Transfer Pricing for Developing Countries

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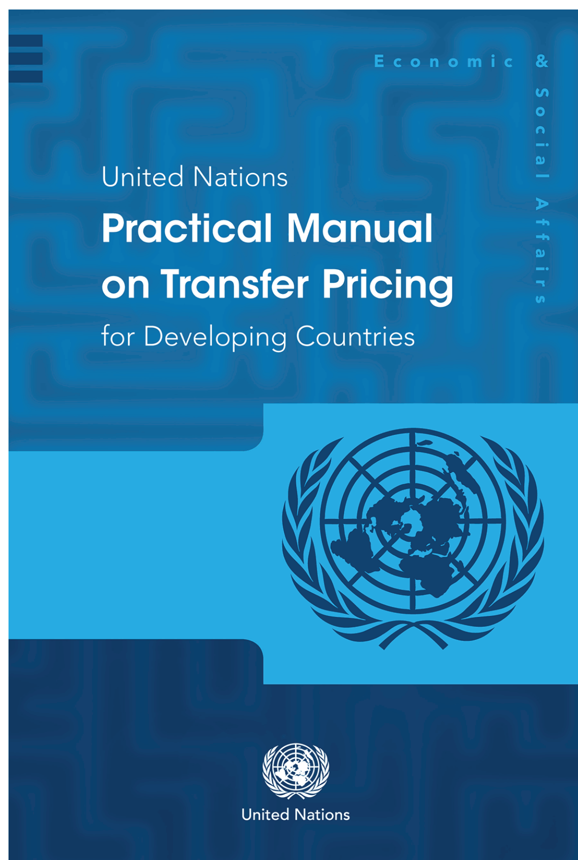

Intra-group Trade

Rapid advances in technology, transportation and communication have given rise to a large number of multinational enterprises (MNEs), which have the flexibility to place their enterprises and activities anywhere in the world. A significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group. Such transfers are called "intra-group transactions". There is evidence that intra-group trade is growing steadily and arguably accounts for more than 30 per cent of all international transactions. The structure of transactions within an MNE group is determined by a combination of the market and group-driven forces, which can differ from the open market conditions operating between independent entities. A large and growing number of international transactions are therefore no longer governed entirely by market forces, but driven by the common interests of the entities of a group.

What is Transfer Pricing?

Transfer pricing refers to the mechanism by which cross-boarder intra-group transactions are priced. In itself, it is a normal incident of MNE operations – it allows MNE to determine which parts of the group are profit- or loss-making, for example. However, if the method used to determine the price of such transactions, for whatever reason, does not reflect their true value, profits might effectively be shifted to low-tax or no-tax jurisdictions and losses and deductions to high-tax jurisdictions. This unfairly deprives a country of tax revenue, reducing the amount of resources available for funding its development objectives (see example 1). Apart from tax base erosion, it can also lead to double taxation, which might undermine the investment climate, which is a critical factor for the promotion of foreign direct investment (see example 2).

Arm's Length Price

Both the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (the UN Model) and the *OECD Model Tax Convention on Income and on Capital* (the OECD Model) have essentially followed the same test of whether transfer pricing has occurred at a proper price or range of prices, namely whether it has occurred at an "arm's length price", the price that would be paid in a market with each participant acting independently in its own interest. The theory of the "arm's length price" is well accepted, and is embodied in Article 9 (Associated Enterprises) of both the UN Model and the OECD Model and in bilateral tax treaties based on them.

Challenges for Developing Countries

Transfer pricing is particularly important for developing countries as MNEs often operate in their economies. The difficulty is in applying the "arm's length principle" in practice,

especially as many MNEs have unique and hard to value intangibles or engage in complex transactions involving many different elements that would not be replicated in any market. Addressing these practical complexities relies heavily on the availability of data and expert skills, often posing special difficulties for developing countries, with the relevant data often being not available, too expensive, and requiring special skills to be adjusted or otherwise properly interpreted.

Example 1: Profit shifting

- A profitable computer company in country A buys hard drives from its own subsidiary in country B. The price the parent company in country A pays its subsidiary company in country B (the "transfer price") will determine how much profit the country B unit reports and how much local tax it pays. If the parent pays the subsidiary a price that is lower than the appropriate "arm's length price", the country B unit may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed computer is sold.
- From the perspective of the tax authorities, country A's tax authorities might agree with the profit reported at their end by the computer group in country A, but their country B counterparts may not agree - they may not have the expected profit to tax on their side of the operation. If the computer company in country A bought its hard drives from an independent company in country B under comparable circumstances, it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. This approach gives scope for the parent or subsidiary, whichever is in a low-tax jurisdiction, to be shown making a higher profit by fixing the transfer price appropriately and thereby minimizing its tax incidence.
- Accordingly, when the various parts of the organisation are under some form of common control, it may mean that transfer prices are not subject to the full play of market forces and the correct "arm's length price" needs to be arrived at.

UN Practical Manual on Transfer Pricing for Developing Countries

The *UN Practical Manual on Transfer Pricing for Developing Countries* (the Manual) addresses the difficulties faced, especially by developing countries, in applying "arm's length principle" as well as some of the OECD Transfer Pricing Guidelines and the need for clear and practical guidance for those countries on the policy and administrative aspects of applying transfer pricing analyses to some of the transactions of MNEs. While consistent with the OECD Transfer Pricing Guidelines, the Manual in effect provides a novel and needs-based approach to explaining what those guidelines mean for developing countries, and how they can be applied in practice in a way that responds to their needs. The Manual was adopted by the Committee during its 2012 annual session (Geneva, 15-19 October 2012). It is being launched in e-version during a special meeting of ECOSOC on "International cooperation in tax matters" (New York, 29 May 2013) and will be issued in print shortly after.

Example 2: Double taxation

- A high-end watch manufacturer in country A distributes its watches through a subsidiary in country B. It is assumed that the watch costs $1,400 to make and it costs the country B subsidiary $100 to distribute it. The company in country A sets a transfer price of $1,500 and the subsidiary in country B retails the watch at $1,600 in country B. Overall, the company has thus made $100 in profit, on which it is expected to pay tax.
- However, when the company in country B is audited by country B's tax administration they notice that the distributor itself does not earn a profit: the $1,500 transfer price plus the country B unit's $100 distribution costs are exactly equal to the $1,600 retail price. Country B's tax administration considers that the transfer price should be set at $1,400 so that country B's unit shows the group's $100 profit that would be liable for tax.
- However this poses a problem for the parent company, as it is already paying tax in country A on the $100 profit per watch shown in its accounts. Since it is a multinational group it is liable for tax in the countries where it operates and in dealing with two different tax authorities it is generally not possible to just cancel one out against the other. So the MNE can end up suffering double taxation on the same profits where there are differences about what constitutes the appropriate transfer pricing.

Next steps

Following the launch, the Financing for Development Office of the United Nations Department of Economic and Social Affairs will commence activities aiming at developing a comprehensive set of capacity development tools based on the Manual. As a first step, a technical meeting is envisioned to determine the content and scope of the capacity building tools to be developed based on actual demand in developing countries.

The Manual will also, it is anticipated, be updated on a "rolling" basis. The next version is likely to address transfer pricing of intangibles and to deal in greater detail with the provision of services by one group entity (such as Head Office) to another. More examples from countries at various stages of their transfer pricing, including smaller developing countries, will also be included.■