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DAC 6 and Transfer Pricing: The Hallmark Concerning Unilateral Safe Harbours

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Council Directive (EU) 2018/822 (generally known as DAC 6) expressly provides for reporting obligations concerning cross-border arrangements that present an indication of a potential risk of tax avoidance. The Annex to the Directive lists the hallmarks triggering reporting obligations, which include the category of specific hallmarks concerning transfer pricing (Category E). The first of these hallmarks concerning transfer pricing regards "*the use of unilateral safe harbour rules*".

The term "safe harbour" is rather generic and requires some clarification to avoid an interpretation that is not consistent with the purposes of the Directive. Safe harbour rules are exceptions to the application of the arm's length principle, which work as automatic presumptions of the appropriateness of the prices and, therefore, of conformity with the arm's length principle, in the event those prices comply with predefined margins (e.g. expressed as percentages of costs or other parameters).

Some States also provide for the non-application of the arm's length principle for certain categories of taxpayers, such as small businesses. In these cases, the relevant rules do not technically stipulate automatic presumptions of appropriateness, but rather an exemption from the application of the transfer pricing rules that, although not literally falling within the notion of safe harbour, does have in practice an equivalent effect. Taking into account such substantial equivalence of the effects (also in terms of connected risk of tax avoidance), such application of those rules could also fall within the hallmark in question.

Turning to safe harbours in the narrow sense (i.e. presumptions of price appropriateness), it is not clear if they all imply the reporting obligation of the DAC 6 Directive. For example, the tax administrations of many States implemented the OECD recommendations on intra-group low-value-adding services in order to establish the profit margins to be applied to the costs incurred for the services provided (see Chapter VII, Section D, of the OECD Transfer Pricing Guidelines). Other cases may be envisaged by the OECD as a result of the work in progress on the impact of the COVID-19 emergency on transfer prices. It is clear that these safe harbours, if complying with the OECD recommendations, are unsuitable to create situations of double non-taxation, or to facilitate tax avoidance behaviours. In fact, they are in line with the agreement reached among the tax administrations of various States at the OECD level (or, perhaps, at the European Union level – see the Report of the Joint Transfer Pricing Forum of February 2010). This view appears to be confirmed also by the position taken by the Commission Services within Working Party IV of the

European Commission, according to which safe harbours should be regarded as "unilateral" only where they depart from the international consensus embodied in the OECD Guidelines (see Summary Record of 24 September 2018). It follows that the unilateral nature – which is a qualifying feature of the hallmark – is only apparent in these cases, as those safe harbours are previously agreed upon and based on an international consensus. It follows that they should therefore be excluded from the scope of application of the Directive. For the same reasons, indeed, the Directive excludes from the notion of safe harbour those agreed upon in bilateral or multilateral advanced pricing agreements.

As previously mentioned, another issue concerns whether cases where one of the companies taking part in the transaction is exempted from the application of the domestic transfer pricing rules due to its size (or other specific characteristics) fall within the scope of DAC 6. In implementing the Directive, for example, the United Kingdom expressly provided for their exclusion, although it is not clear whether this exclusion applies only where both, or even where only one, of the related parties are exempted from the application of domestic transfer pricing rules. A similar question arises for transactions involving companies excluded from the scope of domestic transfer pricing rules due to the application of special income tax determination rules (e.g. companies subject to a tonnage tax regime).

A further question is whether the rules that limit the deductibility of interest expenses fall within the notion of safe harbour rules. In this regard, reference is made, for example, to the domestic rules of various States that limit the amount of deductible interest in proportion to the ROL of the taxpayer (in the European Union, these rules implement and comply with Council Directive (EU) 2016/1164 – generally known as ATAD). The uncertainty concerns, on the one hand, the possibility to bring the phenomenon of thin capitalization within the domain of transfer pricing rules, and, on the other hand, the exact purpose of these rules and, in particular, whether they are also aimed at combating the abusive erosion of the tax base through interest payments. It would seem that these rules, in the light of their mode of operation, i.e. as they merely deny the deductibility of a portion of the interest expenses (also incurred towards third parties), without affecting the actual amount of the interest paid, can be excluded from the category of unilateral safe harbours for the purposes of DAC 6. However, a clarification on the occasion of the implementation of the Directive would be welcomed. A similar question arises with reference to the provisions that set a (tax) ceiling to the debt-to-equity ratio. In this case, it is perhaps easier to conclude that these rules could fall within the scope of DAC 6, also taking into account the conclusions reached in the recent OECD Report *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, OECD*" (see para. B 1).

Another case that raises some interpretative issues is that of intra-group services provided by US companies that apply the Services Cost Method (SCM) governed by the IRS Regulation 1.482. Under this safe harbour, US companies may charge to the foreign affiliates a price equal to the cost incurred in order to provide certain low-value-added services identified by the Regulations. As the application of this rule does not lead to any detrimental effect for the States of residence of the companies receiving the relevant services, it is questionable whether it should be regarded as falling within Category E.

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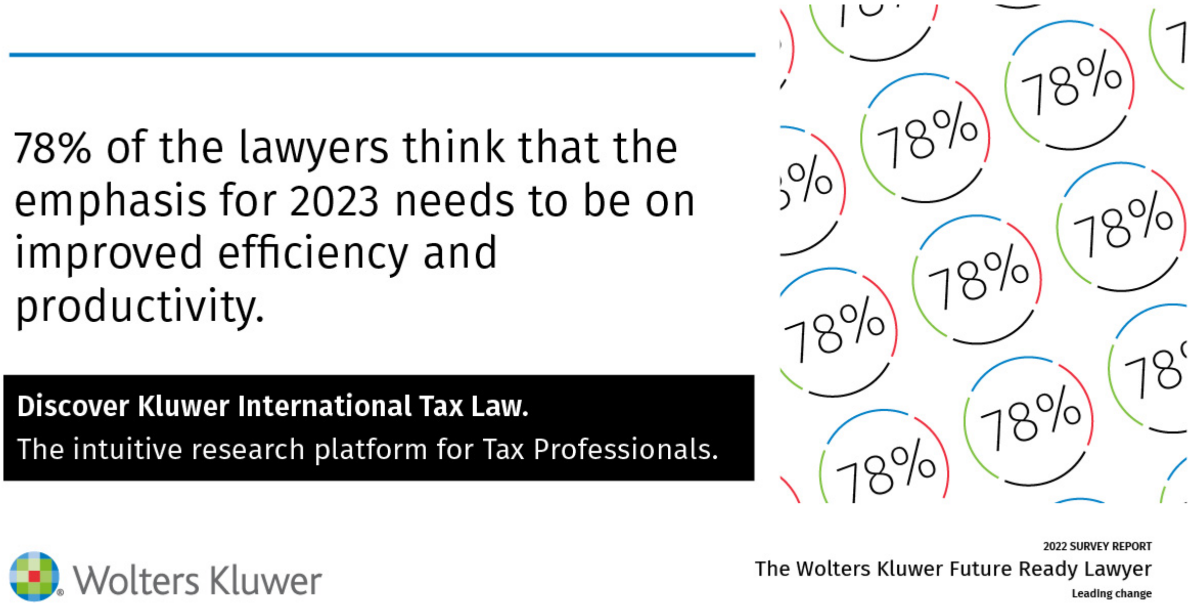

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