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Issues for the next update of the United Nations Practical Manual
on Transfer Pricing for Developing Countries

Secretariat Note – Comments on the United Nations Practical Transfer Pricing Manual for Developing Countries

Summary

This note addresses some of the publically available comments on the United Nations Practical Transfer Pricing Manual for Developing Countries since October 2012. At its eighth session in 2012, the Committee: "Issues that could not be addressed at the present stage would be collected by Mr. Sollund until 30 June 2013 and included in a catalogue of items to be handed over to the new membership of the Committee for future discussion and possible inclusion in later editions."

In the absence of new suggestions for changes or additions of a substantial nature in correspondence to Mr. Sollund or the secretariat, and in view of the interest shown in the Manual since its publication, however, the attachment to this paper gives excerpts of the publicly available responses to the Manual. The views are intended to be broadly representative of views since the time of the last Annual Session, but not comprehensive.

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Introduction

At the conclusion of discussions on the United Nations Practical Transfer Pricing Manual for Developing Countries at its eighth session in 2012, the Committee noted:[1]

> 20. The Subcommittee was thanked for its impressive efforts and, with its mandate met, it was dissolved. The Committee requested Mr. Sollund to work with the Secretariat in preparing the Manual for publication, including non-substantial editing and ensuring consistent terminology. It was agreed that comments addressing inconsistencies and errors would be received until 15 November 2012 but that matters of a substantial nature would not be considered for the first version of the Manual. Issues that could not be addressed at the present stage would be collected by Mr. Sollund until 30 June 2013 and included in a catalogue of items to be handed over to the new membership of the Committee for future discussion and possible inclusion in later editions.

2. As it happened, no suggestions for changes or additions of a substantial nature were proposed in correspondence to Mr. Sollund or the secretariat. There have at times been suggestions about the need to address issues such as intangibles and intra-group services, but these were issues that had already been considered by the Subcommittee on Transfer Pricing – Practical Aspects, and will be subject to decisions by any new subcommittee and the Committee. Paper E/C.18/2013/4 addresses such issues.

3. In view of the interest shown in the Manual since its publication, however, the attachment to this paper gives excerpts of the publicly available responses to the Manual. They are generally favourable, with particular interest shown in the Chapter 10 country positions. Sometimes concerns have been expressed about the possibility of a divergence of rules between the UN and OECD approaches, but the balanced approach taken by the Manual has generally been commented on favourably. The views are intended to be broadly representative of views since the time of the last Annual Session, but not comprehensive.

4. Of course the views reflected in the attachment should not be taken as necessarily reflecting Secretariat, Committee or Subcommittee views as to their accuracy or otherwise.

[1] E/2012/45 at paragraph 20.

ATTACHMENT: A SELECTION OF PUBLIC COMMENTS ON THE UN TRANSFER PRICING MANUAL

Examples of References to the Manual

US Council for International Business Letter on the Manual of 9 October 2012

Comments on the Transfer Pricing Manual[2]

Recognition of actual transactions undertaken. Taxpayer's transactions should be respected, absent exceptional circumstances. Restructuring legitimate business transactions is arbitrary and significantly increases the risk of double taxation. Paragraphs 5.3.1.2.1, 5.4.10.1, and 5.4.10.2 of the draft manual deal with this issue. These paragraphs are very similar to the OECD language on disregarding the transaction, with one extremely important difference. The OECD TPGs4 provide "there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by the taxpayer in entering into a controlled transaction." This language is generally seen as a limitation, that is, if neither of these circumstances existed it would not be appropriate to disregard the controlled transaction. Elimination of this language could be interpreted as a broadening of the ability to disregard the transaction as structured and therefore the language quoted above ought to be added to paragraphs 5.3.1.2.1 and 5.4.10.1 of the manual.

Intangibles. The Subcommittee concluded that they did not have time to adequately address issues relating to intangibles and therefore deferred work on that topic to the next revision of the manual.5 Nevertheless, the manual seems to reach conclusions on a number of key intangible transfer pricing issues; this is premature. In USCIB's view, paragraph 5.3.2.2.13 should be deleted. The issue of ownership of marketing intangibles is one that requires careful analysis and should be dealt with in the context of the overall review of intangibles. Similarly, paragraph 6.1.2.7 concludes that the party that "developed the intangibles should be able to obtain benefits from those intangibles". Identifying the developer of an intangible is not necessarily straightforward. Is the developer the person who funds the development, the person actually performing the functions, a participant in a cost contribution arrangement? This is a complex issue that ought to be considered in depth when the topic of intangibles is taken up. Therefore, the final sentence of section 6.1.2.7 ought to be deleted. Paragraph 6.3.17.3 provides that "this allocation is based on relative R&D expenses which are assumed to be a reliable key to measure the relative value of each company's intangible property." Again, valuation issues are complex and this conclusion ought not to be reached without a thorough analysis of the issues relating to intangible valuation. Thus, this sentence ought to be deleted.

Information requests. Chapter 8 covering Audits generally provides guidance that USCIB believes will be helpful to developing countries initiating transfer pricing audits. In the section on

[2] Note that, while these comments were before the Committee at the eighth annual session (e.g. E/2012/45 at para 17) they remain useful in giving one perspective of possible approaches for the second edition

information requests, however, the manual recommends requesting one item that we believe many taxpayers may not be able to provide. Paragraph 8.6.9, item 12 provides: "Group global consolidated basis (sic) profit and loss statement and ratio of taxpayer's sales towards group global sales for five years." It is not clear precisely what this requires. If global consolidated profit is determined based on the company's financial statements, then this information should be available for publicly traded companies. However, this number is unlikely to be useful for transfer pricing purposes since it does not bear any relationship to any particular transaction. As the manual points out in paragraph 8.6.6.2 the accurate review and assessment of financial results would be impossible without segmented profit and loss statements. This item needs to be either clarified or deleted.

Dispute resolution. USCIB believes that Chapter 9 contains a balanced discussion of dispute prevention, administrative remedies including APAs and MAP, arbitration and litigation. We have two concerns with the chapter. First, we believe that section 9.4.2 (Multilateral Agreements) ought to be deleted in its entirety. In our view, the only purpose of this section is to undercut the value of the OECD TPGs as the global standard in the area of transfer pricing. This is inconsistent with the mandate of the Subcommittee. The preface to the manual provides: "consistency with the OECD Transfer Guidelines has been sought, as provided for in the Subcommittee's mandate and in accordance with the widespread reliance on those Guidelines by developing as well as developed countries." As the manual recognizes in a number of places, global consistency of transfer pricing rules and interpretations promotes cross border trade and investment. Global consistency therefore promotes foreign direct investment, which benefits developing countries. This section of the manual potentially undercuts consistency, serves no other useful purpose and thus ought to be deleted.

The manual contains a number of statements concerning the global transfer pricing policies of MNEs. Generally, the statements concerning global transfer pricing policies recognize the usefulness of such policies. However, two paragraphs (9.3.1.6. and 2.4.9) seem to misconstrue the role of global transfer pricing policies. Paragraph 9.3.1.6 provides: "Many multinational enterprises apply transfer pricing policies to their intercompany transactions on a consistent basis globally, so the absence of national legislation may not encourage compliance by an MNE." If the national legislation contains no rule, then it would neither encourage nor discourage compliance. However, since the MNE will apply its consistent global policy in any event, the absence of legislation does not, in this case, change the transfer pricing result. It would therefore be more accurate to say that the absence of legislation does not "discourage" compliance with the global transfer pricing policy.

Paragraph 2.4.9 provides:

> In principle, designing, implementing and documenting an appropriate transfer pricing policy should not be viewed solely as a compliance issue for MNEs. The main goal should be to develop a consistent global policy which cannot be altered to exploit tax laws. A well developed and consistently applied transfer pricing policy should reduce an MNE's risk of transfer pricing adjustments and the potential for double taxation, thereby increasing profitability by minimizing transfer pricing costs. Moreover, a global transfer pricing policy may be used as evidence in negotiations with tax authorities when transfer pricing disputes occur.

The main goal of MNEs in "designing, implementing and documenting an **appropriate** transfer pricing policy" probably is compliance. The main goal of governments in encouraging the adoption of such policies may be the development of a policy that "cannot be altered to exploit the tax laws". MNEs want governments to respect their global policies. If governments want them to be unalterable, so that they cannot be used to exploit tax laws, then governments should have to respect global policies absent some clear abuse (in which case the policies would likely not be appropriate). Governments cannot require taxpayers to comply with their global policies, but feel free to reject prices computed under such policies merely to bring more revenue into their jurisdiction.

China Formally Announces its Transfer Pricing Policy

PricewaterhouseCoopers

October 2012

The State Administration of Taxation ("SAT") has announced its position on transfer pricing practices in China with the release of its paper, China Country Practices ("the paper"). The paper forms part of Chapter 10 on Country Practices in the United Nations' Practical Manual on Transfer Pricing for Developing Countries ("UN Transfer Pricing Manual").

The paper marks a significant development as it represents the SAT's views and practices on a number of transfer pricing challenges faced by China, as a developing country, which are not addressed by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Transfer Pricing Guidelines").

China's Chapter of U.N. Manual Advocates Reimbursement for Location Savings, Added Profit for Local Intangibles

Bloomberg BNA Tax Management Transfer Pricing Report

(Kevin A Bell)

15 November 2012

U.N. Manual

[Sébastien Gonnet of NERA Economic Consulting in Beijing] said many foreign companies are setting up R&D centers in China—not for the purposes of providing services to the U.S. or German parent, ''but to get closer to the market to develop products that will be more acceptable in the region.''

Previously, the concept of location savings related only to the issue of cost, Gonnett said, but taxpayers now must address the issue of location-specific advantages, because the SAT believes that taxpayers benefit not only from China's cost advantage but also from its large market.

Gonnet pointed out that Chapter 5 of the U.N. manual—in addition to the SAT's position set forth in Chapter 10.2—provides an analytical framework for location savings and location-specific advantages.

Chapter 5 explains that ''[t]aken together, location savings and each of the other types of benefit related to geographical location are called location-specific advantages.''

According to Chapter 5, the relocation of a business, in addition to location savings, may result in location- specific advantages, including:

- highly specialized skilled manpower and knowledge;
- proximity to growing local or regional market;
- large customer base with increased spending capacity;
- advanced infrastructure—for example, information and communication networks and distribution systems; and
- market premium.

…

A New Tax Order

[Glenn DeSouza of Baker & McKenzie in Shanghai] said that in 2000, OECD nations controlled 60 percent of gross world product. Now it is at 50 percent and is expected to drop to about 40 percent in 2030.

With new players such as Brazil, Russia, India, China, and South Africa (BRICS), nongovernmental organizations, and the U.N. entering the fray, the transfer pricing dynamics are different, DeSouza said. ''Ultimately, it's about each country getting a fair deal.''

DeSouza said China is part of the global economic system but wants to safeguard its interests—and it now has the clout to do so. A high-ranking SAT official recently said ''China has become a major source of global profits but it does not show up in China tax books.''

As ''an exceptional country,'' DeSouza said, China will want a say in writing the rules, whether it is greenhouse gases, transfer pricing, or intellectual property, ''and that is the way it will be.''

DeSouza said that with China now the second- largest economy, and accounting for 30 percent of the world's growth, the materiality of China in tax planning has become profound.

China is already the world's largest market for automobiles, steel, and smartphones, he said.

United Nations approves Manual addressing transfer pricing in developing countries

DLA Piper

(Ray H. Brown
Oscar Burakoff
Tim Carreon)

28 November 2012

Compliance with transfer pricing rules, while difficult in many countries, has proven to be especially challenging in certain developing countries, such as Brazil, China and India. Historically, some developing countries have (i) issued unique rules that are often inconsistent with global standards, (ii) instituted burdensome compliance requirements (*e.g.*, central bank registration) and (iii) applied their own rules inconsistently.

As a result, taxpayers have found it extremely difficult and costly to implement, document and defend transfer pricing policies in these countries. For example, such policies mean taxpayers face more extensive audits and more frequent litigation. In addition, dramatic variations across jurisdictions mean taxpayers have often been unable to implement their global transfer pricing policies on a consistent basis.

In an effort to provide guidance to policy makers, administrators and taxpayers on applying transfer pricing principles in developing countries, the Committee of Experts on International Cooperation in Tax Matters recently approved the United Nations' Practical Manual of Transfer Pricing for Developing Countries. The Manual, which is largely consistent with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, explains how the arm's-length approach to transfer pricing can be utilized effectively by developing countries.

While the Manual is primarily intended to assist policy makers and administrators in developing countries, Chapter 10 (Country Practices) is also useful for taxpayers to gain insight on the application of transfer pricing rules in several of the more complex countries. This information is particularly valuable because the chapter was written by country representatives, rather than by the principal authors of the Manual.

The Manual contains ten chapters that focus on the following topics:

- Activities and the value chain of multinational enterprises
- General transfer pricing legislation, including Competent Authority and advance pricing agreements
- Challenges related to establishing a transfer pricing authority
- Application of the arm's-length principle, including comparability analyses and a discussion of the methods available to determine an arm's-length transfer price
- Documentation

- Audits and risk assessment
- Dispute avoidance and resolution and
- Country practices

Insights on Transfer Pricing Issues with "Unique Chinese Characteristics"

Grant Thornton

China Transfer Pricing Alert, 8 December 2012

…In recent years, the SAT has obtained an important position on the global stage of international anti-tax avoidance. The announcement of the "China Country Practices" as part of "Practical Manual on Transfer Pricing for Developing Countries" (draft version) by the UN indicates a great leap in the TP administration of the SAT. Meanwhile, this initiative broadcasts the TP issues with Chinese characteristics to a wider audience. …

United Nations Practical Manual on Transfer Pricing

ITAT Online (India)

3 June 2013

The United Nations has released a publication titled "**Practical Manual on Transfer Pricing**". The Manual contains valuable discussion on a number of important topics. For instance, there is a detailed discussion on the types of transfer methods available (such as CUP, TNMM etc.) and their respective merits and demerits. Practical examples and case studies have also been given to explain in what circumstances a particular method is suitable. There is also detailed discussion on how comparables should be selected and how a comparability analysis should be conducted. There is also detailed discussion on the transfer pricing implications of marketing intangibles (trade marks, technical know-how etc) which becomes very relevant in the light of **L.G.Electronics vs. ACIT** 140 ITD 41 (SB). There is also a write-up on the law & practices being followed in India and other countries.

The Manual will prove invaluable for all professionals seeking in-depth understanding of transfer pricing concepts.

The United Nations Practical Manual on Transfer Pricing: a bluffer's guide

Martin Hearson (blog)

6 June 2013

Last week saw the official launch of a 495-page document by the United Nations tax committee, its new Practical Manual on Transfer Pricing for Developing Countries [pdf]. The final product has been four years in the making and is an impressive, introductory-level guide to transfer pricing. So definitely worth dipping in and out of if you've never quite got your head round exactly how international rules divide up the tax base of a multinational company.

Because of its length, few people outside those who follow the UN committee in depth have really understood what the manual is about, and its implications for the international politics of taxation. So here's a crib sheet on some of its more controversial aspects.

1. The manual is hardly the product of a group of tax mavericks

The subgroup responsible for drafting the manual includes two members of the OECD's Working Party 6, the technical group responsible for its transfer pricing guidelines – indeed the subgroup's Norwegian chair is also a bureau member of WP6 – as well as the head of the transfer pricing unit of the OECD secretariat. The subgroup had several private sector representatives, including people from Ernst & Young and Baker & Mackenzie, who did large amounts of drafting, and Shell's global transfer pricing manager.

This was balanced by government and private sector representatives from developing countries (many of whose countries also have the status of observing participants over at WP6). I understand that there were some quite heated exchanges at times, and the group certainly did include some considerations unlikely to have been given much airtime at the OECD.

2. The main body of the manual is consistent with the OECD guidelines

To set the context, we need to understand the UN committee's position on the OECD transfer pricing guidelines. The 2001 edition of the UN model convention explicitly **endorsed** the arm's length principle, and **recommended** that countries implement it using the methods set out in the OECD guidelines:

> the Contracting States will follow the OECD principles which are set out in the OECD Transfer Pricing Guidelines. These conclusions represent internationally agreed principles and the Group of Experts recommend[s] that the Guidelines should be followed for the application of the arm's-length principle which underlies the article.

The Manual defines the arm's length principle as, "an international standard that compares the transfer prices charged between related entities with the price of similar transactions carried out between independent entities at arm's length."

The 2012 update to the UN model convention also endorses the arm's length principle, but it is more circumspect about the OECD guidelines. This is because in 2011, when the updated model convention was agreed, the Brazilian, Indian and Chinese committee members recorded a reservation to the paragraph of the 2001 model quoted above. (The model conventions are the views of the individual members of the committee at the time they are agreed). Rather than attempting to find a consensus statement for the new model convention, the committee agreed to quote what their predecessors had said in 2001, and then add the following text:

The views expressed by the former Group of Experts have not yet been considered fully by the Committee of Experts, as indicated in the records of its annual sessions.

So we can see that the UN committee's position on the role of the OECD's transfer pricing guidelines has changed over the course of this session (though it continues to endorse the arm's length principle). Depending on how this evolution continues under the new committee membership, future versions of the transfer pricing manual might have the scope to carve out a more distinctive methodology for developing countries. But that was ruled out early on for this manual. The subcommittee concluded, as its chair reported back to the full committee in 2010, that its mandate required that the Manual maintain "consistency" with the OECD guidelines, which the UN model at that time – the old version – recommended that countries follow.

3. Consistent, but not identical

The transfer pricing subcommittee's mandate, from 2009, embodies the balancing act that anyone working on transfer pricing in developing countries faced. The subcommittee must ensure:

> a) That it reflects the operation of Article 9 of the United Nations Model Convention, and the Arms Length Principle embodied in it, and is consistent with relevant Commentaries of the U.N. Model.
>
> b) That it reflects the realities for developing countries, at their relevant stages of capacity development.
>
> c) That special attention should be paid to the experience of other developing countries.

An earlier proposed outline for the manual had included among subheadings on transfer pricing methods 'current' and 'alternatives'. Under the latter, a single bullet point says. "Global Formulary Apportionment – an introduction (alternative method for applying the ALS or alternative to the ALS?)." This was effectively ruled out by the mandate, but there was still a question about how to balance "consistency" with the OECD guidelines on the one hand with "reflecting the realities for developing countries" on the other.

The UN committee continued to discuss 'simplifications' to the methods included in the OECD's transfer pricing guidelines. For example, in 2010:

> The discussions of the group of experts, however, included an exchange of views at some length regarding the use of presumptive arm's length margins, safe harbours and

> formulas when applying arm's length pricing profit methods….[Monique van Herksen of Ernst & Young] explained the potential benefit to developing country tax administrations in making use of presumptive margins and safe harbours in relevant circumstances. Additionally, she mentioned as an idea to be considered that the United Nations, in an appropriate form, might issue temporary industry margins based on research and statistics to be used by taxpayers and tax administrations as arm's length presumptive benchmarks.

The final manual outlines these kinds of simplifications (although not van Herksen's final proposal quoted above) but it doesn't propose them as alternatives to the OECD guidelines – instead it notes that the latter are currently being updated to endorse the use of safe harbours. In the future, as both the OECD and UN consider how developing countries can simplify the implementation of the arm's length principle, it will be interesting to watch the interplay between their respective documents.

4. The manual sets out the contours of current transfer pricing debates, and business is not happy

As I blogged at the time, the US Council for International Business wrote a rather angry letter [pdf] to the committee ahead of its final discussion of the manual last year. One section that it was unhappy about was 9.4.2, which according to USCIB, "ought to be deleted in its entirety. In our view, the only purpose of this section is to undercut the value of the OECD [transfer pricing guidelines] as the global standard in the area of transfer pricing."

That section is still in the final version, and it still notes that, "the interpretation provided by the OECD Transfer Pricing Guidelines may not be fully consistent with the policy positions of all developing countries." It is summed up as follows:

> developing countries may wish to consider the relevance of the OECD Transfer Pricing Guidelines, along with the growing body of UN guidance and other available sources, when establishing their own domestic and cross-border policies on transfer pricing.

It's hard to view this as a dramatic policy statement by the Committee. Rather, it's an accurate description of the current state of affairs, and the concluding recommendation is made in the context of dispute avoidance, for which developing countries need to consider the actual practices of countries with which they may get into a dispute.

5. Chapter 10 is probably the manual's biggest contribution

During 2011, as the manual developed, its outline started to include a chapter 6, on 'The [Possible] Use of Fixed Margins', otherwise known as 'the Brazil chapter'. Although it existed in draft form, this chapter – a description of the Brazilian approach to transfer pricing, which is not consistent with the OECD guidelines – was never published on the UN website. By 2012, it had disappeared from the manual, replaced instead by a chapter 10, which unlike the rest of the manual "does not reflect a consistent or consensus view of the Subcommittee."

I've heard that the proposed 'Brazilian chapter' was the subject of a lot of controversy, as well as variously that it was opposed by OECD members, lobbied against by the OECD secretariat,

and even fought by other large developing countries, who didn't see why Brazil should get a chapter all of its own. Certainly it seems inconsistent with the way the subgroup interpreted its mandate (see 2 above).

Whoever opposed the Brazilian chapter may instead have created a monster in chapter 10. It's probably the only detailed description of Brazil, China, India and South Africa's approach to transfer pricing, both how they follow and how they differ from the OECD methods. Significantly, these contributions are expressed not just in terms of the legal and administrative realities, but also the policy objectives underlying them.

It seems unlikely that smaller developing countries will read this chapter and try to adopt the methodologies it outlines. Rather, chapter 10 functions as a comprehensive critique of the OECD guidelines – almost a manifesto – endorsed and in most cases written by tax officials from some of the world's most powerful economies. As a focal point in transfer pricing discussions, it is politically very significant.

The nature of this critique is the subject of a separate blog.

6. The political significance of the manual depends on what happens next

The UN manual contains a lot of very useful text that, on a technical level, will be very useful for developing countries. The current committee wants the manual to develop in the future, and it seems clear that the UN's arrival on the transfer pricing scene is a fundamental change in international tax governance.

The UN Manual is not an alternative to the OECD Guidelines. Yet. It could evolve in that direction, creating a counterweight in the same mould as its model treaty, but that depends on what the new committee decides to do with it.

It also depends on two more things. First, on the unresolved discussion concerning the UN model convention's position towards the OECD guidelines. Further work on the UN manual will inevitably be framed in terms of the model convention, which is the committee's signature document, so the tension between OECD members and larger developing countries on this point is significant.

Second, it depends on the OECD, which has been working hard to reach out to developing countries [pdf]. Institutionally, it has brought many of them into its new Global Forum on Transfer Pricing, several are observers on its standards-setting committees, and there's of course its Tax and Development Task Force. In terms of content, its project on transfer pricing 'simplification' has already incorporate some of the measures mentioned in the UN manual, and may even go further. So the OECD may succeed in creating a broad enough tent to regain its UN endorsement. It's hard to see, though, how Chinese and Indian measures, which place them at odds with OECD countries, could be incorporated by the OECD itself.

UN Transfer Pricing Manual: what Brazil, India and China do Differently

Martin Hearson (blog)

6 June 2013

'Country Practices'. The title of Chapter 10 of the new United Nations Practical Manual on Transfer Pricing [pdf] doesn't exactly set the pulse racing. But as I noted in my blog on the manual as a whole, this document is politically very significant.

It's probably the only detailed description of Brazil, China, India and South Africa's approach to transfer pricing, both how they follow and how they differ from the OECD methods. Significantly, these contributions are expressed not just in terms of the legal and administrative realities, but also the policy objectives underlying them. Chapter 10 functions as a comprehensive critique of the OECD guidelines – almost a manifesto – endorsed and in most cases written by tax officials from some of the world's most powerful economies.

So what's in it? Here are some digested highlights – but you should read it all.

Brazil: fixed margins

Since the mid 1990s, Brazil has been the world's transfer pricing maverick. It makes no claim to follow the OECD guidelines, although the core of its approach is analogous to some of the methods outlined in those guidelines. Brazil views its approach as consistent with the arm's length approach, since it's another way to approximate the price that would be paid between companies trading at arm's length. Many others disagree with this view.

Under the OECD approach, the taxpayer (and tax authority, if it is challenging a taxpayer) needs to identify a 'comparable' company or transaction for each and every transfer price under assessment, subject to some adjustments. The simplest method is to find two independent companies that are trading a similar good or service, and use that price. Brazil adopts this method too.

If that can't be done, some other OECD methods (Cost Plus and Resale Minus) use comparable profit margins, applying them to the price paid when the good or service under consideration is eventually bought from or sold to a third party. (There are other OECD methods that are even more complicated, but they're not used in any form by Brazil). The Brazilian approach uses the same idea, but prescribes fixed profit margins.

In a simple example, imagine a Canadian mining company operating in Brazil. There are two subsidiaries, a mine in Brazil, and then an intermediary in Bermuda that buys the minerals and sells them on to third parties. To apply the OECD's Resale Minus approach, you'd find a comparable commodity trader that buys minerals from third parties and sells them on to other third parties. You'd look at the profit margin it makes, then apply that same profit margin to the actual price at which the minerals from Brazil were sold on by the Bermudan company to a third party, to obtain the price at which the Bermudan company bought the minerals from its sister company in Brazil.

Brazil's Resale Price Method is similar, except that rather than looking for a comparable, you apply a fixed margin of (usually) 20% to the actual price at which the minerals were sold on to third parties. In other words, the transfer price from Brazil to Bermuda would be 80% of the resale price from Bermuda to a third party. Last year Brazil made its method a bit more fine-grained, by setting out different margins for different sectors, based on data about each sector.

The Brazilian section of Chapter 10 argues that this method is easier to apply and provides more certainty than the OECD approach. It acknowledges that the approach may create double taxation because it's not compatible with other countries that use the OECD methods, and that, "it is unavoidable that some Brazilian enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability."

China, India and South Africa

"As a developing country, China faces a number of difficult challenges, to many of which ready answers have not been found from the OECD guidelines," notes the Chinese section of Chapter 10, written by two senior tax officials. South Africa's submission concurs:

Whilst the OECD Guidelines have been particularly useful in providing a conceptual understanding of what is the nature of the arm's length principle, there are instances when the Guidelines fail to address the more practical aspects of how to apply the principle

According to all three of these countries, the difficulty is with how to implement the arm's length principle. And their sections of the manual set out many practical problems with implementation. But I think that there's something more than that at stake here. These countries (or at least India and China) want to claw back a larger share of the tax base, which is about changing the apportionment between themselves and other countries. They may argue that their position is a more accurate implementation of the arm's length principle, but to do so is to understate what they're trying to achieve. Below are three examples.

Location specific advantages

The premise of the Location Specific Advantage (LSA) approach is that investments by multinational companies in these countries are more profitable than those in other countries, as a result of LSAs such as a cheap, comparatively skilled labour force, a large, relatively untapped consumer market, and more lax environmental legislation. This needs to be take into account when identifying and using comparables that do not have these same advantages.

To determine the transfer price by reference to a comparable transaction or company in another country, "China takes the view that there may be instances where the differences in geographical markets are so material that it warrants comparability adjustments to bridge the differences." In other words, China revises up the profit made by Chinese subsidiaries, and hence the tax charge, when comparing them to other countries, because it thinks the LSAs it offers make investments in China more profitable than those in other countries.

South Africa says it shares this concern:

> There are many instances where unique dynamics exist within the South African market enabling South African subsidiaries to realise higher profits than their related party

> counterparts in other parts of the world, or than are evidenced by comparable data obtained from foreign databases…Building on the practice followed in India and China, the SARS is currently considering its approach to location savings, location specific advantages and market premiums etc. within certain industries and such factors will be addressed when conducting audits.

The Indian section also discusses location specific advantages. Its argument, however, relates to whether local comparables, as well as foreign ones, are valid. Although the chapter doesn't say this, I think India's argument is also that the arm's length principle doesn't work here, because there is no arm's length scenario that captures the location specific advantages:

Hypothetically, if an unrelated third party had to compensate another party to the transaction in a low-cost jurisdiction by an amount that was equal to the cost savings and location rents attributable to the location, there would be no incentive for the unrelated third party to relocate business to a low-cost jurisdiction.

What makes the LSA concept interesting is not merely that these countries are laying claim to a larger share of MNCs' tax base than the OECD guidelines attribute to it. They are saying, quite explicitly in China's case, that under free market ("arm's length") conditions, they don't receive a fair share of the profits from inward investment, because the LSAs aren't fairly priced by the market. China is using the tax system to correct for what it sees as unfair conditions in the global economy.

Below is a presentation by another Chinese official at a Tax Justice Network conference last year. Scroll through to slide 20 for the part on LSAs.

Intangibles

Transfer pricing is supposed to start from a 'functional analysis' that takes into account functions, assets and risks to determine how profit should be allocated. But intangible assets (and risks, see below) can be more easily moved than functions and tangible assets. China and India are concerned that multinationals tend to characterise subsidiaries in their economies as exploiting foreign-owned intellectual property, on which they must pay royalties, in order to deflate the profits made there.

For example, China takes the view that the value of a marketing intangible (such as a brand name) is inextricably linked to the market in which it is sold. In a memorable example, Head & Shoulders is a popular shampoo in China, and a foreign brand. But when it first arrived on the Chinese market, most consumers didn't know what the words "Head and Shoulders" meant. "Over time," says the manual, "the local Chinese affiliates acquire the skill and experience from operations in China, and may even contribute to the improvement of the MNE's original intangibles. The issue in this scenario is whether the local Chinese affiliates should be entitled to additional profit, and if so, what is the appropriate method to calculate the additional profit?"

The Indian approach is similar:

> Indian subsidiaries/related parties (which are claimed as no risk and limited risk bearing distributors by the parent MNE in order to justify low cost plus return) have

> incurred and borne huge expenditure on development of marketing intangibles. These entities generally incur very large losses or disclose very nominal profit as evident from their return of income

Instead of a flow of royalty payments out of India, it argues, the parent company should be reimbursing its Indian subsidiary for the local marketing intangibles created, without which it couldn't sell into India.

Risks, and the formulary apportionment bombshell

India is concerned that the OECD approach overvalues the role of risks in allocating profits. Risk plays an important role in the functional analysis that underpins transfer pricing, because the higher the risk taken by one part of a company, the higher the transfer price it can charge. The Indian section says risks are "a by-product of [a company's] performance of functions and ownership and the exploitation or use of assets employed over a period of time." It "does not agree with the notion that risk can be controlled remotely by the parent company" and says that if "important strategic decisions" are taken in India then "the allocation of risk to the parent MNE is not only questionable but is devoid of logical conclusion." Ouch.

The Chinese section concurs, arguing that "a risk-based approach may place insufficient

regard for the fact that there are sizeable assets located in China (i.e. the work force and factory plants)." It goes as far as to conclude that, in the case of the electrical manufacturing sector, "In this case, the assets and the people should largely dictate where the group's profits should stay, and a global formulary approach should be a realistic and appropriate option."

This is quite a bombshell. The chapter effectively argues that, in order to reduce the distorting effect of risks and intangible assets in transfer pricing, there is a case for the limited use of the formulary system advocated by Tax Justice Network, distributing the profits based on only on the assets and people in each jurisdiction. Wow. That will no doubt get tax justice activists excited, but to me what's more interesting is the open discussion about which factors to take into account in allocating profits, and which to disregard. That's not just about refinements to the technical implementation of the arm's length principle: it's politics.

Transfer Pricing in Africa - A balancing act

Ernst & Young

(Karen Miller)

Undated

There has been an unprecedented amount of activity at the OECD and beyond in the field of transfer pricing. The United Nations released its draft manual on Transfer Pricing electronically in the fall of 2012 and formally on May 29, 2013, which largely shows alignment to the OECD approach but also provides for some divergence if Chapter 10

(country views) is considered.

The new concept of Location Specific Advantages raised in the Manual has been a key topic for developing countries such as China and India. This to some degree adds a different perspective to the traditional view of the arm's length principle advocated by the developed countries of the OECD.

African tax administrations are influenced by the emergence of the developing country view and look more and more towards guidance from countries such as China and India as well as South Africa. They accept that effective transfer pricing rules are key to ensuring that multinationals report and pay tax on the correct proportion of profits they make in Africa. However, they also acknowledge the challenges with effective implementation of such rules. Resource constraints and implementing fledgling legislation is one such challenge. Policy disparity between implementing an effective transfer pricing regime and the existing regulatory environment is another such challenge.

In particular the existence of archaic central bank controls can make the implementation of effective transfer pricing problematic for both the Revenue Administrations and multinationals. The arm's length principle, the bedrock foundation of transfer pricing legislation, assumes an economy free of such regulations. Exchange control restrictions and burdensome withholding taxes, both prevalent in many developing countries including Africa, can make implementation of the principle to some degree unrealistic.

The Revenue Administrations in Africa can find themselves between two worlds as a result of which bringing in a set of rules that play to a developing economic environment creates many challenges. Layer onto that the inevitable disputes, which are likely to arise through implementation of the transfer pricing rules and the result is an increased burden on what are already very constrained government resources.

Many countries are seeking to bring in compulsory documentation, Advanced Pricing Agreements (APA) regimes and additional filing requirements in an attempt to enforce transfer pricing compliance. However good the intentions, the risk facing Africa is that these additional compliance burdens coupled with the level of withholding taxes and the regulatory restrictions will have a negative impact on the Continent's ability to attract direct foreign investment.

We have seen bodies such as the OECD, IMF and a number of developed country Revenue Administrations reach out to Africa to offer support and training. This goes a long way to assist in developing resources to deal with the challenges expressed above. However if South Africa - which has had transfer pricing legislation in place for 18 years serves as an example, it is evident that getting to grips with effective implementation will take a long time for the rest of Africa as a whole. Changes to the legislation in South Africa have created implementation burdens, which everyone is struggling to grasp. The move to an arm's length test for thin capitalisation and the implementation of a secondary imputed loan adjustment have created a level of complexity in South Africa tax rules which surpasses not only most of the developing countries but some of the developed countries too.

As the African continent moves into the transfer pricing age, it needs to balance certain issues. Complexity will impact effective implementation, regulatory issues affect the viability of

implementing the arm’s length principle and a high level of compliance documentation may impact ongoing foreign direct investment.

General Motors India Pvt. Ltd vs. DCIT (ITAT Ahmedabad) –

ITAT Online Summary: Transfer Pricing: Foreign associated enterprise can be taken as ‘Tested Party’

6 August 2013

The assessee bought CKD Kits from General Motor Daewoo Auto & Technology (GMDAT), a foreign associated enterprise. The assessee claimed that to determine whether the transactions were at arm’s length, GMDAT had to be selected as the tested party on the ground that the functions and risks of the assessee are more complex in nature and that numerous adjustments would have to be made if the assessee were taken as the selected part. The TPO & DRP rejected the assessee’s contention on the basis that (a) a foreign entity could not be a tested party, (b) GMDAT is a complex entity owing valuable intangibles & (c) the data for comparability of GMDAT is not available. On appeal by the assessee to the Tribunal, HELD:

While there is nothing in the transfer pricing law as to the selection of the tested party, the tested party normally should be the party in respect of which reliable data for comparison is easily and readily available and fewest adjustments in computations are needed. It may be local or foreign entity, i.e., one party to the transaction. The object of transfer pricing exercise is to gather reliable data, which can be considered without difficulty by both the parties, i.e., taxpayer and the revenue. It is also true that generally least of the complex controlled taxpayer should be taken as a tested party. But where comparable or almost comparable, controlled and uncontrolled transactions or entities are available, it may not be right to eliminate them from consideration because they look to be complex. If the taxpayer wishes to take foreign AE as a tested party, then it must ensure that it is such an entity for which the relevant data for comparison is available in public domain or is furnished to the tax administration. The taxpayer is not then entitled to take a stand that such data cannot be called for or insisted upon from the taxpayer. This is supported by the **United Nation’s Practical Manual on Transfer Pricing for Developing Countries** which stated that a foreign entity (a foreign AE) could also be taken as a tested party for comparison. The revenue’s argument that GMDAT should not be selected as a ‘tested party’ as it does not fall within the ambit of TPO’s jurisdiction and he can neither call for any additional information nor scrutinize their books of accounts is not acceptable because the Revenue can get all the relevant particulars around the globe by using the latest technology under its thumb or direct the assessee to furnish the same (**Ranbaxy Laboratories** 110 ITD 428 (Del), **Mastek Limited**, **Development Consultants** 136 TTJ 129 & **Sony India** 114 ITD 448 (Del) followed; **Onward Technologies** (Mum) & **Aurionpro Solutions** (Mum) not followed/ distinguished)

The Impact of Nigeria's New Transfer Pricing Rules on Multinational Enterprises

PWC Nigeria

(Taiwo Oyedele, Anthony Curtis, Elizabeth Sweigart and Robert Smallwood)

March 2013

"… Over the last several years, Nigeria has worked to develop its own transfer pricing rules based on the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) and the commentary surrounding the creation of the UN Transfer Pricing Manual (UN Manual) which was formally approved in October 2012. The FIRS released the draft transfer pricing rules in May 2012, and the final rules in September 2012, as The Income Tax (Transfer Pricing) Regulations No. 1, 2012 (The Regulations)."

R&D centres and Transfer pricing – The latest controversy

Rajendra Nayak Ernst and Young, India

Undated

...The administrative position of the Indian tax authorities is also asserted in the India chapter of the United Nations Practice Manual on transfer pricing issues for developing countries (UN TP Manual). The India chapter states that during transfer pricing audits the Indian revenue officers often find that the India-based R&D centers perform sophisticated and value-added activities which not only require significant investment in the physical infrastructure but also require the Indian entity to attract, train and retain highly skilled personnel. In cases where the India-based R&D centre was found to be engaged in the creation of unique intangibles, the India transfer pricing administration has allocated additional compensation for transfer of intangibles in addition to the arm's length compensation for the R&D activities, as it believes that risk lies with the Indian entity.

The Indian transfer pricing administration explicitly does not agree with the notion that risk can be controlled remotely by (employees operating out of) the parent company and that the Indian entity engaged in core functions, such as carrying R&D activities or providing services can be risk free entities. According to the India Country specific chapter, the Indian revenue administration believes that core R&D functions which are located in India require important strategic decisions by management and employees of the Indian subsidiary and accordingly the Indian subsidiary exercises control over operational and other risks. In this context, allocation of routine cost plus return will not reflect a true arm's length price (ALP) for the services rendered.

Other Coverage

The Manual has also received wide coverage in specialist journals. In an editorial to the Indian Journal *International Tax Review*, it was noted, inter alia that:

- UN Manual provides no detailed guidance on cost contribution agreements, business restructuring and dispute resolution tools like APA on which OECD TPG contains detailed chapters. I hope those may be covered in later updates.
- The searching of relevant topic in the Manual is slightly difficult as no detailed contents are given in the beginning.

While the published version has an index at the front, it is hoped by the secretariat that a more detailed index of particular concepts can be included at the back of the next version.

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