Practical Manual on Transfer Pricing for Developing Countries

Foreword

The United Nations 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 United Nations Model Double Taxation Convention between Developed and Developing Countries looks (in Article 9 – "Associated Enterprises") to whether dealings between related enterprises, such as two parts of a multinational group, "differ from those which would be made between independent enterprises". The same applies for the Article of the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital. In this respect both Models, which between them are the basis for nearly all bilateral treaties for avoiding double taxation, endorse an "arm's length standard" (essentially an approximation of market-based pricing) for pricing of transactions within multinational enterprises (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 combating 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 losses might appear to be incurred in high-tax jurisdictions (thereby increasing allowable deductions for tax purposes). This may have the net effect of minimizing taxes and, in so doing, may impact on the legitimate tax revenues of countries where economic activity of the MNE takes place, and therefore the ability to finance country development.

There are as yet no figures which clearly indicate the amount of revenue lost to transfer mispricing which might otherwise be directed to development, but with intra-firm trade generally regarded as comprising more than 30% 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 mispricing 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.

Conversely in this complex area there is a risk that taxpayers, especially multinational enterprises, will be faced with a multiplicity of approaches to applying the arm's length principle in practice that can lead to compliance burdens and the risk of unrelieved double taxation. This can be the case even with no issue of tax avoidance or evasion, because of the scope for differences in view about what the arm's length price would be in a particular case.

In offering practical guidance to policy makers and administrators on the application of the arm's length principle, 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.

By showing ways in which an "arm's length" approach to transfer pricing can operate effectively for developing countries, while giving a fair and predicatble result to those investing in such countries, the Manual will also help explain why that approach has been found so broadly acceptable, including in both major Model Tax Conventions. It should therefore assist countries in important decisions on how to approach mispricing issues, whatever approach they ultimately take. It will also play a part in signposting areas where more support and assistance may be needed for countries at the various stages of their transfer pricing "journeys".

An approach to risk management will need to inform transfer pricing strategies, recognising the areas of greatest mispricing risk, and the benefits of constructively engaging with taxpayers who are seeking to meet their responsibilities. Resource-effective ways of addressing those risks from the points of view of both government and taxpayers will be of particular importance for developing country tax administrations.

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

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[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]*

- 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 at least into the other United Nations official languages;
- a key “value added” 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 developing country realities, not just the theory, of transfer pricing;
- the Manual, as a product of the United Nations Committee of Experts on International Cooperation in Tax Matters, has a special role in reflecting the diversity ofthe United Nations 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 capability, focus and efficiency in dealing with limited resources, in particular, bear strongly on the approach taken in the Manual; and
- 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 of 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 it is conceived as a work that should be regularly revised and improved. It is also intended to be a work that can be relied upon in capacity building efforts of the United Nations and others that are so needed in this field.