revenue considerations, over time goaded other countries into equally or more aggressive transfer pricing enforcement themselves. Most new U.S. Competent Authority cases today (over 80 percent in recent years) involve foreign-initiated adjustments. Not only does this situation belie the characterization of the counterpart country as a potential victim, it adds leverage and evenhandedness to the establishment of appropriate safe harbor ranges.

Third, with the growth of CPM and foreign attention to transfer pricing methods, all countries have developed vastly more experience with transfer pricing and a greater awareness of appropriate profit levels for many industries and types of transactions. The scads of individual and industry analyses by accounting and economist firms, along with internal development by examination and APA units of the governments, have created huge databases of potentially usable information. While ''rules of thumb'' have been decried as methods in themselves, there is no doubt that they exist.

Fourth, foreign countries—and their taxpayer constituents—are experiencing first-hand the increased burdens of transfer pricing documentation, compliance, and controversy. This has been stimulated by the burgeoning global reach of business enterprises, large and small, together with the visibility of transfer pricing as a ripe revenue source.

In short, our treaty partners should be considerably less exercised today about potential overreporting of U.S. income under a safe harbor regime, particularly if limited to relatively small taxpayers and transactions. They already have instituted and expanded compliance resources to snag major transfer pricing abuse—and must be experiencing the same resource constraints as the IRS.[22] Their taxpayers have the same problems that U.S.-based taxpayers have. If anything, one would expect foreign jurisdictions to be fairly eager to adopt minimum profit requirements in their own jurisdictions (when the simpler, tested party resides there) so as to be freed to pursue larger transfer pricing cases themselves. Given the wealth of pertinent data developed over the years, it should be considerably easier to determine acceptable profit ranges for small cases. In addition, there are numerous forums for discussing this type of issue, such as the OECD, PATA, the Joint International Tax Shelter Information Centre (JITSIC), and the EU Transfer Pricing Forum (discussed below). Thus it is submitted that the principal topic to be discussed today likely would be how to set the ranges, not whether a safe harbor is a good idea.

2. Need for Anti-Abuse Provisions to Preclude Inappropriate Use by Large Taxpayers; Misuse by Others of Published Measures of Profitability

The second and third deficiencies mentioned in the IRS's 1994 preamble essentially were the same—the risk of arguments from taxpayers outside the covered class that the same rules and ranges should apply to them. Such arguments could be anticipated to arise from either taxpayers who fail the small taxpayer definition or IRS examiners applying the safe harbor ranges to large taxpayers or non-electing small taxpayers.

The first rejoinder to this concern is ''just say no.'' Presumably reasonably appropriate regulatory language to this effect could be drafted.[23]

More pragmatically, it has become evident that with or without explicit safe harbors, the IRS and other governments already are applying their now-extensive experience with large numbers of taxpayers in particular industries or situations to evaluate individual taxpayers by reference to rule-of-thumb ranges. This is driven in part by laudable considerations of consistency and equity, but also by the practical constraints of dealing with endless cases and limited publicly available data. (The same comparables crop up time after time in many different situations, and the ultimate profit ranges are seldom markedly different.)

That is, with both the IRS and foreign tax authorities having developed and gotten comfortable with informal administrative safe harbors, and having a better handle

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[21] OECD, revision of Chapters I-III of the transfer pricing guidelines, 7/22/10, paragraphs 2.1-2.10.

[22] Note that informal understandings between the IRS and Mexican tax authorities over the years regarding the profitability of maquiladoras have operated as cross-border safe harbors for these kinds of reasons.

[23] See, for example, IRS Notice 2007-9, 2007-1 C.B. 401 on the ''look-thru'' exception under Section 954(c)(6).

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on appropriate ranges, it is a much smaller step to the adoption of explicit safe harbors.

The concern with misuse by large taxpayers arguably has been mitigated to a significant extent by the greater balance of transfer pricing enforcement among developed countries, as well as the increased use of competent authority. The bilateral forces at play in competent authority cases are a great leveler. Moreover, the post-1994 worldwide proliferation of bilateral APA programs now accommodates much of the large taxpayer population.

At bottom, this concern should be manageable, if not moot.

Indeed, to play devil's advocate, if safe harbors are developed on the basis of reasonable ranges, what is so bad about other taxpayers using them? (As discussed below, a safe harbor should be able to use arm's-length ranges; there is no need to use non-market levels.) More broadly applicable safe harbors might well be appropriate, but that is a subject for another day.[24]

3. Adequacy of Informal Relief for Small Taxpayers

The suggestion in the IRS 1994 preamble that examiners' sensitivity in applying the Section 6662(e) regulations to small, unsophisticated taxpayers would serve as a de facto safe harbor sounded half-hearted at the time and seems absurd today. In the first place, the documentation rules apply only to penalty assertions, not to transfer pricing adjustments themselves. Given the statutory threshold for the application of the Section 6662(e) penalties (and, concomitantly, its contemporaneous documentation requirements),[25] small taxpayers are more likely concerned with the adjustments themselves than with the penalty provisions. However, if cross-border transactions underlie a significant part of a taxpayer's business, 10 percent of gross revenue can be exceeded even by a small taxpayer. Anecdotally, application of a lesser audit standard to small taxpayers is not evident, although small transactions of large taxpayers, or of taxpayers with APAs, sometimes may receive less scrutiny.

The OECD similarly had suggested that ''more flexible administrative practices toward smaller taxpayers'' may achieve the same objectives as safe harbors, and others may feel that audit forbearance by the IRS field is a preferable way to reduce the burden on small taxpayers. This is a seriously debatable point: if such a practice is broadly recognized, the potential abuse and inattention by small taxpayers could be significant. Moreover, fair and enlightened application of such a standard demands careful administration. So the IRS (and its foreign counterparts) still must maintain a credible enforcement program.

Thus small taxpayers are caught in the middle. Their potential exposure may make it advisable to prepare contemporaneous documentation, but the reports they obtain are unlikely to create a definitive defense to adjustments. An adjustment requires a move to Appeals or Competent Authority to reduce or eliminate the adjustments, or to eliminate double taxation, at additional cost. These taxpayers also may be experiencing adjustments on the other side of the border. Taxpayers caught in this vice cry out for an inexpensive bilateral APA-like solution—they view themselves merely as stakeholders and are eager for an effective resolution program.

4. Adverse Selection

Although not mentioned in the IRS's 1994 preamble, the elephant in the room remains the concern evinced in the IRS white paper—that only taxpayers benefitting from a safe harbor would select it, and that the IRS would always lose out, apart from administrative savings.

The IRS did not provide statistics to justify its view, nor does this article. However, experience with large and small taxpayers over more than 20 years convincingly indicates that many taxpayers, particularly those involved in relatively routine cross-border activities, readily would trade the opportunity to customize their transfer pricing at a lower-than-safe-harbor return for the elimination of audit risks and documentation costs. Resentment about the need to prepare costly transfer pricing documentation for myriad cross-border transactions—not just for the IRS but for tax authorities around the world—is resounding. Efforts to mitigate this burden—such as, for example, through the EU masterfile approach—have helped somewhat, but not enough, especially for U.S. taxpayers. The appetite for certainty is confirmed by the popularity of the APA Program, which offers that trade-off. (Indeed, the program undoubtedly would be even more popular if the costs, in time and money, were lower.) Moreover, the desire for certainty should be increased by the new reporting requirement for uncertain tax positions,[26] especially as its application is broadened.

Institution of a safe harbor regime also has the potential to increase U.S. tax revenues by simplifying the compliance ability of small taxpayers and thus assuring reasonable U.S. profit levels for many taxpayers who otherwise would escape audit. According to a GAO report issued in July 2008, the percentage of small foreign-controlled domestic corporations and U.S.-controlled corporations reporting zero tax liability in 2005 was remarkably high—around 65 percent in each case, although the cross-border component was not examined.[27] In this analysis, a small corporation was defined as one with assets of less than $250 million and gross receipts of less than $50 million.

Thus the potential for and costs of adverse selection may well be overblown, viewed today.

5. Double Taxation Concerns

One significant remaining concern that was not particularly stressed or evaluated by the IRS is the possibility of double taxation when one country adopts a safe harbor that is not accepted by the counterparty country. The resulting double taxation, or the costs and uncertainty of going through the competent authority process, could nullify the benefit of the safe harbor.

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[24] The Durst article closes with this thought: ''If it is sensible for developing countries to adopt the simplified approach, it also should be sensible for industrialized countries to adopt it.''

[25] The penalty is applied only to adjustments exceeding the lesser of $5 million or 10 percent of the taxpayer's gross receipts, or where the claimed price is at least 200 percent more than, or 50 percent less than, the correct price.

[26] Regs. §1.6012-2(a)(4).

[27] GAO-08-957, ''Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1998-2005,'' Appendix II, Table 4.

The OECD took a tough stance on this in its 1995 guidelines, opining that competent authority should be unavailable in safe harbor cases, with potential double taxation viewed as the price of electing a safe harbor.[28] Double taxation could be avoided only if the taxpayer could prove the arm's-length nature of its pricing to the counterparty country—presumably without help from the U.S. Competent Authority. This would amount to an extreme version of the U.S. rule applicable to a taxpayer who has entered into a closing agreement or final Appeals settlement, or obtained a judicial decision, in which case the U.S. Competent Authority will request correlative adjustment from the other government but will not compromise U.S. tax to reach an agreement.[29] The more appropriate analogy should instead be to a unilateral APA, where competent authority assistance is available, although the IRS acknowledges that the unilateral APA ''may hinder'' the potential for double taxation relief.[30] At bottom, the situation is little different from the case where two countries have different domestic rules on the tax treatment of a particular item.

Of course, the best situation would be for the safe harbor to approximate and be recognized as an arm's-length result, so that there are no foreign adjustments, or for foreign governments to adopt complementary or parallel provisions. For instance, the long-standing IRS interest rate safe harbor presumably works bilaterally because it is market-based, and the services safe harbor (the services cost method) has increasingly proved workable because its appropriateness has gradually been recognized and, indeed, adopted by counterpart countries. Absent such fortuitous developments, potential recourse to competent authority should be addressed in any safe harbor proposal and, preferably, such recourse should not be foreclosed.

6. Inconsistency with Arm's-Length Standard

Both the white paper and the OECD guidelines strongly intimate that a safe harbor is, almost by definition, arbitrary and therefore non-arm's-length.[31] But there is no reason why a prescribed range, based on appropriate facts, should be considered either. The regulatory safe harbor for intercompany interest rates is a perfect example, being both based on market rates and automatically adjusting to changes in economic conditions. Moreover, this criticism overlooks both the natural subjectivity of transfer pricing to begin with and the now well-accepted range concept. (The latter concept was also premiered in the 1994 regulations.) The white paper's indictment of safe harbors as typically non-market probably reflected its preoccupation with intangibles—where market rates may be harder to divine—but extrapolation of that view to smaller, more routine transactions is unjustified. Finally, the proliferation of profit-based transfer pricing methods such as CPM in displacement of hard-to-demonstrate transactional tests should mitigate the concern with the loss of ''better'' methods.

Accordingly, it should be possible to provide reasonable comfort that a safe harbor range *is* compatible with the arm's-length standard.

7. Potential for Income Shifting to Low-Tax Jurisdictions

The potential misuse of safe harbors to enable relatively profitable companies to shift income to low- or no-tax jurisdictions is a legitimate concern. This concern should be assuaged by low dollar levels for eligibility and safe harbor ranges or other methods that are demonstrably arm's-length. Other ways to mitigate the problem include limiting the safe harbor to relatively high-tax counterpart countries, or incorporating this consideration in an anti-abuse rule.

E. Safe Harbor Resurgence

Before shifting to specific proposals, several recent developments regarding safe harbors bear mention: recent legislation in India authorizing substantive safe harbors, U.K. legislation completely exempting small and medium-sized enterprises from arm's-length transfer pricing rules, the EU Transfer Pricing Forum's focus on transfer pricing considerations for small and medium-sized entities, and the OECD's announcement that it is reviewing its guidance on safe harbors with a view to possible updating.

1. Indian Safe Harbor Legislation

India's 2009 Finance Act authorized the Central Board of Direct Taxes to establish safe harbor rules for determining the arm's-length price under generally applicable transfer pricing provisions. This provision no doubt reflected frustration at the proliferation of transfer pricing audits and adjustments under India's fairly new transfer pricing regime, the resultant administrative, judicial and competent authority congestion, and some desire to moderate the impact on foreign investment in India. The authority is far-reaching and not intended to be limited to small taxpayers or transactions, but no specifics have yet been proposed. The delay has been attributed in the media to the difficulty of designing appropriate safe harbors, though no retrenchment from the concept has been announced. Obviously this situation bears close watching. An excellent, comprehensive white paper on this subject was published by Deloitte in October 2009.[32]

2. Safe Harbors in Other Countries, Including the United Kingdom

The paper referred to in the preceding paragraph details safe harbor regimes in other countries, primarily in the areas of documentation and intercompany services. One of particular note is a U.K. provision, enacted in 2004, that *exempts* small and medium-sized firms from the need to comply with the generally applicable arm's-length rule.[33] For this purpose, a small or medium-sized

[28] OECD guidelines, paragraph 4.112.

[29] Rev. Proc. 2006-54, 2006-2 C.B. 1035, section 7.05.

[30] Rev. Proc. 2006-9, 2006-1 C.B. 278, section 7.07.

[31] The Durst article at p. 1112 suggests that the strength of this criticism may have reflected the separate concern that safe harbors would be seen as signs of potentially dangerous wavering of international support for arm's-length transfer pricing generally.

[32] See ''An overview of international Safe Harbor provisions and the need for Safe Harbor in India.''

[33] ICTA 1988, Sch. 28AA para. 5B, reflecting amendment by Finance Act 2004. Based on information prepared for the EU JTPF described below, Hungary may have a somewhat similar rule in the case of certain intercompany contracts.

enterprise is defined by the EU as an enterprise with fewer than 250 employees and annual revenue not exceeding €50 million (US$68 million) or an annual balance sheet total not exceeding €43 million (US$59 million).[34]

The exemption automatically applies to a small or medium-sized enterprise unless it elects otherwise (which is irrevocable) or if the counterparty to the transactions is a resident of a country that does not have a double tax treaty with the United Kingdom that includes a non-discrimination provision (subject to certain exceptions and refinements). The exemption is somewhat conditional for a medium-sized enterprise (over 50 employees and annual turnover or balance sheet total above €10 million [US$14 million]), since the exemption can be withdrawn by a specified type of notice from H.M. Revenue and Customs (subject to certain appeal rights).

This provision was adopted at the same time that the U.K.'s cross-border transfer pricing rules were extended to domestic transactions, apparently in recognition of the extra burden on small taxpayers.[35]

3. EU Joint Transfer Pricing Forum Project Regarding Small and Medium-Sized Enterprises

The EU Joint Transfer Pricing Forum (JTPF), established in 2002 by the European Commission, consists of representatives from the business sector as well as tax administrators of the member states. Its role is to work within the framework of the OECD guidelines to produce pragmatic, non-legislative solutions to practical problems posed by transfer pricing practices in the EU. In 2007, the JTPF decided to undertake a project to address issues affecting small and medium-sized entities, and held its initial meeting on that topic in June 2010.

A stated focal point was to minimize the compliance burden for small and medium-sized companies, with consistent implementation among member countries and without providing an inappropriate competitive advantage over larger enterprises. Various materials were assembled and presented, though this is clearly a work in progress. Safe harbors for small companies or small transactions are one of a variety of topics on the table (others may include simplified documentation requirements as well as audit, APA, competent authority and other dispute resolution procedures).

4. OECD Revisiting Safe Harbor Guidance

On March 9, 2011, the OECD's Committee on Fiscal Affairs announced a new project on the administrative aspects of transfer pricing, in part to consider "the cost-effective use of taxpayers' and tax administrations' resources for improved compliance and enforcement processes." Included in the project is a review of the OECD's 1995 guidance on safe harbors, with a view to possible updating to reflect experience acquired since 1995. Comments from interested parties are requested by June 30.

[34] This definition is found in the Annex to Commission Recommendation 2003/361/EC (5/6/03).

[35] Commentary regarding the potential impact of this legislation and its justification has not been reviewed.

F. Safe Harbor Proposal

To have the desired effect, a safe harbor provision should be simple and its limits clear.[36] The short-lived safe harbor in the IRS's 1993 temporary regulations met these criteria, but was derailed in significant part by the newness of the CPM concept and the stage of the transfer pricing development curve. Now CPM is widely accepted, there is considerable global familiarity with comparable data and ranges, and the balance between inbound and outbound transactions is improving. Thus this article proposes a safe harbor in the same vein as that in the 1993 regulations but with further refinements and broader applicability. Key features would include:

- It would be available for small tested parties and small transactions.
- It would be available for most types of transactions, including transfers of tangible property for use in either limited-risk or full-risk distribution or manufacturing, along with related intangibles, stand-alone intangibles, and services not eligible for the services cost method.
- It would be based on published CPM ranges—adjusted periodically—and specified PLIs.
- Transactions would be categorized based primarily on two-digit Standard Industry Classification (SIC) codes, reflecting functions and risks.
- It would be elected by taxpayers, not mandated.
- If elected, the safe harbor must be applied to all of the taxpayer's eligible transactions in the case of a small taxpayer, or to all of the taxpayer's transactions of the same type in the case of small-transaction eligibility.
- Application of the safe harbor would continue indefinitely until the year following growth beyond eligibility limits or revocation with Commissioner's consent; alternatively, a five-year term could be considered.
- An anti-abuse rule would apply.

One element crucial to the success of a safe harbor for cross-border transactions is its acceptability in the counterpart country. The potential need to engage in competent authority proceedings—or to bear double tax cost—can defeat the simplicity, cost, revenue, and administrative advantages of a safe harbor. Thus, consideration should be given to developing safe harbors together with specific treaty partners, who would have similar incentives to such an approach.

Such a consideration can be found in the Australian safe harbor rule for non-core or de minimis intercompany services. Australia's standard cost plus 7.5 percent safe harbor was expressly adopted by its neighbor and frequent trading partner, New Zealand, with the stated purpose of minimizing compliance costs without compromising the arm's-length principle. Moreover, the rules of both countries permit cost plus 10 percent if another country has a reciprocal or symmetrical practice with respect to such a markup "[t]o accommodate the varying requirements of other jurisdictions and lessen

[36] This would describe the U.K. provision, discussed above, that simply exempts small taxpayers from application of the transfer pricing rules. This seems too radical and fiscally unsound for serious consideration in the United States at this time.

the possibility of double taxation.''[37] In addition to eliminating double tax exposure, collaborative safe harbor development would institute sufficient arm's-length bargaining—between the tax authorities—so that concerns with over- and under-taxation should be minimized. JITSIC or PATA might be good forums to try this out, focusing on countries with similar domestic rules, similar audit pressures, a good competent authority track record, and a fairly even balance of transactions. Of course, the OECD's recently announced project to reconsider safe harbor approaches may enable development of a broad consensus, albeit through a potentially lengthy process.

Absent such a bilateral aspect, the safe harbor should be limited to transactions involving countries with tax rates similar to the United States. This would minimize the potential for misuse and adverse selection.

To assuage critics of the safe harbor concept (or, conversely, to validate their concerns), it might be desirable to start off on a trial or pilot basis and evaluate the results through random audits and other review measures. Thus the safe harbor could be made available for a limited startup period (perhaps two years), with a guarantee that participants could keep the protection for a specified longer period (perhaps five years) even if the program were discontinued. Gradual phase-in of various types of coverage (for example, tangible property before intangible property) could also be considered.

The specific features, and their rationales, are set forth below. Various alternatives are indicated. There are no absolute bests among them, and different permutations are certainly feasible and potentially viable. All would be informed by the IRS's considerable experience and available data.

G. Eligibility for Safe Harbor

1. Size of Tested Party

The natural tendency is to base eligibility on the smallness of the taxpayer. One limit could be derived from the IRS's distinction between taxpayers falling under the Small Business/Self-Employed division and LB&I, where SB/SE taxpayers are those with assets (book value) of $10 million or less. Using some very general assumptions, the sales equivalent would be around $50 million. Thus, safe harbor eligibility could be limited to taxpayers with less than either $10 million assets or $50 million in annual sales. An alternative would be the somewhat higher EU standard for small and medium-sized enterprises: fewer than 250 employees, and sales of less than $68 million or assets less than $59 million (at current exchange rates). A higher limit would encompass more taxpayers who would otherwise be preparing contemporaneous documentation under the Section 6662(e) rules and thus desirably conserve those resources.[38]

The APA small business taxpayer definition for simplified procedural handling—$200 million of worldwide sales—seems too high for this purpose, and the 1993 regulations' standard of $10 million of sales seems too small (at that level, today, exemption would be tempting).

In keeping with the simplification and resource objectives, any size test should be applied on the basis of the tested party—that is, the simpler party to the transactions—rather than the U.S. taxpayer per se or the overall group. By determining eligibility (in part) on the basis of the tested party's size, coverage could be extended to large multinational enterprises with only small enterprises in a particular country. Although they may be better able to bear the cost of traditional analysis and dispute resolution, that is not true from the tax administration's perspective—a small U.S. affiliate of a large multinational enterprise is still a ''small'' taxpayer and would require disproportionately large IRS resources for the revenue at stake.

2. Transaction Size

The same considerations suggest that safe harbor treatment also should be available for cross-border transactions that themselves are small. This should not be measured directly—because those are the very transactions that need to be priced—but rather indirectly by an actual arm's-length aspect of the transactions. Thus the measuring rod should be sales to third parties of property incorporating the covered related-party transactions, such as a distributor's external sales of products purchased from an affiliate or a manufacturer's external sales of products incorporating tangible or intangible property acquired from an affiliate.

However, where the related-party materials are only a subset of the manufacturing materials, the relevance of the sales threshold would be diluted. To accommodate this on a simplified basis, the sales-level criterion could be increased where unrelated-party costs exceed a certain proportion of the sales value. (Again, the measurement would need to be based on external transactions—sales and unrelated-party costs—to provide an objective, non-circular measurement.) For example, the eligibility limit could be less than $50 million in sales for distributors or manufacturers, or less than $100 million in sales for a manufacturer whose unrelated-party cost of goods sold exceeded 50 percent of sales.

External revenue data with respect to intercompany services may be more difficult to identify in the typical case where the recipient does not market the same services. The measuring criterion instead could be the external cost of the services (wages and related overhead).

The APA Program's rules for small taxpayer procedures include a transaction-based measurement: covered transactions under $50 million per year, or $10 million per year if the transactions involve intangible property (such as a royalty). However, as noted above, it seems inappropriate for a safe harbor to base the measuring rod on the covered transactions themselves, although that rough (but simple) measurement may be acceptable for a procedural simplification.

For purposes of determining whether the small transaction limit has been satisfied, ''transactions'' should be defined to aggregate similar transactions in the same business—that is, those with similar functions, risks, and markets. To add some objectivity to this standard, three-digit SIC codes could be applied. Thus, for example, the transactions being tested for size would be

[37] Australian Tax Ruling 1999/1, paragraph 83; New Zealand transfer pricing guidelines (2000), paragraphs 557-567.

[38] For a variety of reasons, simply broadening the Section 6662(e) exemption would not achieve the same objectives.

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the distribution of all products within SIC Code 506 (Wholesale Trade, Electrical Goods).

3. Counterpart Countries

At a minimum, the safe harbor should be limited to transactions involving treaty countries so that mutual agreement procedures are available.[39] The competent authority relationships provide an opportunity to develop informal agreements or standards for the acceptability of safe harbor approaches. Although safe harbor eligibility could be further limited to transactions with countries with a reciprocal safe harbor arrangement in place, that might make it very hard to get started; a preferable approach, discussed above, would be to limit eligibility to countries that agree to participate on a pilot basis or provide an expedited competent authority process in the case of taxpayers using the safe harbor.

In any event, eligibility should be limited to countries with tax rates not markedly different from that in the United States. One might for this purpose use the standard in Section 954(b)(4) for the foreign base company exception—a foreign rate exceeding 90 percent of the U.S. rate—but this may be too restrictive today. The idea is to minimize adverse selection and abuse potential and to target situations where the counterpart countries have similar motivations (at both governmental and taxpayer levels) to ours.

4. Election Versus Mandate

One way to minimize adverse selection would be to mandate use of the safe harbor for eligible taxpayers, or make it the presumptive rule absent demonstration of a different arm's-length rate by the taxpayer (similar to the Section 482 approach for interest on loans). However, a mandate would not be consistent with the U.S.'s arm's-length standard. A presumption rebuttable by the taxpayer might be feasible, but a presumption rebuttable by the IRS would add undesirable uncertainty and lessen the IRS's administrative savings even though giving the IRS some protection. If small transactions are covered, a presumption could be cumbersome for large taxpayers, particularly those with operations in multiple countries. For example, application to a U.S. manufacturer with simple distributors of varying sizes in five countries could interfere with a well-intentioned global pricing policy. On balance, an elective approach seems preferable, particularly if a simple ''check the box'' tax return approach were used to facilitate small taxpayer compliance.

H. Eligible Transactions

The focus of the safe harbor should be on transfers of tangible and intangible property. Cross-border financing already has an interest rate safe harbor, and routine services already are covered by the services cost method. The safe harbor also could be extended to services *not* covered by the services cost method so long as they meet the pertinent ''smallness'' tests. As indicated above, the test for services could be based on the cost of providing the services (whether the tested party is the provider or the recipient). Cost sharing arrangements would not be eligible.[40]

As discussed below, the safe harbor PLI and boundaries would be determined by the nature of the covered transactions. The categories could be:

- limited-risk distribution of products purchased from related parties (defined to mean that inventory risk and marketing costs are primarily borne by the related-party supplier);
- full-risk distribution of products purchased from related parties, with normal attendant intangibles;
- limited-risk manufacture of products using related-party tangible property, with or without related related-party intangible property (for example, contract manufacturers);
- full-risk manufacture of products using related-party tangible property, with or without related related-party intangible property;
- transfer of intangibles without related transfers of related-party tangible property; and
- services not eligible for the services cost method, such as contract research.

Despite the facial concern with high-value intangibles, limitation of eligibility to small taxpayers or transactions, measured by external revenues, should substantially mitigate the concern. That is, if the intangible truly is a ''crown jewel,'' sales are likely to exceed the $50 million threshold, or whatever is decided on. In any event, the dollars involved should not be huge; for example, an extra 5 percent of return to a taxpayer with $50 million of sales would be $2.5 million per year. Nevertheless, because of the sensitivity, this aspect should be considered in the data analysis leading up to, or following trial of, a safe harbor provision.[41]

If a concern regarding intangibles persists, several alternatives could be considered. Covered intangibles could be limited to process, rather than product, intangibles, or to routine marketing intangibles, if it is felt that fewer high-value intangibles are likely to be involved. Certain industries that tend to have high-value intangibles could be excluded from the safe harbor provision for intangibles. Or safe harbor eligibility could be restricted to limited-risk situations (for example, simple distributors or contract manufacturers), accompanied by only the intangibles typical of such entities. For example, contract manufacturing situations are unlikely to involve significant marketing intangibles. This constraint may turn out to capture most of the ''small'' situations, with less potential intangible leakage.

Ineligible transactions also might be defined to the extent possible. For example: services eligible for the services cost method, cost-sharing arrangements, loans or extension of credit, and financial guarantees.

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[39] The considerations in the case of non-treaty, and often low-tax or less developed, countries are complex and varied, and best left for much later in the evolution of a safe harbor regime.

[40] Cost sharing arrangements present a complex and very different topic. However, the author has in the past informally suggested a set of simplified cost sharing rules for low-level manufacturing and product enhancements to facilitate use and administrability of the arrangements in situations with little potential for abuse.

[41] The Durst article understandably excluded intangibles transfers from its proposed simplified transfer pricing approach for developing countries. The context was to simplify rules for the bulk of a country's cross-border commerce and thus address more sizeable situations (for example, entities with $1-2 billion of sales) on a mandatory basis, where coverage of intangibles would present much more potential for abuse.

One further requisite would be that no significant comparable uncontrolled prices be available. This would be defined by reference to the current regulatory standards—that is, a transaction involving closely similar property, with adjustments feasible as to any material differences.[42] To add clarity, refinements as to scale of a potential CUP could be added (for example, transactions with an annual volume exceeding 20 percent of the volume of the taxpayer transactions in at least two years), or the nature could be limited (for example to publicly available market, index, or industry data).

I. Safe Harbor in Practice

1. Methods

With the exception of stand-alone transfers of intangible property, the transfer pricing method would be CPM. That is already used in most cases today, and the United States and its treaty partners have considerable familiarity with both the method and pertinent ranges.

For stand-alone transfers of intangible property, the simplest measure would be a 50-50 residual profit split method. This would attribute routine returns to both parties' routine functions, using the median of the ranges developed below (or 7 percent for routine services, borrowing from the services cost method). System returns in excess of routine returns would be split 50-50. (There may be some economic justification for a different rule of thumb, such as one-third to the inventor and two-thirds to the licensee. But a 50-50 split seems more in keeping with balancing the two countries' interests and minimizing design debate.)

A focus on profitability measures may raise expense allocation questions. To some extent this is mitigated because the profit test is being applied to the simpler entity. The concern could increase if residual profit split is used to price stand-alone intangibles, since both parties would be tested and the inventor party tends to be more complex and involved in multiple businesses. In this case, the presumption should be to follow allocation methods used for shareholder or management reporting, subject to an anti-abuse rule. Another ring-fencing approach could be to limit allocated selling, general, and administrative expenses to the overall SG&A-to-sales ratio of the entity in question. Or allocation inaccuracies may just be a risk to be borne by the safe harbor experiment, to avoid excessively detailed requirements.

2. Profit Level Indicators

For full-risk distribution and manufacturing, the PLI would be operating margin. For limited-risk distribution and manufacturing, the PLI would be operating margin or value-added cost plus (or Berry Ratio, which is an algebraic equivalent).[43]

For services, the PLI would be the ratio of operating profit to total services costs (see Regs. §1.482-9(f)(2)(ii)), sometimes referred to as net cost plus.

[42] Regs. §1.482-3(b).

[43] Theoretically, return on assets could be used in all cases, but this poses difficult valuation questions and is not widely accepted.

3. Ranges

The CPM ranges would be periodically published by the IRS in a revenue procedure. The IRS has the best perspective on how to develop these, but hopefully could rely on fairly broad industry averages, on an interquartile or similar statistical basis. If felt necessary (that is, if there are in fact significant differences), there could be some major industry dividing lines (including frequency-based groupings used by the APA Program and the Competent Authority Office—automotive, pharmaceuticals and medical devices, and semiconductors),[44] or fairly wide SIC code groupings could be used, determined after an internal review of the IRS's experience.[45] Because the ranges would be based on comparables data, they should be considered arm's-length for treaty purposes, not arbitrary.

A potentially useful approach can be found in a portion of the APA Program training materials titled ''Financial Terrain of U.S. Manufacturers and Distributors.''[46] That analysis (which is expressly denoted ''not a safe harbor'') calculated interquartile ranges under various PLIs for broad groups of distributors, manufacturers, and contract manufacturers, above and below a $100 million sales threshold, based on Compustat data for publicly held companies over five- and 10-year periods. The return ranges for smaller companies generally were considerably lower. The grouping was done on the basis of all two-digit SIC codes for the wholesale trade (50 and 51) and all two-digit SIC codes for durable goods manufacturers (30-39).

One would expect the range for full-risk entities to be higher than that for limited-risk entities, though the pertinent comparables data would govern.

Since the range would also apply if the tested party is abroad, consideration could be given to regional adjustments so that location savings would accrue to the principal (at least for typical limited-risk affiliate situations). Currency-based adjustments also might be relevant, though this is an analytically complex matter that would require serious economic input and might ultimately need to be sidestepped for simplicity and administrability reasons.[47]

The ranges should not be less than arm's-length (which foreign governments had urged in 1993), but overreaching should be avoided to minimize double tax risks.

The ranges would be adjusted periodically by the IRS in the same manner as cost-of-living adjustments. That is, a need-to-change threshold should be specified, such

[44] Financial products, the other APA/Competent Authority group, are unlikely to meet any smallness test and probably should be explicitly excluded from eligibility for the safe harbor.

[45] The appropriate breakdown may vary by category, depending on IRS experience with prevalent range variations. For instance, two-digit SIC codes for wholesale trade (such as durable goods or non-durable goods) may be too broad, whereas two-digit SIC Codes for manufacturing (for example, paper, printing) may be too narrow. Groupings of three-digit codes may be appropriate under the more granular NAICS classifications, if considered preferable to use.

[46] Section K of the New Hire Training Manual, dated 7/24/01, available online at www.irs.gov.

[47] *See* Deloitte India white paper (note 30) for discussion of Brazilian currency-related adjustments to profitability percentages (p. 25).

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as a whole percentage point difference. Avoiding minor changes each year would be highly desirable for administrative simplicity.

The ranges would be set on an understanding that normally present intangibles, such as the typical marketing intangibles of a distributor, would be included.

To reduce potential for manipulation, the ranges could be expressed on an adjusted-to-zero basis, so that taxpayers would have to make asset intensity adjustments to their own data. Admittedly, this would add complexity, and IRS data should be reviewed to determine whether such adjustments typically are sufficient to warrant such a feature. Perhaps it would be feasible to require asset intensity adjustments only if certain relationships fall outside a prescribed range (for example, accounts receivable as a percentage of sales).

One of the reasons for limiting eligibility to treaty countries, high-tax jurisdictions, or pilot situations is to operate in reasonably balanced inbound-outbound situations. Imprecision of the ranges thus would be muted from an overall government perspective, with more generous returns on some transactions, and less generous returns on others. To encourage country-to-country cooperation, there should be no difference between inbound and outbound ranges (even aside from treaty nondiscrimination considerations).

4. Competent Authority

Competent authority assistance should be available in the event the counterpart country disagrees with its end of the safe harbor result, in the same fashion as for unilateral APAs today. But a formal or informal streamlined procedure for small cases would be highly desirable. Of course, if eligibility for the safe harbor is limited to reciprocal situations or if the specified ranges hit the arm's-length sweet spot, the issue would not arise.

5. Duration, Pilot Aspect

The election would be required to apply to all of the taxpayer's related-party cross-border transactions, in the case of taxpayers eligible by reason of taxpayer size, and to all similar transactions, in the case of taxpayers eligible by reason of transaction size. As indicated above, ''similarity'' would be based primarily on three-digit SIC codes. Although an argument might be made for mandating a single election across all size-eligible transactions to minimize adverse selection, that could be hard to manage for large taxpayers, and the uncovered transactions would remain subject to audit.

The simplest approach would be to require the election to stay in effect until the year following a year in which all pertinent eligibility criteria were failed. The election also could be revoked with the Commissioner's permission, for which examples or standards could be developed over time.

Alternatively, the election could apply for a five-year term, to avoid oppressive application in the event of significant changes in the industry, economic, technological, or competitive environment, since double taxation uncertainties make the situation not exactly a zero-sum game. Although this would also enable reconsideration by the taxpayer with some hindsight or foresight, size limitations again would be helpful.

If done as a pilot program, some minimum period in which application of the safe harbor is available could be guaranteed. This would help entice people into the program so that its effectiveness could be evaluated.

6. Anti-Abuse Rule

To be on the safe side, an anti-abuse provision should be added. While these sometimes are criticized as adding undesirable or unlimited uncertainty, one hopefully would be manageable here. It would be wise to dampen enthusiasm for ''creativity'' from the beginning, given the scale of cross-border transactions. The rule could incorporate the objectives of the safe harbor (for example, grouping of transactions).

7. Other Features

Of course, taxpayers reasonably electing the safe harbor provisions would be exempted from the contemporaneous documentation requirements of Section 6662(e). Although the documentation rules would be irrelevant since the safe harbor would foreclose any adjustments, provision of an explicit reasonableness test would avoid whipsaw if it were ultimately determined that the taxpayer was ineligible for the safe harbor.

One would need to consider whether to limit the safe harbor to U.S.-foreign transactions, or whether domestic-to-domestic situations should be included in cases where returns are not consolidated. Since the latter situations tend to be less common, and would add complexity, it would be preferable not to cover them unless required under treaty nondiscrimination provisions.

The IRS still would have audit responsibilities as far as verifying eligibility for the safe harbor, grouping approaches, application of the appropriate ranges, and the anti-abuse rule. However, the largely mechanical nature of the rules should limit the audit burden.

The IRS should be required to maintain statistics regarding utilization of the program and issue a report and assessment after two years.

The discussion above touches on a wide array of features and ideas in order to explore possible contours and anticipate possible concerns. Ultimately, it would be desirable to winnow the details and streamline the requirements to facilitate administrability.

J. Cost-Revenue Considerations; Congruity with LB&I Goals

To determine whether a safe harbor program would be desirable from LB&I's perspective so as to justify the development effort, as well as to determine whether a trial or adopted safe harbor program is achieving its objectives, data collection and analysis are required. Some statistics that would be useful in this evaluation are:

- the size distribution of taxpayers with cross-border transactions;
- the breakdown of transfer pricing audits;
- an estimate of revenue lost due to noncompliant small taxpayers (which may include a sampling analysis of the reasons for zero-tax-liability situations);[48]
- a breakdown of competent authority cases to identify relatively small taxpayers and transactions by years to complete, percentage of U.S. adjustment compromised, or extent of double taxation); and

[48] See GAO-08-957, note 27, above.

- typical profit ranges, by type of transaction or function, size, and industry (from APA Program data if audit data is not available).

The size distribution of taxpayers with cross-border transactions could be broken down by the relative dollar value of sales and taxable income and by whether the companies are U.S.- or foreign-owned.

Transfer pricing audits could be broken down by:

- the size of taxpayer;
- whether it is U.S.- or foreign-owned;
- the size of the transfer pricing adjustment (both absolute amounts and relative to related-party transactions);
- the type of transaction;
- administrative costs per audit;[49]
- resolution of adjustments at Appeals (sustention rates) or other measures of revenue productivity; and
- the number of disputes that end up in competent authority.

Perhaps some of this data already is in hand, or in process, within the IRS in connection with the recent LB&I restructuring. However, publicly available data from the IRS's Statistics of Income Division, GAO, the Commerce Department's Bureau of Economic Analysis, and the APA and Competent Authority offices, does not contain many breakdowns based on size[50] and is quite limited in isolating and quantifying transfer pricing transactions to begin with.

K. Conclusions

Growth of cross-border transactions by U.S. taxpayers is inexorable in today's global marketplace. For both the IRS and taxpayers to efficiently manage this situation, shepherding smaller transactions into contained situations is highly desirable, if not essential. Simplification of the rules and reduction of taxpayer administrative burdens are high-priority government objectives in themselves. The above suggestions for safe harbor approaches recognize this situation while attempting to strike an appropriate fiscal balance. Increased sophistication and balance of trade with our treaty partners have made this type of approach much more feasible and fiscally reasonable than when it was considered 15-20 years ago. Adoption of documentation requirements and sharply increased enforcement around the world are accelerating the imperative. Other countries, and the EU and OECD as well, are beginning to explore safe harbor ideas on a serious basis. Although not without challenging aspects, the issues can be tackled and ought to be resolvable on a systematic basis.

The time has come to mold the IRS's vast transfer-pricing experience and data into a manageable and attractive-to-all small-fry safe harbor regime.

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[49] A GAO analysis done in 1994 for the Senate Finance Committee (B-257356), looking at the effectiveness of the IRS's international tax compliance activities, evaluated the amount of recommended additional taxes per hour of IRS international examiners' time spent, comparing large U.S.- and foreign-controlled companies as well as taxpayers within and outside the Coordinated Examination Program. For non-CEP (smaller) taxpayers, the recommended tax per hour was (not surprisingly) significantly lower than for the CEP taxpayers.

[50] GAO-08-957, note 27, contains some breakdowns between small and large taxpayers from the perspective of amount of tax paid, but without further subdivision.

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