UN updates its Practical Manual on Transfer Pricing for Developing Countries

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In brief

On April 7, the UN released the second edition of its Practical Manual on Transfer Pricing for Developing Countries. Like its 2013 predecessor, this revised edition provides detailed guidance on application of the arm's-length principle for developing countries, with the objective of addressing base erosion risks and issues, such as a lack of local comparable data to determine market prices. The revision serves as an update to incorporate aspects of the changes to the OECD Transfer Pricing Guidelines following the final papers of the OECD/G20 BEPS Project released in October 2015.

The initiative is intended as further endorsement of the arm's-length principle as stipulated in Article 9 of both the UN Model Convention and OECD Model Tax Convention, as well as the OECD Transfer Pricing Guidelines. The Practical Manual is intended to strengthen the consistency of international tax rules and facilitate inclusion of developing countries. With the document presenting broad consensus among the members of the drafting Subcommittee, questions remain, however, on the cohesiveness of the approaches and long-term application of this revision, particularly in light of ongoing OECD initiatives.

In detail

Background and context

The UN Economic and Social Council released the second edition of the Practical Manual on Transfer Pricing for Developing Countries (UN TP Manual) at a meeting of the Committee of Experts on International Cooperation in Tax Matters. The revision follows the mandate set out for the first edition released in 2013, namely, to strengthen application of the arm's-length principle applied by Article 9 of both the UN Model Double Taxation Convention (UN Model Convention) and OECD Model Tax Convention on Income and on Capital (OECD MTC), as well as OECD Transfer Pricing Guidelines (OECD TPG), while providing additional guidance specifically to developing countries.

The revision serves to incorporate changes to the OECD TPG resulting from the final papers from the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, particularly Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) as well as Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting) released in October 2015.

This Tax Insight covers key elements of the revised version of the UN TP Manual and serves as an overview of the content. A detailed technical review will be the topic of a separate Tax Insight.

Objectives

Developing countries face challenges in determining market-based pricing of transactions within Multinational Enterprises (MNEs). These include information asymmetries between tax administrations and taxpayers and potential insufficient account for local intangible development activities. In particular, the UN TP Manual seeks to address a lack of local comparable market data or access thereto, as well as a lack of sufficient legislation and capacity within local tax authorities to apply the arm's-length standard while limiting the risk of shifting of taxable profits.

The revised UN TP Manual aims to update and enhance transfer pricing approaches for developing countries, showing ways in which the arm's-length standard for transfer pricing can be applied effectively, while at the same time seeking to provide a fair and predictable result to investors in such countries. This includes additional guidance on the use of non-public information available to tax authorities (so-called secret comparables), the application of one-sided transfer pricing methods such as the Transactional Net Margin Method (TNMM), and the use of the so-called sixth method for commodity transactions. The UN TP Manual also illustrates areas of non-consensus, outlining specific country rules as potential variations.

The UN TP Manual further provides practical examples and information on the implementation of legislative models, as well as on capacity building within local tax authorities, reflecting the diversity of the UN membership and placing transfer pricing in its developmental perspective to build and advance fair and effective tax systems.

Content overview

The revised UN TP Manual follows the general structure of the first edition, maintaining a general section plus sections on policy considerations, practical implementation of transfer pricing rules, and selected country issues. The main additions are new chapters on intra-group services, cost contribution arrangements, and treatment of intangibles, corresponding to changes to the OECD TPG following BEPS Actions 8-10.

Part A: *Transfer Pricing in a Global Environment*

Serving as an introduction to both the background and objectives of transfer pricing rules, the first part details the theory of the firm, MNE structures, value chains, and the underlying principles of the arm's-length standard.

Part B: *Design Principles and Policy Considerations*

As the main part on transfer pricing policy and issues for developing countries in application of the arm's-length principle, this section covers, inter alia, comparability analysis as well as transfer pricing methods and their selection and application.

New topics added to this revision are cost contribution arrangements and treatment of intangibles in line with the updated OECD TPG, as well as further guidance applicable specifically to issues relating to developing countries. These include reasoning and issues pertaining to use of secret comparables, application of the TNMM when foreign comparables are used and the so-called sixth method, referring to commodity pricing rules as applied, e.g., in Brazil and Argentina and discussed briefly as well in the updated OECD TPG.

Part C: *Practical Implementation of a Transfer Pricing Regime*

The third part of the UN TP Manual provides guidance on the structure and implementation of effective tax systems in developing countries, with examples, frameworks for transfer pricing rules, and practical advice on capacity building within tax authorities in developing countries.

Part D: *Country Practices*

The final part of the manual contains country-specific examples of transfer pricing rules, with individual deviations that do not represent the consensus view and may depart from the arm's-length principle outlined by Article 9 of both the UN Model Convention, OECD MTC, and OECD TPG.

The countries covered are Brazil, South Africa, India, and China, which were already covered in the first edition, with the addition of Mexico. Key deviations and focus areas described in the manual are noted below.

- **Brazil:** With the introduction of the so-called sixth method, Brazilian transfer pricing methodology applies specific margins to certain commodities transactions, setting both prices and timings to a transaction regardless of additional value drivers and contributions of the tested parties.
- **China:** China's country practices respond to challenges of a lack of appropriate transfer prices, quantification and allocation of location-specific advantages (e.g., readily available migrant labour, low labour and infrastructure costs, a growing population and consumer demand for foreign and

luxury products) and identification and valuation of intangibles. The China SAT shares additional insights and guidance, particularly on the application of one-sided transfer pricing methods.

- **India:** India faces challenges in identifying and quantifying country-specific added values, such as location savings and the local development of intangible assets. The applied approach generally adopts the framework of control over risk and the importance of the Development, Enhancement, Maintenance, Protection, and Exploitation (DEMPE) functions in respect of intangibles as outlined by Actions 8-10 of the BEPS project, but deviates from the safe harbour provisions for Low Value Adding Services (LVAS).
- **Mexico:** Mexican transfer pricing rules include safe harbour provisions for Maquiladoras (foreign-owned Mexican assembly companies), which may be viewed as running the risk of base erosion if not sufficiently accounting for locally generated intangibles.
- **South Africa:** South African transfer pricing rules have strict recordkeeping requirements for transfer pricing transactions and do not foresee a simplified approach for intra-group services. Comparability analyses are a concern for the South African Revenue Service (SARS) due to a lack of local comparable data and a location advantage to companies operating in South Africa, which for certain industries may be viewed as having significant impact on the profit margins compared to companies operating in foreign countries. APA programs are viewed as a benefit to tax certainty, though capacity restrictions are considered a significant challenge.

The takeaway

The UN TP Manual provides guidance to both tax administrations and taxpayers on determination of the arm's-length price for intercompany transactions, addressing risks and limitations specific to developing countries, including a lack of local comparable market data and location advantages.

The revision to the UN TP Manual also includes updates corresponding to the final BEPS papers, providing additional support to the OECD Inclusive Framework in its goal for widespread adoption and incorporation of global considerations. Beyond BEPS, the manual references the EU Joint Transfer Pricing Forum's guidance on LVAS, the EU Consolidated Common Corporate Tax Base (CCCTB), and ongoing efforts by the Platform for Collaboration on Tax (a joint initiative of the IMF, OECD, UN, and World Bank Group), which in February of this year published a discussion draft of a Toolkit for Addressing Difficulties in Accessing Comparables Data For Transfer Pricing.

Uncertainty may arise as ongoing efforts are still in draft form and subject to changes. An example is the Value Chain Analysis, which is discussed as a helpful tool to delineate transactions, and currently is under review in the OECD discussion draft on BEPS Actions 8-10 – Revised Guidance on Profit Splits. Some BEPS revisions to the OECD TPG are not considered in the UN TP Manual (e.g., list of LVAS and the different steps to perform in comparable searches) or implemented with minor deviations (such as the consideration of acquisitions alongside DEMPE functions, jointly termed DAEMPE), which may lead to additional questions.

Non-consensual approaches applied by individual countries remain a source of discussion between tax authorities and taxpayers, particularly on the use of fixed ratios/mark-ups and commodity pricing. These may exclude the consideration of a functional analysis and thus run the risk of being contrary to the principles of value creation and substance as underlying principles of the BEPS project. With transfer pricing analyses becoming increasingly relevant in developing countries, additional guidance particularly on these critical items would be welcomed to ensure the necessary level of transparency and cohesiveness in the context of the international tax landscape.

The initiative provides guidance on application of the arm's-length standard in developing countries. The UN TP Manual is accessible, comprehensive, and generally in line with the OECD guidelines, making it an additional helpful tool for tax administrations and taxpayers when applying internationally accepted transfer pricing standards.

Approaches specific to developing countries are also presented, showing limitations and potential issues for critical topics such as the sixth method or the use of safe harbours. While the UN TP Manual presents broad consensus of the drafting Subcommittee rather than an intergovernmental body, it can serve to bridge persisting information asymmetries and to provide guidance in developing countries, with potential applications in transfer pricing planning, documentation, and tax audit scenarios.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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