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Update of the United Nations Practical Manual on Transfer Pricing for Developing Countries

1.7. Transfer Pricing in Domestic Law

Introduction

1.7.1. Article 9 ("Associated Enterprises") of tax treaties typically only regulates the basic conditions for adjustment of transfer pricing and corresponding adjustments in case of double taxation. The Article advises the application of the arm's length principle but does not go into the particulars of transfer pricing rules. It is generally understood that Article 9 is not "self-executing" as to domestic application — it does not create a transfer pricing regime in a country where such a regime does not already exist.

1.7.2. It should be recognized that transfer pricing regimes are creatures of domestic law and each country is required to formulate detailed domestic legislation to implement transfer pricing rules. Many countries have passed such domestic transfer pricing legislation which typically tends to limit the application of transfer pricing rules to cross-border related party transactions only.

1.7.3. It is important to note that the definition of an "associated enterprise" is based on domestic circumstances and hence varies, to some extent, amongst different countries. For example, a majority of countries employ a hybrid qualification for such taxpayers, namely a mixture of qualification by minimum shareholding (generally equal to or more than 50 per cent) and effective control by any other factors (dependency in financial, personnel and trading conditions). *De minimis* criteria for the value of related party transactions may also exist. In other words, some transactions may be considered small enough that the costs of compliance and collection do not justify applying the transfer pricing rules, but this should not allow what are in reality larger transactions to be split into apparently smaller transactions to avoid the operation of the law.

1.7.4. It must be noted that transfer pricing being essentially domestic regulation has a long history, and international consistency of transfer pricing rules is beneficial not only regarding the basic structure of taxable persons and events but also in the manner of application of the arm's length principle. However, it is ultimately for each country to adopt an approach that works in its domestic legal and administrative framework, and is consistent with its treaty obligations.

Safe harbours

1.7.5. There are countries which have “safe harbour” rules providing that if a taxpayer meets certain criteria it is exempt from the application of a particular rule, or at least exempt from scrutiny as to whether the rule has been met. The intention is to increase taxpayer certainty and reduce taxpayer compliance costs, but also to reduce the administration’s costs of collection, as well as allowing the administration to concentrate scarce audit and other resources on those cases where more is likely to be at stake in terms of non-compliance and revenue.

1.7.6. Safe harbour rules are provisions whereby if a taxpayer’s reported profits are within a certain range or percentage or under a certain amount, the taxpayer is not required to follow a complex and burdensome rule, such as applying the transfer price methodologies. They may only be used by the taxpayers at their option. There are some risks to safe harbours, such as arbitrariness in setting parameters and range, equity and uniformity issues, incompatibility with the arm’s length principle, opportunities for tax planning and tax evasion and potential risk of double taxation. In any case, consistent with the purpose of this Manual, introducing a safe harbour rule should involve analysis of whether, in a broad sense, the administrative and simplification benefits of a safe harbour outweigh the potential costs of applying something other than the arm’s length principle.

Controlled foreign corporation provisions

1.7.7. Some countries operate Controlled Foreign Corporation (CFC) rules. CFC rules are designed to prevent tax being deferred or avoided by taxpayers using foreign corporations in which they hold a controlling shareholding in low-tax jurisdictions and “parking” income there. CFC rules treat this income as though it has been repatriated and it is therefore taxable prior to actual repatriation. Where there are CFC rules in addition to transfer pricing rules, an important question arises as to which rules have priority in adjusting the taxpayer’s returns. Due to the fact that the transfer pricing rules assume all transactions are originally conducted under the arm’s length principle, it is widely considered that transfer pricing rules should have priority in application over CFC rules. After the application of transfer pricing rules, countries can apply the CFC rules on the retained profits of foreign subsidiaries.

Thin capitalization

1.7.8. When the capital of a company is made up of a much greater contribution of debt than of equity, it is said to be “thinly capitalized”. This is because it may be sometimes more advantageous from a taxation viewpoint to finance a company by way of debt (i.e., leveraging) rather than by way of equity contributions as typically the payment of interest on the debts may be deducted for tax purposes whereas distributions are non-deductible dividends. To prevent tax avoidance by such excessive leveraging, many countries have introduced rules to prevent thin capitalization, typically by prescribing a maximum debt to equity ratio. Country tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in calculating the measure of a company’s profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive debt, and thus aim to protect a country’s tax base. From a policy perspective, failure to tackle excessive interest payments to associated enterprises gives MNEs an advantage over purely domestic businesses which are unable to gain such tax advantages.

Documentation

1.7.9. Another important issue for implementing domestic laws is the documentation requirement associated with transfer pricing. Tax authorities need a variety of business documents which support the application of the arm's length principle by specified taxpayers. However, there is some divergence of legislation in terms of the nature of documents required, penalties imposed, and the degree of the examiners' authority to collect information when taxpayers fail to produce such documents. There is also the issue of whether documentation needs to be "contemporaneous", as noted above.

1.7.10. In deciding on the requirements for such documentation there needs to be, as already noted, recognition of the compliance costs imposed on taxpayers required to produce the documentation. Another issue is whether the benefits, if any, of the documentation requirements from the administration's view in dealing with a potentially small number of non-compliant taxpayers are justified by a burden placed on taxpayers generally. A useful principle to bear in mind would be that the widely accepted international approach which takes into account compliance costs for taxpayers should be followed, unless a departure from this approach can be clearly and openly justified because of local conditions which cannot be changed immediately (e.g. constitutional requirements or other overriding legal requirements). In other cases, there is great benefit for all in taking a widely accepted approach. See further Chapter 7 of this Manual which details the most widely accepted approaches.

Advance pricing agreements

1.7.11. Recently, multinational businesses have often depended on Advance Pricing Agreements (APAs) (or "Advance Pricing Arrangements", as some countries prefer) with tax authorities, especially in the framework of the Mutual Agreement Procedure. These APAs are so named because pricing methodologies are agreed in advance in relation to certain types of transactions, often called the "covered transactions". APAs provide greater certainty for the taxpayer on the taxation of certain cross-border transactions and are considered by the taxpayers as the safest way to avoid double taxation, especially where they are bilateral or multilateral. Many countries have introduced APA procedures in their domestic laws though having different legal forms. For example, in certain countries an APA may be a legally binding engagement between taxpayers and tax authorities, while in other countries it may be a more informal arrangement between the tax authorities and the taxpayer. The possible advantages and disadvantages of APAs for developing country administrations and taxpayers, including some implementation issues, are addressed in Chapter 9.

Time limitations

1.7.12. Another important point for transfer pricing domestic legislation is the "statute of limitation" issue — the time allowed in domestic law for the tax administration to do the transfer pricing audit and make necessary assessments or the like. Since a transfer pricing audit can place heavy burdens on the taxpayers and tax authorities, the normal "statute of limitation" for taking action is often extended compared with general domestic taxation cases. However, too long a period during which adjustment is possible leaves taxpayers in some cases with potentially very large financial risks. Differences in country practices in relation to time limitation may lead to double taxation. Countries should keep this issue of balance between the interests of the revenue and of taxpayers in mind when setting an extended period during which adjustments can be made.

Domestic transfer pricing rules and tax treaties

1.7.13. Both developed and developing countries need to have domestic transfer pricing rules to counter transfer pricing manipulation and also need the associated enterprises article of tax treaties (usually Article 9) which is relevant to avoidance and elimination of double taxation due to transfer pricing adjustments. One view is that the associated enterprises article of a tax treaty provides a separate and independent domestic basis for making transfer pricing adjustments. The contrary view is that tax treaties do not increase a country's tax jurisdiction and consequently the associated enterprises article of a country's tax treaties cannot provide a separate source of tax jurisdiction. The detail in such domestic laws will vary from country to country and will often vary depending on how advanced the country is in its transfer pricing journey.

1.7.14. One view is that a country's tax jurisdiction, usually some mixture of residence and source-based taxation, is based on its domestic legislation and that when two countries enter into a tax treaty with each other they agree to mutually modify the exercise of their respective taxing rights to prevent double taxation. A tax treaty is in this respect a mechanism to allocate the taxing rights to prevent double taxation arising from the overlap of residence and source jurisdiction. Tax treaties operate by altering the operation of domestic tax law; by either excluding the operation of the domestic tax law of a treaty country or by requiring a treaty country to provide a credit against its domestic tax for tax paid in the other treaty country. The generally held view is that under a tax treaty a tax obligation exists if the requirements of the treaty country's domestic law and the tax treaty are both satisfied. The taxing powers of each treaty country are based on their respective domestic taxation law and may be limited but not expanded by the treaty. Also, treaties do not provide the necessary detail on how a transfer pricing regime will work in practice, such as the documentation required. As a consequence of these factors it is generally considered that a country with tax treaties should enact domestic transfer pricing measures rather than asserting that its treaties provide it with a power to make transfer pricing adjustments.

1.7.15. For transfer pricing measures to be effective, a tax jurisdiction must enforce them and ensure that taxpayers comply with the rules. If jurisdictions either do not enact transfer pricing measures or do not enforce those measures there is an incentive for taxpayers to ensure that intra-group transfer prices favour jurisdictions that enforce their rules. This may be described as taking the line of least resistance, but it does provide an incentive for developing jurisdictions to enact and enforce some form of transfer pricing rules to protect their revenue base.

1.7.16. That MNEs might use transfer prices to shift profits from lower tax countries to higher tax countries is a paradox, but happens in practice (e.g. to benefit from certain tax incentives in the high tax country or because there are losses in the high tax country that can be offset with profits from a lower tax country). MNEs may also have an incentive to shift profits to jurisdictions in which tax laws, such as transfer pricing rules, are not enforced. Transfer pricing is a "zero sum game" — a situation in which the "gain" of taxable profits by one jurisdiction must be matched by a "loss" by the other jurisdiction. Consequently some international enterprises might set their transfer prices to favour a jurisdiction expected to enforce its transfer pricing rules, in order to minimize the risk of transfer pricing adjustments and penalties in that jurisdiction. Moreover, transfer pricing disputes are generally time consuming and expensive.

1.8. Transfer Pricing in Treaties

UN and OECD Model Conventions: An overview

1.8.1. The OECD Model Convention[1] was first published in 1963 as a draft version. A final version was first published in 1977. This OECD work followed up some work already done by the League of Nations; and then after World War II by the United Nations. The United Nations produced a UN Model Convention for Treaties between Developed and Developing Nations in 1980, with a new version produced in 2001.[2] The UN Model Convention has now been further updated, and was launched as the 2011 Update on 15 March 2012. The UN Model is in many respects similar to the OECD Model but the differences (such as preserving greater taxation rights to countries hosting investments) are very significant, especially for developing countries.

1.8.2. There has historically been a widespread view that the OECD Model was most appropriate for negotiations between developed countries and less suitable for capital importing or developing countries. In general, it can be said that the UN Model preserves more taxation rights to the source state (i.e. host state of investment) or capital-importing country than the OECD Model. The UN Model has been embraced by many developing states as the basis of their treaty policy. Some developed countries also adopt some UN Model provisions, and at times it has influenced changes to give aspects of the OECD Model a greater source country orientation.

Transfer pricing and the model conventions

1.8.3. Article 9 of the OECD Model is a statement of the arm's length principle and allows for profit adjustments if the actual price or the conditions of transactions between associated enterprises differ from the price or conditions that would be charged by independent enterprises under normal market commercial terms, i.e. an arm's length basis. It also requires that an appropriate "corresponding adjustment" be made by the other Contracting State in such cases to avoid economic double taxation, taxation of essentially the same profit in the hands of two different legal entities if justified in principle and in amount. In other words, if one country increases the profit attributed to one side of the transaction, the other country should reduce the profit attributed to the other side of the transaction. The competent authorities[3] of the Contracting States are if necessary to consult with each other in determining the adjustment.

1.8.4. Other OECD Model Tax Convention articles which apply the arm's length principle include the article concerning dealings between the head office and a permanent establishment (Article 7(2)).

[1] A read-only but downloadable version of the OECD Model is available from http://www.oecd.org/tax/treaties/oecdmtcavailableproducts.htm

[2] The UN Model is available from http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

[3] Officials designated by countries to discuss treaty and other international tax-related issues with each other.

Article 7(4) previously explicitly permitted the use of the apportionment of total profit by countries customarily using it, provided the result was consistent with the arm's length principle, but this has been removed from the latest (2010) version of the OECD Model in a major re-write of Article 7.

1.8.5. The UN Model contains similar provisions to the OECD Model in Article 9 (at Paragraph 1 especially) and therefore serves as a guide for applying the arm's length principle for developing countries. However the UN Model also includes an additional paragraph (Article 9(3)) which stipulates that a Contracting State is not required to make the corresponding adjustment referred to in Article 9(2) where judicial, administrative or other legal proceedings have resulted in a final ruling that, by the actions giving rise to an adjustment of profits under Article 9(1), one of the enterprises concerned is liable to a penalty with respect to fraud, or to gross or wilful default.

1.8.6. There is some ambiguity in the concept of "associated enterprises" in the context of the Model Conventions; e.g. the term is used in the heading of Article 9, but not in the text. The Model Conventions use the concept to cover relationships between enterprises which are sufficiently close to require the application of transfer pricing rules. Concepts such as "management", "capital" and "control" are often defined under the domestic law in many countries and may be extended for transfer pricing. E.g., if parties to the transaction make arrangements differing from those made by unrelated parties this could be considered to lead to a situation of "control". Also, sometimes a wider definition including both de jure (i.e., according to legal form) and de facto (i.e., according to practical reality) control, which are difficult to define, may be adopted based on the anti-avoidance provisions in domestic law.

1.8.7. The Model Conventions also spell out in Article 25 a key transfer pricing dispute resolution mechanism — the Mutual Agreement Procedure (MAP). The MAP facilitates the settlement of disputes on corresponding adjustments among competent authorities. It should be noted that the MAP Procedure does not guarantee relief as it is voluntary; there is however a duty to negotiate in good faith to try to achieve a result consistent with the treaty allocation of taxing rights. Chapter 9 discusses MAP in more detail.

1.8.8. Finally, there are a small number of bilateral treaties which allow for arbitration to resolve transfer pricing disputes.[4] Further, the EU Arbitration Convention[5] establishes a procedure to resolve disputes where double taxation occurs between enterprises of different Member States in the EU as a result of an upward adjustment of profits of an enterprise of one Member State.

1.8.9. Overall, the Model Conventions are a critical source of acceptance for the arm's length principle. Given that many countries around the world follow fairly closely one of the Model Conventions, the arm's length principle has been widely accepted, even though its imperfections are also widely recognized.

Relevance of UN and OECD Model and the OECD Guidelines to developing countries

1.8.10. Transfer pricing rules have been developed mainly within the Members of the OECD (i.e developed countries) only because of their historical and economic backgrounds. Many developing

[4] A paragraph relating to arbitration has also been included in Article 25 of the OECD Model Tax Convention.

[5] Convention 90/436/EEC 1990.

countries currently face some of the same conditions as the OECD countries did in the period from the 1970s to the 1990s. It is therefore useful to focus on certain key areas where many developing countries are encountering difficulties with administering the arm's length principle.

1.8.11. Developing countries often have substantial problems with the availability of comparable transactions. This issue is considered more fully in Chapter 5; it suffices to note that due to a typically small domestic market in many developing countries, third party transactions comparable to the MNE's intra-group transactions are rarely discovered in the home market.

1.8.12. Documentation requirements should as far as possible be common between the two Models (UN and OECD), because diversity in documentation rules results in excessive compliance costs for MNEs and smaller enterprises. Targeted documentation requirements can be an alternative to full scale documentation where transactions are simple and the tax at issue is not large. This may be especially important in responding to the needs and capabilities of small and medium-sized enterprises (SMEs).

1.9. Global Transfer Pricing Regimes

1.9.1. The UN and OECD Model Conventions, the OECD Guidelines and domestic legislation of various countries have provided examples for introduction of transfer pricing legislation worldwide, as a response to increasing globalization of business and the concern that this may be abused to the detriment of countries without such legislation. Many other countries depend on anti-avoidance rules to deal with the most abusive forms of transfer pricing; see further Chapter 3 on the General Legal Environment.

1.9.2. By the end of 2012, there were around 100 countries with some form of specific transfer pricing legislation as shown by the light grey shading in the diagram below.