Background Paper

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Practical Manual on Transfer Pricing for Developing Countries

Foreword

The UN Practical Manual on Transfer Pricing for Developing Countries is a response to the need often expressed by developing countries for clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises (MNEs) in particular. Such guidance should not only assist policy makers and administrators in dealing with complex transfer pricing issues, but should also assist taxpayers in their dealings with tax administrations.

The UN Model Double Tax Convention between Developed and Developing Countries looks to whether dealings between different parts of an enterprise "differ from those which would be made between enterprises" as does the similar OECD Model. In this respect both Models, which between theme are the basis for nearly all bilateral treaties for avoiding double taxation both endorse an "arm's length standard" (essentially an approximation of market-based pricing) for pricing of transactions within MNEs.

While it is for each country to choose its tax system, this Manual is addressed at countries seeking to apply an "arm's length standard" to transfer pricing issues, as the approach which nearly every country seeking to address such issues will decide to take. Such an approach minimises double taxation disputes with other countries, with their potential impact on how a country's investment "climate is viewed" while combatting potential profit-shifting between jurisdictions where a MNE operates. In recognising the practical reality of the widespread support for, and reliance, on the arm's length standard among both developing and developed countries, the drafters of the Manual have not found it necessary, or helpful, for it to take a position on wider debates about other possible standards. The Manual will, at most help inform such debates at the practical level, and encourage developing country inputs into debates of such importance to all countries and taxpayers.

Without an effective response to transfer pricing, there is a risk, for example that profits might appear to be earned in low or no-tax jurisdictions (thereby serving to reduce tax rates on taxable profits/incomes and associated tax obligations), and deductions / losses appear to be incurred in high-tax jurisdictions (thereby increasing allowable deductions for tax purposes), with the net effect of minimizing taxes and, in so doing, impacting on the legitimate tax revenues of countries where economic activity of the MNE takes place.

There are as yet no figures which clearly indicate the amount of revenue lost to transfer pricing which might otherwise be directed to development, but with intra-firm trade comprising perhaps 40% of global trade[1], there is reason to believe that the figures are large. While more research needs to be done on the size of the transfer pricing issue for developing countries, and the situation will no doubt vary greatly from country to country, there is clearly great scope for mispricing of intra-firm transactions to severely impact on domestic revenues for development.

In offering practical guidance to policy makers and administrators on the application of arm's length principles, the Manual does not seek to be prescriptive. In particular it recognises that the needs of countries, along with their capabilities, will evolve over time. A "phased" or "life cycle" approach, with a transfer pricing capability strategy identifying short, medium and longer term objectives and areas of focus will therefore often yield the best results. It follows that many developing countries may find the early history of transfer pricing in developed countries to be of special relevance, as well as the current practices in other, especially developing, countries.

An approach to risk management will also need to inform such strategies, recognising the areas of greatest "mis-pricing" risk, and the most resource-effective ways of addressing those risks from the points of view of both government and taxpayers.

There are a number of other guiding principles that have informed this Manual, including that:

- the drafting should be as simple and clear as the subject matter permits;
- the Manual will be prepared initially in English, but with a recognition both that this will not be the first language of most users and that it should later be translated into the other UN official languages;
- a key "value add" of the Manual is to be its practicality - addressing real issues for developing countries (and of course those dealing with such countries) in a practical and problem-solving way. It therefore seeks to reflect the realities, not just the theory, of transfer pricing;
- the Manual, as a product of the UN Committee of Experts on International Cooperation in Tax Matters, has a special role in reflecting the diversity of UN Membership and placing transfer pricing in its developmental perspective. This recognises both the importance to development of fair and effective tax systems, but also the fact that foreign investment, on appropriate terms, is seen as an important path to development by most countries;
- helpful guidance in this complex area must, in particular, be geared to the inevitable limitations in some countries' administrations, and deficits in information and skills that many countries are affected by in this area. Issues of building and retaining

[1] See the discussions in Irarrazabal, Moxnes, and Opromolla, "The Margins of Multinational Production and the Role of Intra-Firm Trade" (unpublished manuscript 2010) and in Egger and Seidel, "Corporate Taxes and Intra-firm Trade" (working paper, 2010) *[Further referencing to be added]*

capability, focus and efficiency in dealing with limited resources, in particular, bear strongly on the approach taken in the Manual;

- practical examples relevant to developing countries have been especially relied upon, because the experiences of other developing countries in addressing the challenges of transfer pricing is an important way of finding effective solutions that work in their context, and doing so in the most cost and time effective ways.

Just as building an effective and efficient transfer pricing capability is a journey, so too is the preparation of a Manual seeking to give guidance on that journey. This Manual has been the work of many authors, as acknowledged separately, and is conceived as a work that should be regularly revised and improved. It is also conceived as a work that can be relied upon in the capacity building efforts by the United Nations and others so needed in this field, and that will itself be improved by that process.