

Special meeting of ECOSOC on “International Cooperation in Tax Matters”



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The United Nations Tax Committee and Transfer Pricing

What is Transfer Pricing?

Transfer pricing refers to the mechanism by which cross-border intra-group transactions (“transfers”) are priced. In itself, it is a normal incident of the operation of Multinational Enterprises (MNEs) allowing them to evaluate which parts of the group are profit or loss-making, for example. However, if the method used to determine the price of such transactions does not, for whatever reason, reflect their true value (i.e., there is “transfer mis-pricing”), profits might effectively be shifted to low-tax or no-tax jurisdictions and losses and deductions to high-tax jurisdictions. This unfairly deprives a country of tax revenue, reducing the amount of resources available for funding its development objectives. Because of the highly technical nature of much transfer pricing analysis, and the resource and skills deficits in this area that many developing countries struggle with, such countries are especially susceptible to transfer mis-pricing.

Apart from such tax base erosion, which is a matter of concern for both developing and developed countries, differences between countries about what the correct price for transactions should be can lead to double taxation, and this may undermine the investment climate, which is an important factor for the promotion of foreign direct investment as part of a development strategy. Clarifying the operation of transfer pricing approaches and seeking as much commonality as is reasonable is therefore in the interests of all stakeholders in tax systems.

The Arm’s Length Price

Both the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (the UN Model) and the *OECD Model Tax Convention on*

Income and on Capital (the OECD Model) have essentially followed the same test of whether transfer pricing has occurred at a proper price, namely whether it has occurred at an “arm’s length price”, the price that would be paid in a market with each participant acting independently in its own interest.

The theory of the arm’s length price is well accepted, and is embodied in Article 9 (Associated Enterprises) of both the UN Model and the OECD Model and in bilateral tax treaties based on them. Applying the arm’s length principle in practice can be difficult for any country, however, and resource and information gaps already noted can make this especially difficult for developing countries to assure themselves that profits made in their economies are properly reported and taxed.

The UN Tax Committee becomes Involved

The Committee of Experts on International Cooperation in Tax Matters (the Committee) recognized the difficulties transfer pricing created for many developing countries and began its work on the *United Nations Practical Manual on Transfer Pricing for Developing Countries* (the Manual) in 2009, when it established its first Subcommittee on Transfer Pricing. The Manual was adopted by the Committee during its 2012 annual session and was issued in print form in 2013.

About the Manual

The Manual is designed to be in accord with the arm’s length principle. Such an approach seeks to minimize potential double taxation disputes among countries while combating potential mispricing of internal transactions within an MNE for shifting profit 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 analysis to some of the transactions of MNEs. While consistent with the *OECD Transfer Pricing Guidelines*, the Manual effectively provides a novel and needs-based approach to explaining what the arm's length approach means for developing countries, and addresses how it can be applied in practice in a way that reflects their realities.

The Manual is not intended to be prescriptive. It is left 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.

As an extension of this approach, the Manual has a unique feature that has attracted a great deal of interest since the Manual was published. For the first nine chapters of the Manual the Subcommittee undertook considerable effort to achieve a general consensus that the guidance in those chapters reflected the application of the arm's length principle as embodied in the UN Model. Chapter 10 (Country Practices) is different, however in that it reflects the practices of countries in this area without seeking to achieve a similar consensus on those practices. In the current version of the Manual, the practices of Brazil, China, India and South Africa are very usefully outlined.

The other Chapters of the Manual address the following topics:

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 and 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 they are able to take advantage of integration opportunities in the cross-border production of goods and provision of services through a "value chain".

Chapter 3, entitled "The Legal Environment", reviews the legal environment for transfer pricing and raises key issues and options for developing countries.

Chapter 4, entitled "Building Transfer Pricing Capability", addresses the need for specific transfer pricing capabilities in developing countries. The chap-

ter addresses practical issues in setting up a dedicated Transfer Pricing Unit in the tax administration.

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 (evidence of arm's length prices for similar transactions). The difficulty in finding comparables in many countries is not just due to issues of the affordability of databases, but also due to the lack of underlying data about business transactions in such countries.

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. Several methods are reviewed without expressing any preference. Which method should be used depends on particular circumstances, such as the type and characteristics of transaction, and the 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.

Chapter 8, entitled "Audits", surveys audit issues related to transfer pricing and stresses the need for risk assessment. 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 examinations.

Chapter 9, entitled "Dispute Resolution" deals with dispute avoidance and dispute resolution in this area.

The Future

The "Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing" was created in 2013 to take the Committee's work forward in this area. Its first task is to provide a draft revised commentary on Article 9 of the UN Model, the key article dealing with transfer pricing. The Subcommittee will present its proposed draft Commentary for discussion and decision at the tenth annual session of the Committee in October 2014.

The Subcommittee is also mandated to update the *United Nations Practical Manual on Transfer Pricing for Developing Countries*. It will, in particular, consider comments and proposals for amendments to the Manual and provide draft additional chapters on intra-group services and management fees as well as intangibles. It will also develop a text on available technical assistance and capacity building resources that may assist developing countries.

It is hoped that in the next version of the Manual more examples of practice from countries at various stages of their transfer pricing, including smaller developing countries, will also contribute to making the Manual an even more important guidance document in this area.



Several members of the Transfer Pricing Subcommittee attending the launch of the UN Practical Manual on Transfer Pricing in May 2013

For further Information

Please refer to the Financing for Development website at www.un.org/esa/ffd/

Link to the UN Manual on Transfer Pricing: http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf

Link to the UN Model Tax Convention: http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

Link to Transfer Pricing <http://www.un.org/esa/ffd/tax/TransferPricing/index.htm>