

PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES

Foreword to the Second Edition (2017)

This second edition of the United Nations Practical Manual on Transfer Pricing for Developing Countries (the Manual) is intended to draw upon the experience of the first edition (2013) including feedback on that version, but it is also intended to reflect developments in the area of transfer pricing analysis and administration since that time.

At the Ninth Session of the United Nations Committee of Experts on International Cooperation in Tax Matters in October 2013, a Subcommittee was formed with the task, among others, of updating this Manual.

The mandate of the reconstituted *Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing* in relation to this Manual was as follows:

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

The Subcommittee as a Whole is mandated to update the United Nations Practical Manual on Transfer Pricing for Developing Countries, based on the following principles:

- That it reflects the operation of Article 9 of the United Nations Model Convention, and the Arm's Length Principle embodied in it, and is consistent with relevant Commentaries of the U.N. Model;
- That it reflects the realities for developing countries, at their relevant stages of capacity development;
- That special attention should be paid to the experience of developing countries; and
- That it draws upon the work being done in other fora.

In carrying out its mandate, the Subcommittee shall in particular consider comments and proposals for amendments to the Manual and provide draft additional chapters on intra-group services and management fees and intangibles, as well as a draft annex on available technical assistance and capacity building resources such as may assist developing countries. The Subcommittee shall give due consideration to the outcome of the OECD/G20 Action Plan on Base Erosion and Profit Shifting as concerns transfer pricing and the Manual shall reflect the special situation of less developed economies.

The Subcommittee shall report on its progress at the annual sessions of the Committee and provide its final updated draft Manual for discussion and adoption at the twelfth annual session of the Committee in 2016.

The Committee at its twelfth session recognised that the Subcommittee's mandate had been met and approved the proposed update to the Manual. The Manual is improved, and made more responsive to issues of current country concern and also more in tune with rapid developments in this area,

including those relating to the OECD/G20 Action Plan on Base Erosion and Profit Shifting mentioned in the Subcommittee mandate. It was decided by the Subcommittee, and agreed by the Committee, that the Manual was not the best place for a draft annex on available technical assistance and capacity building resources such as may assist developing countries, as mentioned in the mandate. This was considered better addressed by a webpage updated and managed by the UN Secretariat.

The changes in this edition of the Manual include:

- A revised format and a rearrangement of some parts of the Manual for clarity and ease of understanding, including a reorganization into four parts as follows:
 - Part A relates to transfer pricing in a global environment;
 - Part B contains guidance on design principles and policy considerations;
 - Part C addresses practical implementation of a transfer pricing regime in developing countries; and
 - Part D contains country practices, similarly to Chapter 10 of the previous edition of the Manual. A new statement of Mexican country practices is included and other statements are updated;
- A new chapter on intra-group services;
- A new chapter on cost contribution arrangements;
- A new chapter on the treatment of intangibles;
- Significant updating of other chapters; and
- An index to make the contents more easily accessible

The Foreword to the First Edition of this Manual, which is included below, remains relevant as to its substance. In particular, its recognition that:

"While consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not be reached, and it follows that specific views expressed in this Manual should not be ascribed to any particular persons involved in its drafting. [Part D]¹ is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. [Part D] should be read with that difference in mind."

As with the Subcommittee involved in drafting the first edition of this Manual, the current Subcommittee is comprised of Members from tax administrations with wide and varied experience in dealing with transfer pricing as well as Members from academia, international organizations and the private sector, including from multinational enterprises and advisers. The Subcommittee met successfully in New York (thrice), Santiago de Chile, Rome, and Bergamo, Italy, with the three last-mentioned meetings being made possible by the generosity of the host countries. The support of the

¹ Changes in square brackets are made to reflect the new structure of the Manual.

European Commission's Directorate General for International Cooperation and Development (DEVCO) and especially its Budget Support and Public Finance Management Unit, was especially important in ensuring a successful meeting in Bergamo.

(The members of the Subcommittee and their countries (in the case of government officials) or affiliations (in other cases) contributing to this updated version of the Manual at various times, were, although membership is assumed on a personal capacity: Stig Sollund (Norway - Coordinator); Joseph Andrus; Ganapati Bhat (India); Melinda Brown (OECD); Hafiz Choudhury (The M Group); Giammarco Cottani (Ludovici & Partners, Italy); Johan de la Rey (South Africa); Nishana Gosai (Baker & McKenzie, South Africa); Noor Azian Abdul Hamid (Malaysia); Toshiyuki Kemmochi (Japan); Michael Kobetsky (Australian National University and Melbourne University, Australia); Michael McDonald (USA); Toshio Miyatake (Adachi, Henderson, Miyatake and Fujita, Japan); T.P. Ostwal (TP Ostwal & Associates, India); Christoph Schelling (Switzerland); Jolanda Schenk (Shell, Netherlands); Carlos Perez-Gomez Serrano (Mexico) Caroline Silberztein (Baker & McKenzie, France); Monique van Herksen; Marcos Valadão (Brazil); Xiaoyue Wang (China) Ingela Willfors (Sweden) and Ying Zhang (China). The assistance to the Subcommittee is also acknowledged of Mr. Cao Houle (China) and Mr. Marc Bochsler and Mr. Basil Speyer (both from Switzerland).

The additional special role of Subcommittee Member Mr. Hafiz Choudhury as technical coordinator is recognized with thanks. The assistance of the Secretariat, including Michael Lennard, Ilka Ritter and Tatiana Falcão in this work is also acknowledged.

Foreword to the First Edition (2013)

The United Nations Practical Manual on Transfer Pricing for Developing Countries is a response to the need, often expressed by developing countries, for clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises (MNEs) in particular. Such guidance should not only assist policy makers and administrators in dealing with complex transfer pricing issues, but should also assist taxpayers in their dealings with tax administrations.

The United Nations Model Double Taxation Convention between Developed and Developing Countries² considers (at Article 9 — “Associated Enterprises”) whether conditions in commercial and financial relations between related enterprises, such as two parts of a multinational group, “differ from those which would be made between independent enterprises”. The same test is applied at Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital.³ In this respect both Models, which between them are the basis for nearly all bilateral treaties for avoiding double taxation, endorse the “arm’s length standard” (essentially an approximation of market-based pricing) for pricing of transactions within MNEs.

²United Nations, “Model Double Taxation Convention between Developed and Developing Countries”, updated 2011. Available from: http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

³OECD, “Model Tax Convention on Income and Capital”.

While it is for each country to choose its tax system, this Manual is addressed at countries seeking to apply the “arm’s length standard” to transfer pricing issues. This is the approach which nearly every country seeking to address such issues has decided to take. Such an approach minimizes double taxation disputes with other countries, with their potential impact on how a country’s investment “climate” is viewed, while combating potential profit-shifting between jurisdictions where an MNE operates.

In recognizing the practical reality of the widespread support for, and reliance on, the arm’s length standard among both developing and developed countries, the drafters of the Manual have not found it necessary, or helpful, for it to take a position on wider debates about other possible standards. The Manual will, at most, help inform such debates at the practical level, and encourage developing country inputs into debates of great importance to all countries and taxpayers.

There is a risk, without an effective response to transfer pricing issues, that profits might appear to be earned in low- or no-tax jurisdictions (thereby serving to reduce tax rates on taxable profits/incomes and associated tax obligations), and losses might appear to be incurred in high-tax jurisdictions (thereby increasing allowable deductions for tax purposes). This may have the net effect of minimizing taxes and, in so doing, may impact on the legitimate tax revenues of countries where economic activity of the MNE takes place, and therefore the ability of such countries to finance development.

For the purposes of this Manual, the term “mis-pricing” is used to refer in a short form to pricing that is not in accordance with the arm’s length standard. It is not intended to imply that a tax avoidance or evasion motive necessarily exists in a particular case. From the country development perspective, the impact of non-arm’s length pricing does not depend on whether or not such an intention exists, though that may of course affect how countries respond to particular instances of such behaviour.

There are as yet no figures which clearly indicate the amount of revenue lost to transfer mis-pricing that might otherwise be directed to development. However, with intra-firm trade generally regarded as comprising more than 30 per cent of global trade,⁴ there is reason to believe that the figures are large. While more research still needs to be done on the size of the potential losses for developing countries, and the situation will no doubt vary greatly from country to country, there is clearly great scope for pricing decisions about intra-group transactions that detrimentally impact domestic revenues for development.

Conversely, in this complex area, there is a risk that taxpayers, especially MNEs, will be faced with a multiplicity of approaches to applying the arm’s length standard in practice that can lead to

⁴See for example Alexander Yeats, “Just How Big Is Global Production Sharing?”, in *Fragmentation: New Production Pattern in the World Economy*, Sven Arndt and Henryk Kierzkowski, eds. (Oxford, Oxford University Press, 2001); Alfonso Irarrazabal, Andreas Moxnes and Luca David Oromolla, “The Margins of Multinational Production and the Role of Intra-Firm Trade”, *Journal of Political Economy*, vol. 121, No.1 (February 2013) and Peter Egger and Tobias Seidel, “Corporate taxes and intra-firm trade”, July 2010. Available from <http://www.etsg.org/ETSG2010/papers/seidel.pdf>. The share of intra-firm trade is however, very difficult to measure, varies significantly between countries and depends on the definition of relevant relationships. See for example Rainer Lanz and Sébastien Miroudot, “Intra-Firm Trade: Patterns, Determinants and Policy Implications”, OECD Trade Policy Working Papers, No. 114, (Paris, OECD, 2011). Available from [http://search.oecd.org/officialdocuments/displaydocumentpdf/?cote=TAD/TC/WP\(2010\)27/FINAL&docLanguage=En](http://search.oecd.org/officialdocuments/displaydocumentpdf/?cote=TAD/TC/WP(2010)27/FINAL&docLanguage=En) at page 12 following.

compliance burdens and the risk of unrelieved double taxation. This can be the case even where there is no issue of tax avoidance or evasion, because of the scope for differences of view about what the arm's length price would be in a particular case. Helping achieve common understandings on transfer pricing issues can also improve trust between taxpayers and tax authorities, both avoiding some differences between them and helping resolve others more quickly.

In offering practical guidance to policy makers and administrators on the application of the arm's length principle, the Manual does not seek to be prescriptive. In particular it recognizes that the needs of countries, along with their capabilities, will evolve over time. A "phased" or "life cycle" approach, with a transfer pricing capability strategy identifying short, medium and longer term objectives and areas of focus will therefore often yield the best results. It follows that many developing countries may find the early history of transfer pricing in developed countries to be of special relevance, as well as the current practices in other, especially developing, countries.

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

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

There are a number of other guiding principles that have informed this Manual and reflect the mandate of the Subcommittee involved in its drafting, including that:

- This is a practical Manual rather than a legislative model;
- The drafting should be as simple and clear as the subject matter permits;
- The Manual will be prepared initially in English, but with a recognition that this will not be the first language of most users. It should be translated at least into the other official United Nations languages;
- A key "value added" of the Manual is to be its practicality — addressing real issues for developing countries (and of course those dealing with the administrations of such countries) in a practical and problem-solving way. It therefore seeks to address the theory of transfer pricing, but in a way that reflects developing country realities in this area;
- The Manual, as a product of the United Nations Committee of Experts on International Cooperation in Tax Matters, has a special role in reflecting the diversity of the United Nations Membership and placing transfer pricing in its developmental perspective. This recognizes both the importance to development of fair and effective tax systems, but also the fact that foreign investment, on appropriate terms, is seen as an important path to development by most countries;
- Helpful guidance in this complex area must, in particular, be geared to the inevitable limitations in some countries' administrations, and deficits in information and skills that many countries are affected by in this area. Issues, in particular, of building and retaining capability

as well as the need for focus and efficiency in dealing with limited resources, bear strongly on the approach taken in the Manual;

- Practical examples relevant to developing countries have been especially relied upon, because the experiences of other developing countries in addressing the challenges of transfer pricing are an important way of finding effective solutions that work in their context, and of doing so in the most cost and time effective ways; and
- Consistency with the OECD Transfer Pricing Guidelines⁵ 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.

Just as building an effective and efficient transfer pricing capability is a journey, so too is the preparation of a Manual seeking to give guidance for that journey. This Manual has been the work of many authors, and particular thanks are due to the Members of the Subcommittee on Transfer Pricing - Practical Matters at the time of completion of the Manual:⁶ Stig Sollund (Norway - Coordinator); Julius Bamidele (Nigeria); Giammarco Cottani (Italy); Nishana Gosai (South Africa); Mansor Hassan (Malaysia); Michael McDonald (USA); Sanjay Mishra (India); Harry Roodbeen (Netherlands); Marcos Valadão (Brazil); Shanwu Yuan (China); Joseph Andrus (OECD); Keiji Aoyama (University of Waseda, Japan); Carol Dunahoo (Baker & McKenzie, US); Michael Kobetsky (Australian National University & Melbourne University, Australia); Kyung Geun Lee (Yulchon Lawyers, Korea); Toshio Miyatake (Adachi, Henderson, Miyatake & Fujita, Japan); T.P. Ostwal (Ostwal and Associates, India); Jolanda Schenk (Shell, Netherlands); Caroline Silberztein (Baker & McKenzie, France); and Monique van Herksen (Ernst and Young, Netherlands).

Former Members of the Subcommittee who also contributed were Amr El-Monayer (Egypt); José Madariaga Montes (Chile); Carmen van Niekerk (South Africa); and Stefaan de Baets (OECD). Observers at various Subcommittee meetings provided valuable insights. Secretarial support for the Manual was provided by Michael Lennard, assisted in particular by Ilka Ritter.

Appreciation is expressed to the European Commission, particularly its Departments of Company Taxation Initiatives and of Budget Support, Public Finance and Economic Analysis, for making possible the valuable editorial work of Hafiz Choudhury, and to the Royal Norwegian Ministry of Foreign Affairs for additional support. The Subcommittee also expresses its gratitude to the relevant ministries and agencies of the governments of Malaysia, India, Japan, South Africa and the People's Republic of China for generously hosting Subcommittee meetings. Thanks are also due to those who made comments on the draft chapters.

While consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not be reached, and it follows that specific views expressed in this Manual should not be ascribed to any particular persons involved in its drafting. Chapter 10 is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. Chapter 10 should be read with that difference in mind.

⁵OECD, "Transfer Pricing Guidelines for Multinational Enterprises".

⁶Members as of October 2012, when the Manual was presented to the Committee for consideration. Members of the Subcommittee serve purely in their personal capacity. Accordingly, the references to countries (in the case of those in government service) or employers (in other cases) are for information only.

To assist in understanding the practical application of transfer pricing principles, this Manual frequently refers to hypothetical examples, such as in relation to Chapter 5 on Comparability Analysis and Chapter 6 on Methods. Such examples are intended to be purely illustrative, and not to address actual fact situations or cases. Finally, it should be noted that this Manual is conceived as a living work that should be regularly revised and improved, including by the addition of new chapters and additional material of special relevance to developing countries. This will only improve its relevance to users and its significance as a work that can be relied upon in the capacity building efforts of the United Nations and others that are so needed in this field.