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Item 5 (e) of the provisional agenda

Transfer Pricing

Secretariat note

Summary

This paper provides background information on the topic of transfer pricing for consideration of the Committee of Experts in developing its work programme. The Committee has done substantial work on transfer pricing since 2009 through a multi-stakeholder Subcommittee. Transfer pricing continues to be a priority area to strengthen domestic resource mobilization as part of the post-2015 development agenda. Transfer mis-pricing may impact on the legitimate tax revenues of countries where economic activity of MNEs take place, and therefore the ability of such countries to finance sustainable development activities. Abusive transfer pricing practices are considered to pose major risk to the direct tax base of many countries and developing economies, which are particularly vulnerable as corporate income tax tends to account for a relatively larger share of their revenue.

A decision is sought from the Committee regarding the establishment of a Subcommittee on Transfer Pricing for the 2021 to 2025 membership, which would follow the precedent of prior work done and allow for the efficient involvement of subject matter experts. The paper presents some potential topics for work undertaken by the Subcommittee, such as, for example, practical risk assessment tools, transfer pricing aspects of marketing or trading hubs and simplification measures. It is additionally recommended to closely follow the outcome of the BEPS 2.0 project to examine and explain the interaction between non-arm's length taxing rights under amount A for certain multinationals and the application of the arm's length principle for most companies as well as possible spill-over aspects of safe harbour rules under amount B. A draft Subcommittee mandate is provided for consideration of the Committee.

Background

1. The United Nations Committee of Experts on International Cooperation in Tax Matters (“UN Tax Committee”, “Committee”) debated and decided to work on transfer pricing issues at its fourth session in 2008 and subsequently formed a Subcommittee at the Committee’s fifth session in 2009. The members of the UN Tax Committee agreed that transfer pricing posed significant policy challenges for developing countries. The intention of the Committee’s work was to provide guidance tailored towards developing countries on how to apply the “arm’s length principle” with their input and priorities fully incorporated but recognizing that transfer pricing capability was a “journey” and different countries were at different stages. Ultimately, the goal was the sharing of successful tax practices to ensure that countries are able to protect their legitimate taxing rights. It was decided that the guidelines issued by the United Nations were to follow the main premises as defined by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“OECD Guidelines”), and to assist countries in practical ways when following such guidance.
2. The Subcommittee, that was composed of Committee members, representatives from government and international organizations, taxpayers and academics, commenced work on the Practical Manual on Transfer Pricing for Developing Countries (“TP Manual”, “Manual”) in 2009. The first edition of the Manual was published in 2013. Descriptive chapters that represent consensus among the Committee members were supplemented with country practices that describe particular country administrative practices. In comparison to the OECD Guidelines, the TP Manual is more detailed in some aspects, focuses on easy-to-understand language and offers many illustrative examples.
3. A subsequent update of the United Nations Practical Manual on Transfer Pricing for Developing was published in 2017. The Subcommittee responsible was a broad coalition of Committee members, industry experts and international organizations. This second edition includes even more practical examples and – just as the first edition – pays special attention to the experience of developing countries and transfer pricing capacity development work. Next to editorial changes, new chapters on intra-group services, cost contribution arrangements and the treatment of intangibles were added and other chapters including the country practices were significantly updated or extended.
4. In 2021, the third edition of the United Nations Practical Manual on Transfer Pricing for Developing was published. The most current version of the Manual encompasses parts A, B and C as well as country practices contained in part D. Part A covers a broad and general introduction on how multinational enterprises function and provides insight on how they organize their business models. Part B comprises substantive chapters and topics dealing with the design of transfer pricing legislation and the arm’s length principle, and topics dealing with transfer pricing comparability analysis and transfer pricing methods, services and intangibles. Part C gives guidance on transfer pricing legislation design and implementation followed by part D that includes practical insights into country administrative practices. The 2021 UN Transfer Pricing Manual extends existing guidance by introducing a new chapter on financial transactions as well as further details on profit splits, centralized

procurement functions and on comparability. A preliminary version of the Manual was launched at the 22nd session of the Committee in April 2021; an edited version was presented during the Publication Launch Event on 7 October 2021.

Transfer Pricing as a Policy Priority

5. Transfer pricing continues to be a priority area to strengthen domestic resource mobilization (“DRM”) as part of the post-2015 development agenda. 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 reducing taxable profits/income and associated tax obligations), and losses might appear to be incurred in high-tax jurisdictions. This will likely 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 sustainable development activities. Abusive transfer pricing practices are considered to pose major risk to the direct tax base of many countries and developing economies, which are particularly vulnerable because corporate income tax tends to account for a relatively larger share of their revenue.¹
6. Transfer pricing remains a hot topic: At the level of the OECD / Inclusive Framework work is ongoing regarding a two-pillar solution to address the tax challenges arising from the digitalization of the economy. Pillar 1 touches on transfer pricing issues in several points. Firstly, the proposed re-distribution of residual profits of large multinational enterprises to market jurisdictions upon fulfillment of a special purpose nexus rule using a revenue-based allocation key (so-called amount A) is a move away from the arm’s length principle. It is also proposed that along with amount A specific dispute prevention and resolution mechanisms will be introduced. Companies which are in scope for Pillar 1 will also have access to marketing and distribution profits safe harbors (so-called amount B), which, over time, might have spill-over effects into the application of the arm’s length principle for other companies.²

Issues to Consider by the Committee

7. In furthering the work on transfer pricing, the Committee may decide to conduct a more thorough workshop with representatives from developing countries to ensure that the most pressing issues for developing countries not yet covered by the Manual can be identified. Such a workshop could take place in the first quarter of 2022, to ensure that the Subcommittee has enough time to deliberate on the feedback received and decide on a work plan.
8. Given the recent publication of the Transfer Pricing Manual, the Committee may consider to work on interstitial guidance. This would allow any future Subcommittee to be responsive to new topics and priorities and finalize guidance within a shorter

¹ Cooper, Fox, Loeprick & Mohindra (2016). *Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners*. Washington, DC: World Bank. Available from <https://openknowledge.worldbank.org/handle/10986/25095>.

² OECD/G20 Inclusive Framework (2021). Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy. Available from [Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy – 1 July 2021 \(oecd.org\)](https://www.oecd.org/tax/inclusive-framework-statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-1-july-2021/)

time frame as compared to an update of the Transfer Pricing Manual. At the same time, the Committee could decide that any interstitial guidance could form part of any updated version of the Manual in the future.

9. The following are possible topics that any future Subcommittee might consider for interstitial guidance. This list is in no means exhaustive.
10. 10. The *covid-19 pandemic* has brought about many challenging questions for transfer pricing purposes, not least the treatment of losses in principal structures, changes in supply chains and their impact on risk, the treatment of government subsidies and grants, etc. The Committee may wish to consider publishing guidance on transfer pricing aspects arising due to disruptions in supply chains and a general business downturn. Any guidance given could pay special attention to the situation of developing countries.
11. In collaboration with the Subcommittee on the Taxation of the Extractives Industries, the Transfer Pricing Subcommittee completed guidance on transfer pricing issues for the extractive industries that forms part of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, which has been met with great interest. The Committee may wish to work on further *sector-specific guidance* such as, for example, transfer pricing issues in the real estate sector or in industries engaged in project development.
12. Lastly, the Manual in part C discusses transfer pricing legislation design and implementation, which has been identified as helpful by many developing countries. In line with this, the Committee may wish to work on a separate publication that *discusses best practices in domestic legislation* with special attention to the capacities and priorities of developing countries in varying situations, especially those in special situations. This could include, for example, work on potential *anti-avoidance provisions to address transfer pricing abuse*.
13. Likewise, the Committee may consider undertaking work on *practical toolkits*, for example in the area of risk assessments including checklists, linkages between exchange of information and domestic investigations, MAP strategies, etc. While the Manual includes some of this information, practical tools could be developed to be used in capacity building programmes. As with all proposals, any further work should be undertaken after a careful stock-taking of existing resources. This work stream could also include the streamlining of guidance in the Manual with work undertaken by the Committee on dispute resolution more broadly.
14. Further work on *centralized sales functions* as well as on *marketing and sales hubs* is recommended due to their potential for profit shifting and base erosion. In terms of centralized sales functions, the Subcommittee received input from interested stakeholders. As the core of the substance has been addressed in the third edition of the Manual, the Subcommittee decided that further appraisal of the perspectives given and refinement of the Manual could be taken up by the new membership, if thought appropriate.

15. In light of more complex value chains, it has been questioned whether a function and risk analysis as the starting point for the determination of transfer prices is sufficient to capture the essence of transactions. It has been argued that moving from a function and risk analysis to a **function, risk and market analysis** would be better suited to capture “location-specific advantages”, which are widely argued to be more relevant for developing countries. Such work would entail a systematic review of location-specific advantages and methods on how to reflect this in both a function, risk and market analysis as well as in the application of transfer pricing methods.
16. Against the background of further digitalization of the economy, the Committee may want to consider scrutinizing if and how existing transfer pricing rules based on the arm’s length principles could be applied to the **digitalization of non-digital companies**. Such work could focus for example on the digitalization of service offerings and possible consequences (centrally developed app, local adaptation, local data collection used firm-wide). This work would have to be especially conscious of work undertaken in other fora, most notably at the OECD level.
17. The Committee may also wish to be an early mover on acknowledging **new trends** that may necessitate transfer pricing guidance. This could include crypto-denominated loans or crypto-backed loans as well as the treatment of Co2 certificates for transfer pricing purposes.
18. Should the Subcommittee decide to update the Transfer Pricing Manual at a later stage, the following topics would benefit consideration:
19. The third edition of the Manual introduced a dedicated chapter on financing activities. The focus of this chapter was on loans and guarantees. Other financing instruments, such as cash pools, were not covered. The Committee may decide to extend the chapter to capture **further financing instruments** – an area prone to profit shifting. Moreover, the topic of pricing of minerals could be broadened to cover other **commodities such as in the agricultural and farming sector**.
20. The third edition of the Manual contains in part D several **country practices**. As the Manual’s aim is to be as practical as possible, part D could be extended further. Though, as the country practices are not products of the Committee this would not involve approval by the Subcommittee or Committee.
21. Lastly, the Committee may wish to closely monitor the discussions and outcome of the **BEPS 2.0 project** with regard to Pillar 1. According to a statement issued in July 2021, 134 countries have, in principle, agreed on the application of rules for multinational companies with a worldwide turnover of over 20 billion euros and a profitability of over 10% (excluded are extractive industries companies and the regulated financial services industry). Companies that fall within the scope of application should allocate between 20% and 30% of the profit that exceeds 10% of revenue to market countries in which there is a nexus (so-called amount A). The basis for the allocation of the profit, using a sales-based distribution key, is the balance sheet profit, with only a small number of adjustments. There are also simplification safe harbours foreseen for the application of the arm’s length principle to in-country

baseline marketing and distribution activities (so-called amount B) and with regards to tax certainty / dispute resolution measures. At this stage we cannot presume the final configuration or uptake of that work, and cannot assume adherence to any resulting multilateral convention by any particular UN Member country. It should be noted that many UN Members are not currently IF Members, even if consensus is achieved in that body. It has been suggested by some that against this background, a more general discussion about fractional allocation would be beneficial.

22. Firstly, it is recommended that in case of an adoption of (the non-arm's length) reallocation of global residual profits by the largest multinationals (amount A), such a deviation from the arm's length principle and its interaction with the guidance given by the Committee would need to be explained.
23. Secondly, any simplification measures, i.e. the marketing and distribution profits safe harbors, would need to be examined in terms of their potential for spill-over effects on transfer pricing more broadly.
24. Lastly, changes to dispute prevention and dispute resolution should be monitored in terms of their (potential) impact on existing country practice.

Recommendation

25. Any work undertaken by the Committee on transfer pricing issues, should focus on the realities and priorities of developing countries, including by giving practical examples and by presenting country administrative practices. As the proper application of transfer pricing rules continues to be a crucial element in the fight against tax evasion and avoidance, continued work on this topic would contribute to domestic resource mobilization and, ultimately, to sustainable development efforts through higher tax receipts.
26. A decision is sought by the Committee on establishing a Subcommittee on Transfer Pricing. The Committee may consider the following mandate for a Subcommittee on Transfer Pricing to govern their work:

The Subcommittee is mandated to consider, report on and propose guidance on transfer pricing issues, on the basis:

- That it reflects 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 (except as that may be affected by any OECD/IF Multilateral Convention, in relation to parties adhering to such multilateral agreement);
- That the Subcommittee identifies and considers the transfer pricing topics where guidance from the Committees is the most useful;
- That it reflects the realities for, and the needs of, developing countries, at their relevant stages of capacity development;

- That it draws upon the work being done in other fora, i.e. the Subcommittee shall consult broadly and seek to engage with academia, regional organizations and other international organizations, as well as civil society active in the field.
- The Subcommittee shall give due consideration to the outcome of the BEPS 2.0 project as concerns transfer pricing, in relation to parties adhering to such outcomes.

The Subcommittee shall report on its work at each session.

As in the past, it would be recommended to bring together a broad range of Subcommittee members from government, private sector, and academia. Civil society is also active in this area and some civil society participation is recommended.