UN Releases Practical Manual on Transfer Pricing for Developing Countries

The United Nations Committee of Experts on International Cooperation in Tax Matters on October 15-19 adopted the Practical Manual on Transfer Pricing for Developing Countries during its eighth annual session. The UN Manual is a response to a need expressed by non-member countries of the Organisation for Economic Cooperation and Development for clear practical guidance on the policy and administrative aspects of the application of the arm’s length principle for purposes of establishing transfer prices for transactions among related parties of a multinational enterprise. The UN Manual is intended to assist not only policy makers and administrators but also taxpayers in their dealings with tax administrations.

The UN Manual was drafted by the UN’s Subcommittee on Transfer Pricing – Practical Issues, which was constituted in 2009 by the Committee of Experts. The subcommittee was asked to develop a practical mandate on transfer pricing to consider and reflect the practical realities for developing countries and MNEs, and to provide clear guidance in dealing with complex transfer pricing issues. ¹

Article 9 (Associated Enterprises) of the United Nations Model Double Taxation Convention between Developed and Developing Countries endorses the arm’s length principle as defined in the OECD’s Model Tax Convention on Income and on Capital.² The foreword to the UN Manual expresses both the objective of achieving consistency with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ³ as well as “minimizing 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 a MNE operates.”⁴ As a result, the UN Manual is designed to reflect the arm’s length principle for pricing transactions within multinational enterprises, with reference to the issues faced by developing countries, and the approach is practical rather than legislative.

The UN Manual is comprehensive – it includes almost 400 pages of guidance – in that it covers central policy, administrative, and technical issues. However, the preface makes it clear that the UN Manual would benefit from further, more detailed, work on issues such as the treatment of intangibles and services, and suggests an additional mandate for the subcommittee to continue its work on these areas. Moreover, while the UN has sought consensus as far as possible, there are some areas where consensus could not be reached.

Structure and Content of the UN Manual

The manual covers the following areas:

- Chapter 1 – Introduction
- Chapter 2 – The Business Environment
- Chapter 3 – The Legal Environment
- Chapter 4 – Building Capability
- Chapter 5 – Comparability
- Chapter 6 – Methods
- Chapter 7 – Documentation
- Chapter 8 – Audits
- Chapter 9 – Dispute Resolution
- Chapter 10 – Country Practices: Preamble, Brazil, China, India, South Africa
- Appendix I – Comparability Examples
- Appendix II – Documentation

¹ The subcommittee is comprised of academics, representatives of various country governments, advisors, and industry representatives. The subcommittee met on five occasions (Kuala Lumpur, Malaysia in June 2010, New Delhi, India in February 2011 September 2011 in Tokyo, Japan February 2012 in Johannesburg, South Africa, and finally, in Shanghai, China in June 2012.) Throughout the drafting process and at every session extensive feedback was provided by various experts and stakeholders.

² Revised on July 22, 2010.

³ Revised July 2010.

Chapter 1 of the UN Manual provides an explanation and overview of transfer pricing, and addresses the practical issues and concerns of developing countries. Chapter 2 discusses multinational business operations, and Chapter 3 provides an overview of the transfer pricing regimes adopted globally from a legal perspective, and the various approaches to consider when developing transfer pricing laws. Chapter 4 focuses on the skills, resources, structures, and behaviors that tax authorities may require to successfully implement a transfer pricing regime, and on how requirements may change over time as a country develops. Chapters 5 and 6 (and Appendix I) provide a detailed discussion of acceptable transfer pricing methods and the associated need for, and challenges in obtaining, data to allow comparability with arm’s length transactions. Indeed, comparability (especially a lack of access to local data on third-party transactions) is a hurdle to be overcome, particularly for some countries with small domestic markets. Chapter 7 (and Appendix II) discuss documentation requirements and penalties for failure to provide documentation, with reference to existing guidance and practice in this area. However, Chapter 7 also acknowledges that when a UN member country does not have an extensive tax treaty network, it will have to place greater reliance on taxpayer-provided information. Chapter 8 considers procedures for transfer pricing audits and in particular, the need for tax administrations to focus limited resources on cases which pose the highest risk of tax underpayments. In terms of guidance, Chapter 9 is the final chapter and sets out potential dispute resolution mechanisms for both domestic taxpayer/domestic tax authority and cross-border domestic tax authority/foreign tax authority disputes.

Chapter 10 is different from the previous chapters. It does not reflect consensus (or near-consensus) views from the subcommittee members, but draws on the transfer pricing experiences – and therefore reflects the country-specific transfer pricing views – of Brazil, China, India, and South Africa, both on items covered in the broader text of the UN Manual as well as on matters not explicitly covered by the UN Manual. It should be noted that Brazil has not adopted the traditional arm’s length principle approach to transfer pricing.

UN Manual and OECD Transfer Pricing Guidelines

As stated above, the UN Manual seeks consistency with the OECD Transfer Pricing Guidelines in applying the arm’s length principle found in Article 9 of both the UN Model Convention and the OECD Model Convention. As a result, there is a fundamental consistency between the UN Manual and the OECD Transfer Pricing Guidelines. While there are some differences between the two, those tend to reflect differences in perspective and emphasis, rather than differences in the principles to be applied. Following the stated purpose of the UN Manual – to provide practical guidance to policymakers and administrators in developing countries on the application of the arm’s length principle – the UN Manual seeks to follow the OECD Guidelines whenever possible. For example, the UN Manual specifies that documentation requirements should be as far as possible common between the UN Model Convention and the OECD Model Convention, because diversity in documentation rules could result in excessive compliance costs for companies.5

The UN Manual is stated to be a work in progress and, unlike the OECD Transfer Pricing Guidelines, does not currently have dedicated chapters on services, intangibles, cost contribution arrangements, and business restructuring. Moreover, the subcommittee’s comments and positions as presented in the UN Manual were actually expressed in respect of the 1995 OECD Transfer Pricing Guidelines, and were not updated to reflect subsequent changes in the 2010 version of the Guidelines. This issues was brought forth during the February 2011 meetings of the subcommittee held in India, whereby the subcommittee stated that the committee does not have jurisdiction to determine whether the 2010 OECD Guidelines should be followed by the governments of developing counties and thus become the internationally agreed standards as described in the UN Manual.6 It is not clear to what extent this would impact the objective of consistency.

Intangibles

Although the UN Manual does not yet include a chapter on intangibles, it does provide some commentary on the subject. The comments focus largely on marketing intangibles, and the issue of a subsidiary performing marketing activities and incurring expenses for a product trademark or brand name that is legally owned by a foreign affiliate.

The comments indicate that the UN Manual supports the concept of economic ownership, whereby the marketer that incurs significant marketing expenditures either adds value to the affiliate’s intangible so as to obtain an economic ownership interest that entitles it to share in the profits of that intangible, or creates its own local marketing intangible for

5 UN Manual, Chapter 1, paragraph 1.8.12
6 Letter to the Financing for Development Office of United Nations Department of Economic and Social Affairs from the Permanent Representative of India to the United Nations, No. PMI/NY/152/2/2012. Paragraph 3.2
which it is entitled to be rewarded. The UN Manual seems to focus on the perspective of a marketer located in a developing
country, and ensuring that it receives an appropriate level of return for its value-adding activities and the value of the
marketing activities in that country.

The UN Manual's comments on this issue are not inconsistent with the current OECD Guidelines, but the attention given in
the UN Manual to developing countries reflects its importance for countries like India and China, and signals that such
countries can be expected to take an aggressive position in applying these guidelines.

**Location-Specific Advantages**

The UN Manual discusses extensively the concept of location-specific advantages, which includes location savings and other
commercial or economic benefits derived from operating in a particular location. The UN Manual defines location savings as
the net cost savings that a company realizes as a result of relocation to a low-cost jurisdiction (as a result of, for example,
skilled labor, rent, and infrastructure). Such relocation of operations may give rise to location-specific advantages (LSAs)
such as easy access to specialized manpower, proximity to market, or a large customer base with high purchasing power.
When a multinational enterprise successfully exploits the LSAs, the incremental profit derived is termed “location rent.” The
OECD Transfer Pricing Guidelines indicate that the allocation of these benefits normally depends on the functions, assets,
and risks of each party, and on their bargaining powers. Consistent with this approach, the UN Manual states that an arm’s
length allocation of these benefits depends on competitive factors relating to access to the benefits, and on alternatives
available to the parties given their relative bargaining power.

The UN Manual also states that location savings may be offset at times by “dis-savings,” which are higher costs incurred, for
example, on account of poor infrastructure or high transportation costs. The UN Manual cautions that location savings do
not always automatically lead to location rent, and the principal company may be forced to pass on the savings to the
ultimate customer to be competitive in pricing.

As MNEs increasingly outsource their manufacturing or services functions to low-cost jurisdictions, determining the arm’s
length price of the potential “location savings” is attracting the attention of tax authorities globally. Countries like China and
India, which offer low costs and other significant local market advantages, will likely be particularly concerned about the
taxing implications arising from distribution of these benefits within an MNE.

**Lack of Comparables**

The UN Manual recognizes that there can be problems in obtaining reliable comparables data, because there is commonly
either a lack of reliable local comparables or an inability to access public data on uncontrolled comparables. Accordingly,
while the use of comparables from the same geographic market is generally preferred, the UN Manual supports a flexible
approach to searching for comparables, including the use of foreign comparables. It also recognizes the potential for
geographic market differences affecting the reliability of foreign comparables, and the need to make reliable comparability
adjustments to take into account any such differences.

Similarly, the OECD Transfer Pricing Guidelines recognize that geographic markets are an important comparability factor,
and that while foreign comparables can be used, reasonably accurate adjustments are needed to account for any
geographic market differences.

Both the UN Manual and the OECD Transfer Pricing Guidelines indicate that the difficulty of making reasonably accurate
and reliable adjustments to account for geographic market differences will affect the appropriateness of a pricing method
that relies on foreign comparables data. The Chinese country report in the UN Manual states that this may require the use
of a profit split method. It is apparent from the UN Manual that problems with availability of reliable comparables data may
mean that a profit split is commonly viewed as the most appropriate method by tax authorities.

**Risk Allocation**

Globalization has led MNEs to establish R&D, contract manufacturing, and back-office operations in many countries to take
advantage of low-cost labor markets. These operations often take the form of limited-risk structures where local entities are
insulated from business risks and are compensated on a net costs plus basis.
The UN Manual states that in many countries the availability of independent comparables is limited and the use of foreign comparables may therefore be necessary. The UN Manual explicitly recognizes the need for comparability adjustments, including risk adjustments. It goes on to state that there is no universally accepted method for risk adjustment and most statistical methods have their limitations.

In the absence of comparables, the UN Manual adopts the same economic substance test as the OECD Transfer Pricing Guidelines for evaluating whether the allocation of risk between associated enterprises is arm’s length, indicating that control over risk and the financial capacity to bear the risk are important factors in this regard. The Manual provides practical examples to test the claims of foreign associated enterprises located in developed countries that they exercise control over R&D activities performed by subsidiaries based on the ability to make strategic decisions, to bear the risk of unsuccessful R&D, to monitor the associated enterprises’ activities, and to control the overall budget.

The UN Manual includes examples similar to those found in the OECD Transfer Pricing Guidelines to illustrate scenarios whereby the risk of R&D activities is considered controlled either by a parent company or by the subsidiaries that actually perform the activities. These examples are likely to be useful for developing countries in challenging the risk allocation under contract R&D and other service arrangements, and in arguing that a profit split method is more appropriate than rewarding the subsidiary merely with a cost plus return.

**Country-Specific Considerations**

**India** — On the issue of location savings, the India country report states that MNEs operating in India not only enjoy location savings but also generate “location rent.” The main issue, as far as the Indian Transfer Pricing Administration is concerned, is the quantification and allocation of location savings and location rent among the related entities, for which a profit split method can be used when the functional analysis and the relative bargaining power would be important factors for consideration. The Indian Transfer Pricing Administration believes the benefit of location savings will not be taken into account by using local comparables, but rather can only be computed by taking into account cost differences between a low-cost and a high-cost jurisdiction.

Regarding risk allocation, the Indian Transfer Pricing Administration challenges the ability of foreign principal entities to exercise control remotely, and states that most foreign entities are unable to submit documents in support of their claim of exercising control. The Indian Transfer Pricing Administration contends that Indian entities undertake core R&D activities, strategic operational decisions relating to budgets, and the design and direction of R&D activities, and thus control substantial part of the risks. In such cases, the allocation of routine cost-plus returns to Indian entities will not be considered to be at arm’s length.

The report highlights the difficulty of finding comparable transactions involving intangible assets in the public domain, and emphasizes that Indian associated enterprises need to be compensated for intangibles created through extraordinary advertising, marketing, and promotion expenses beyond what an independent local distributor would incur. Compensation could take the form of reimbursement of excessive expenditures, along with a mark-up or an arm’s length return for the development of marketing intangibles.

On the issue of adjustments to comparable data, the report states that it is possible to address accounting differences, differences in capacity utilization, and intensities in working capital, but that it is extremely difficult to make risk adjustments in the absence of reliable internationally agreed methods. With respect to providing risk adjustments using the capital asset pricing method, the Indian Transfer Pricing Administration believes the method is flawed and may not provide accurate results.

The India report also provides the Indian tax authorities views on issues such as intragroup services and financial transactions. In relation to intragroup services, the Indian Transfer Pricing Administration asserts that most principal entities globally do not allow any profit mark-up for services rendered by Indian entities, or in exceptional cases, allow low mark-ups on a restricted cost base. On the other hand, when Indian entities are receiving services, MNEs charge high mark-ups on all services, including shareholder services and duplicate services. In relation to financial transactions, the Indian Transfer Pricing Administration highlights the challenges faced because of the lack of availability of specialized databases to handle such complex transactions.

**China** — The China country report discusses location savings in relation to its electronics manufacturing, luxury goods, and automotive industries. The Chinese Tax Administration relies on an adjusted cost plus mark-up to calculate an arm’s length
result for contract R&D centers. To determine the additional profit attributable to location savings, the Chinese Tax Administration computes the difference in cost base between the Chinese taxpayer and the average cost base of foreign companies before applying an arm’s length markup rate that is determined using comparable data.

On the issue of risk allocation, the Chinese country report asserts that often the principal entity determined to be responsible for the R&D is found to have neither the technical expertise nor the financial capacity to control the associated risk. Moreover, a risk-based approach may place insufficient emphasis on the fact that sizeable assets and the majority of the headcount are located in China, with few management personnel located in the foreign entity that claims to control the risk. In such situations, a net cost plus approach would not be appropriate; rather, the tax authorities would consider a profit split approach or a contribution analysis more suitable.

The report states that marketing intangibles and LSAs are often closely integrated, as developing countries provide access to a fast-growing market to help MNEs monetize the value of such intangibles. As a result, consideration is necessary to properly compensate each entity for its contribution. Issues such as the associated enterprises’ entitlement to additional profits for improvement of the original intangibles or process-related know-how and marketing intangibles identified through excessive operating expenses-to-sales ratios are addressed by the Chinese State Administration of Taxation by employing a profit split method or performing comparability adjustments when the TNMM is used.

The report notes that a key challenge regarding the issue of comparability is the lack of reliable public information on comparable companies. The use of foreign comparable would require significant adjustments to the comparable data, and in some cases may require a different methodology, such as a profit split, because no reliable comparability adjustments are feasible.

The China report also touches on practical challenges to applying the arm’s length principle when a Chinese entity relies on its related parties for both input purchase and output sales. In such cases, the SAT’s approach is to start with the general presumption that the related-party purchase of materials is at arm’s length, and evaluate the reasonableness of the mark-up earned by the contract manufacturer on its cost base. The rationale for accepting the related-party purchase price is that Chinese Customs would check the value of imports and safeguard against unreasonably low intercompany purchase prices.

In another example, the China report describes the challenges to determine the proper return for a toll manufacturer, given that there are only a few independent listed companies available that perform such activities. In such a situation, the SAT’s approach is to determine the return for a contract manufacturer and then adjust for factors such as inventory carrying costs to arrive at the profit for the toll manufacturer.

Brazil – The Brazilian country report explains that the use of transactional profit methods is not permitted under the country’s transfer pricing legislation. With specific reference to the cost plus method and the resale price method, the law establishes fixed margins for gross profit and mark-up that are specified by the Ministry of Finance across various sectors, instead of relying on independent comparable transactions. The Brazilian report discusses the strengths and weakness of the fixed margin rules, which are designed for simplicity and to facilitate ease of administration and compliance, not necessarily to foster a fair and flexible system and maximum compatibility with the arm’s length principle. The Brazil report also provides guidance to countries considering adopting the fixed margins system. It recommends that tax authorities do extensive pricing research on public databases prior to specifying a fixed margin and determine a statistical range of tolerance that is then verified by taxpayers or groups that represent them.

The Brazilian rules prescribe methods for computing arm’s length prices that are different from the methods approved by the UN Manual. Because the Brazilian rules do not adopt the arm’s length principle, MNEs with Brazilian operations have to evaluate their potential tax exposure and develop a special transfer pricing plan to defend and optimize their overall international tax burden.

South Africa – The South African country report states that in many instances, unique dynamics exist in the South African market that enable subsidiaries of foreign associated enterprises to realize higher profits than are evidenced by comparable data obtained from foreign databases. Accordingly, building on the practices of India and China, the South African tax authority – SARS – is currently considering approaches to location savings.

On the reliability of comparable data and adjustments, the report states that the main challenge encountered in determining arm’s length profits is the lack of domestic comparable data and reliance on European databases to establish arm’s length price. In practice, SARS has attempted to make complex comparability adjustment for geographic differences; however, those are made with caution and in specific circumstances.
The report presents a unique transfer pricing challenge in relation to the sale of intangibles, on account of the exchange control regulations that prohibit relicensing of intangible property once sold outside of South Africa. In these situations, the foreign associated enterprises that become the legal owners of the intangible assets relicense the intangible worldwide, earning a royalty, whereas the South African entity continues to perform functions in relation to the development of intangible for a cost plus return. As a result, disputes arise on issues of economic versus legal ownership, allocation of a share of the profits on the sale of intangibles, and the valuation of the intangibles.

The South African country report emphasizes the challenges faced in accessing important information from the taxpayer while conducting audits. The report also touches on management charges paid out by South African entities, and the difficulty in determining whether the intercompany service has provided economic and commercial benefit to the recipient based in South Africa.

**Significant Issues for Future Updates of the UN Manual**

The treatment of intangibles remains an important topic in transfer pricing that the UN Manual touches upon, but there is no chapter exclusively dedicated to an in-depth discussion and detailed guidance on the treatment of intangibles. The subcommittee has acknowledged the importance of intangibles and will address the issue in more detail in future updates, once the OECD finalizes the discussion draft on intangibles released in June 2012. Similarly, the UN Manual mentions intercompany services and business restructuring throughout the report, but does not dedicate individual chapters to those significant issues. Cost sharing arrangements and advance pricing arrangements (APAs) are mentioned in passing, but again, are not detailed in separate chapters. Accordingly, the UN Manual is seen as a work in progress and will be significantly updated in future phases.

**Conclusion**

Taxpayers are well advised to intensify and streamline their transfer pricing documentation requirements and pay attention to issues such as allocation of risks between entities, location savings and location-specific advantages. The UN Manual stresses that additional consideration should be paid to the particular attractiveness a market may offer to companies doing business in that market, and the subsequent turnover generated from activities there. This aspect is emphasized more than in the OECD Transfer Pricing Guidelines. This might encourage tax authorities to exercise broadened powers on ongoing transactions and thereby increase the risk of double taxation.

The Indian, Chinese, and South African country chapters broadly reflect the UN Manual and the arm’s length principle it embodies, while highlighting the implementation challenges faced locally. While there is no complete harmony between the country-specific views and those expressed by the subcommittee in the first nine chapters of the UN Manual, many of the differences expressed seem to arise from the tension that dominates transfer pricing issues between developed and developing countries, and others that have not been addressed in the current draft of the UN Manual. Nevertheless the publication of the UN Manual provides taxpayers with a new level of understanding of the evolving transfer pricing practices of various countries and enables tax administrations to frame effective legislation more effectively.

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