

United Nations Practical Manual on Transfer Pricing for Developing Countries



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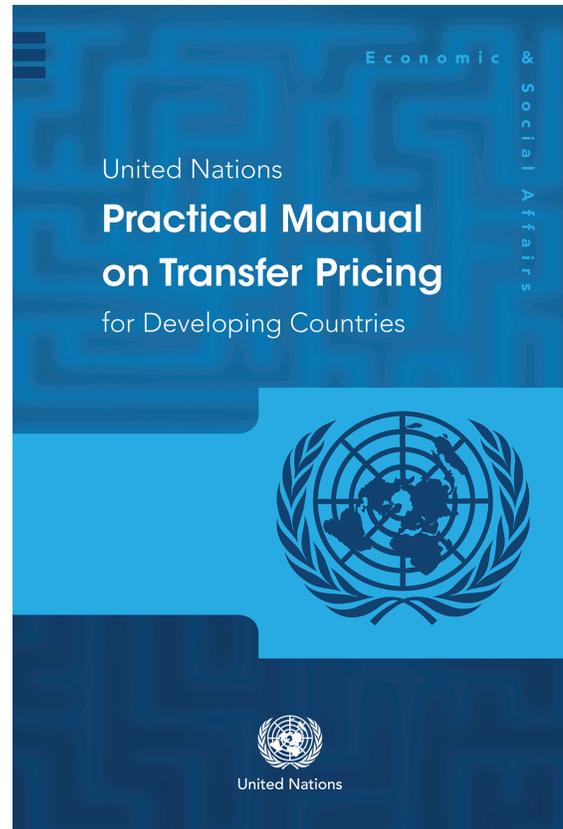
United Nations Practical Manual on Transfer Pricing for Developing Countries

Introduction

The Committee of Experts on International Cooperation in Tax Matters (the Committee) began its work on the United Nations Practical Manual on Transfer Pricing for Developing Countries (the Manual) in 2009, when it established its Subcommittee on Transfer Pricing—Practical Issues. The Subcommittee was to develop a Practical Manual on Transfer Pricing for Developing Countries, which would: (a) follow the “arm’s length principle” adopted in Article 9 of the *UN Model Double Taxation Convention between Developed and Developing Countries* (the UN Model), which is consistent with the *OECD Model Tax Convention on Income and on Capital* (the OECD Model); (b) reflect the realities of developing countries, at their relevant stages of capacity development; (c) pay special attention to the practical experience of developing countries; and (d) draw upon the work being done in other fora, in particular OECD.

The Subcommittee fulfilled its mandate and the Manual was adopted by the Committee during its 2012 annual session (Geneva, 15-19 October 2012). It is being launched in e-version during a special meeting of ECOSOC on “International cooperation in tax matters” (New York, 29 May 2013) and will be issued in print shortly after.

The Manual is designed to be in accord with the “arm’s length principle”, an approximation of the market-based pricing provided for in both the UN Model and the OECD Model. Such an approach seeks to minimize potential double taxation disputes among countries while combating potential mispricing of internal



transactions within a multinational enterprise (MNE) for profit shifting between jurisdictions.

The Manual addresses the difficulties faced, especially by developing countries, in applying some of the OECD Transfer Pricing Guidelines and the need for clear and practical guidance for those countries on the policy and administrative aspects of applying transfer pricing analyses to some of the transactions of MNEs. While consistent with the OECD Transfer Pricing Guidelines, the Manual in effect provides a novel and needs-based approach to explaining what those guidelines mean for developing countries, and how they can be applied in practice in a way that responds to their priorities and realities.

Content of the Manual

The **Foreword** makes it clear that the Manual is not intended to be prescriptive as it is left up to each country to choose a tax policy most appropriate to its stage of economic development. It rather intends to offer developing countries a basis for an informed debate at a practical level about transfer pricing. Furthermore, the Manual recognizes the existence of other approaches and offers a set of specific country examples in Chapter 10.

On a more technical level and given breadth and depth of the topic, the Manual is organized around several chapters. They are briefly described below.

Chapter 1 introduces the Manual as a whole and represents a broad survey of transfer pricing issues for developing countries, starting with an overview of the transfer pricing concept itself. The chapter describes the difficulties faced by developing countries when designing tax policies that take into account the rapid evolution of global trade and the increasing share of MNEs in that trade.

In recent years as the volume of global trade has been increasing, the share of “intra-group” transactions within an MNE, such as transfers of goods and services, capital, and intangibles has also been growing. Furthermore, transactions involving intangibles and multi-tiered services constitute a rapidly growing proportion of an MNE’s commercial transactions and have greatly increased the complexities involved in analyzing and understanding such transactions.

When analyzing such intra-group transactions for tax purposes, it often becomes clear that many developing countries currently lack sufficient skills and knowledge in this important area. The frequent lack of “comparables” and other data needed to confirm whether the transaction between related parties is conducted on an “arm’s length” basis is also addressed. With the help of examples and cases, the chapter explains in detail the concept of transfer pricing, describes its evolution and defines the “arm’s length principle”.

Chapter 2, entitled “The Business Environment” outlines the business background to transfer pricing. The chapter describes the factors that gave rise to MNEs and shows how an MNE is able to exploit integration opportunities in the cross-border production of goods and provision of services through a “value chain”. The chapter outlines the legal structures that are used by MNEs, and considers the differences between them.

Management of the transfer pricing function in an MNE, with a view to minimizing the risk of transfer pricing adjustments and avoiding double taxation, is detailed in this chapter. It notes that an MNE’s transfer pricing policy should provide guidance on documentation requirements, such as reporting for transfer pricing purposes, dealing with audits, as well as appropriate measures for dispute resolution with a tax authority. Such an understanding will help the authorities use their limited resources in engaging in policy and administration of transfer pricing and limit the possible negative impact that an overly aggressive policy and tax audit measures may have on the investment climate.

Chapter 3, entitled “The Legal Environment” reviews the legal environment in regard to transfer pricing and raises key issues for developing countries. The development of transfer pricing legislation was historically led by developed countries in the context of a rapid growth of international trade and investment. However, the growth and complexity of intra-group transactions seen in recent years, has led a wider group of countries, developed and developing alike, to introduce legislations to address transfer pricing issues. The chapter gives a structural overview to domestic transfer pricing legislation and describes the key concepts including, among other issues, the definition of associated enterprises, the transactions covered and methods used, the treatment of cases without sufficient comparables, the burden of proof, and the “arm’s length principle”.

Chapter 4, entitled “Building Transfer Pricing Capability” addresses the need for transfer pricing capabilities in developing countries. The chapter addresses issues of setting up a dedicated Transfer Pricing Unit in the tax administration. In setting up such a unit for the first time there are important opportunities but also challenges on many fronts. In designing such a unit, its vision and mission statements, as well as the measurement of its success will have to take into account factors widely recognized to be key features of modern tax administrations. These include: (1) relationships between tax policy and tax administration; (2) the need to evaluate current capabilities and gaps to be filled; (3) the need for a clear vision, mission and culture that reflects them; (4) organizational structure; (5) approaches taken to building team capability; (6) the need for effective and efficient business processes; (7) the advantages of staged approaches to reaching long term goals; and (8) the need for monitoring to assess effectiveness and allow fine tuning.

Chapter 5, entitled “Comparability Analysis” deals with comparability analysis under the “arm’s length principle” and addresses in particular the main hurdles faced by many countries, especially developing ones, in finding appropriate comparables. The comparability analysis involves two distinct but closely related steps: (1) an understanding of the economically significant characteristics of a transaction between associated enterprises, and of their respective roles in the transaction; and (2) a comparison between such a transaction and a transaction between independent enterprises taking place in comparable circumstances.

This concept of comparability analysis is used in the selection of the most appropriate transfer pricing method to the circumstances of the case, as well as in applying the selected transfer pricing method to arrive at an “arm’s length price” or financial indicator (or range of prices or financial indicators). Thus, it plays a central role in testing the “arm’s length” nature of prices or profits.

Chapter 6, entitled “Transfer Pricing Methods” reviews the different transfer pricing methods used to determine an “arm’s length price” and how these methods are applied in practice. Transfer pricing methods are used to calculate or test the “arm’s length” nature of prices or profits. Transfer pricing methods are ways of establishing “arm’s length prices” or profits from transactions between associated enterprises. The transaction between related enterprises, for which an “arm’s length price” is to be established is referred to as the “controlled transaction” and it is being tested against an “arm’s length” transaction of similar type. The application of transfer pricing methods therefore helps assure that transactions conform to the “arm’s length” standard. Several methods are reviewed without expressing any preference. Which method should be used depends on particular circumstances, such as type of transaction, functional analysis, comparability factors, and availability of comparables.

Chapter 7, entitled “Documentation” deals with the importance of documentation. Adequate documentation will make it easier for tax authorities to review a taxpayer’s transfer pricing analysis and thereby contribute to avoiding a dispute or to a timely resolution of any transfer pricing disputes that may arise. Adequate documentation is characterized by: (i) the sufficiency of the

details demonstrating the taxpayers’ compliance with the “arm’s length principle”; and (ii) the timely manner, in which such details are prepared and submitted to tax authorities upon request.

This chapter first introduces some existing international guidelines on transfer pricing documentation, which will be helpful to tax administrations. It is then followed by a more in-depth discussion on several topical issues frequently raised in the process of transfer pricing documentation, with the goal of providing practical guidance on such issues. An Appendix to the Manual sets out some countries’ legislation examples on transfer pricing documentation and provides a sample transfer pricing study.

Chapter 8, entitled “Audits” surveys audit issues related to transfer pricing and stresses the need for risk assessment. The establishment of an appropriate “arm’s length” result is not an exact science and requires judgment, based on sound knowledge, experience and skill. Given the complexities inherent in transfer pricing, a transfer pricing enquiry is usually complicated and can become a costly exercise both for a revenue authority and a taxpayer. The chapter describes difficulties in conducting such audits and advises on preparation of cases and the necessary risk assessment that needs to be done before starting such a process. The quality of the risk assessment and the documentation needed are in many cases inherent to the organizational structure of the tax administration or the administrative unit in charge of transfer pricing. The chapter reviews some key administrative issues to audit preparation such as: (1) organization and staffing; (2) selection of taxpayers for transfer pricing examination; (3) requirements for review of risk assessment; and (4) planning for transfer pricing examination.

Chapter 9, entitled “Dispute Resolution” deals with dispute avoidance and dispute resolution. Dispute avoidance and resolution procedures are essential to the effective and efficient functioning of all tax administrations. Such procedures, if properly designed and implemented, enable fair and expeditious resolution of differences between tax administrations and taxpayers regarding interpretation and application of the laws. They reduce the uncertainty, expense and delay associated with a general resort to litigation or a failure to

provide any recourse. They can also avoid the integrity issues sometimes associated with an over-reliance on ad hoc (case-by-case) settlements.

This chapter examines processes and procedures of dispute avoidance and dispute resolution and advises on effective ways to prevent disputes. It also recognizes that in spite of the best efforts, some disputes will arise. For such cases the chapter details how they are handled from the point of view of the tax authorities. It also reviews the possible role of Advance Pricing Agreements (APAs) and arbitration and outlines the advantages and disadvantages in each case without taking position, as it takes a view that what suits some countries will not suit others.

Chapter 10, entitled “Country Practices” is devoted to country practices. The chapter compiles four papers on country practices from China, India, Brazil, and South Africa. The papers were prepared by country officials and each case seeks to inform the readers/users of specific country experience in dealing with transfer pricing issues in its specific country conditions. The Manual does not take any position on whether or not the described cases follow the “arm’s length” approach. It is not a chapter agreed by consensus, as it was felt that to seek consensus would be unproductive and unnecessary.

In the Brazilian case, the approach of setting “fixed margins” for gross profits and mark up in using the cost plus resale price methods, rather than using the individual analyses dealt with elsewhere in the Manual, is preferred to the use of comparable transaction. Such approach is described as a simplified response to scarcity of skills and resources in developing countries. The South African paper shows the difficulties faced by tax authorities in applying the “arm’s length” standard in practice, particularly in finding comparables.

The paper on China’s practice also reviews the persistent lack of comparables especially when one takes into account the concept of location specific advantages (relating to the advantages of relocating to new markets) and issues involved in valuing unique intangibles (such as a brand name). The paper notes that China has addressed such issues by using practical solutions to take into account the concept of location savings and market premiums, concepts that are often unique to a country’s geographic and economic situation.

In the case of India, the paper notes that “increased market volatility and increased complexity” is a constant challenge when it comes to finding appropriate comparables. The paper points out the increased roles of local Indian companies in R&D and intangibles, such as brand building that should be taken into account in a manner more favorable to local companies allowing them to retain a higher share of profits generated.

Next steps

It is proposed that the Manual be the subject of UN capacity building efforts to assist developing countries in addressing the complexities, skills gaps and information gaps in the area of transfer pricing. The Manual will also, it is anticipated, be updated on a “rolling” basis. The next version is likely to address transfer pricing of intangibles and to deal in greater detail with the provision of services by one group entity (such as Head Office) to another. More examples from countries at various stages of their transfer pricing, including smaller developing countries, will also contribute to making the Manual an increasingly important contribution to the fulfillment of the Committee’s mandate. ■

For further Information

Please refer to the Financing for Development Web site at www.un.org/esa/ffd/
Link to the UN Manual on Transfer Pricing at http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf