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7 March 2014

Mr. Stig Sollund
Director-General, Deputy Head of the Tax Law Department,
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Coordinator of the UN Subcommittee on
Article 9 – Associated Enterprises
United Nations
New York, NY

VIA EMAIL: ritter@un.org

**RE: Comments of Tax Executives Institute Regarding the
United Nations Practical Manual on Transfer Pricing for
Developing Countries**

Dear Mr. Sollund:

In 2012, the United Nations Committee of Experts on International Cooperation in Tax Matters (the Committee) published its *United Nations Practical Manual on Transfer Pricing for Developing Countries* (UNTPM or Manual). At the time of publication, the Committee noted that the UNTPM is a living document, to be regularly revised and improved. In that regard, the Committee formed a Subcommittee on Article 9 – Associated Enterprises (Subcommittee) to further develop the UNTPM, specifically with respect to intra-group services and management fees as well as intangibles. The Subcommittee invited comments on these and other aspects of the UNTPM earlier this year. On behalf of Tax Executives Institute, Inc. (TEI or the Institute), I am pleased to respond to the Subcommittee's call for comments regarding the UNTPM.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 55 chapters around the world. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government.

Our nearly 7,000 members represent over 3,000 of the largest companies in Asia, Canada, Europe, and the United States.

1. Overall Comments on the UNTPM

TEI commends the Committee for its development and publication of the UNTPM, as well as its continuing work to improve and update the Manual. The UNTPM represents an important advance in addressing the needs of developing countries with respect to transfer pricing rules and practices. TEI recognizes and appreciates that the UNTPM generally addresses a different, but not completely separate, audience than the OECD's Transfer Pricing Guidelines (OECD Guidelines) and thus must emphasize different points and approaches in certain cases. Nevertheless, TEI urges the United Nations and the Committee to adhere as closely as possible to the OECD Guidelines while further developing the UNTPM. Significant differences between the two documents will only lead to cross-border transfer pricing disputes between nations that follow the two different approaches, leaving taxpayers caught in the middle and facing the prospect of significant double taxation.

2. Principles

The UNTPM rightly focuses on risk assessment (*see* UNTPM Chapter 8). As a threshold matter we note that the vast majority of multi-national enterprises (MNEs) report all their revenue and profit and create, maintain, and adhere to robust transfer pricing compliance and documentation policies as part of their internal controls. Thus, most transfer pricing disputes that arise between MNEs and tax authorities around the world involve good-faith differences in interpretation of transfer pricing principles as applied to *bona fide* commercial transactions. From this perspective, most MNEs should be viewed as "low-risk" when it comes to transfer pricing compliance.

As correctly stressed under Paragraph 2.4.8. of the UNTPM, most MNEs have developed a global and consistent transfer pricing policy aimed at reducing transfer pricing controversy and the potential for double taxation. MNEs design their transfer pricing policies for worldwide standardization and consistency by applying the OECD Guidelines. This is currently the only accurate and efficient manner for MNEs to pay their fair share of taxes in each country without suffering double taxation. Thus, the transfer prices of MNEs are based upon the arm's length principle and the underlying economics of their business endeavors.

As a general matter, TEI strongly supports harmonization of the UNTPM with the OECD Guidelines. Discrepancies between the UNTPM and the OECD Guidelines would mean that the UNTPM is effectively a second set of rules. This would be contrary to the UNTPM's clearly stated intention, and create additional complexity, uncertainty, and a material likelihood of double taxation where there is no applicable double taxation treaty.

In this regard, TEI emphasizes the following principles and observations:

- a. Chapters I-III and IX of the OECD Guidelines stress that legal rights and contractual arrangements between related companies form the starting point for any functional analysis of transactions between such parties. They also form the keystone of Article 9 “Associated enterprises” of the OECD Model Tax Convention. The importance of contracts and the conduct of the parties are recognized in the UNTPM at Par. 5.3.2.30. TEI emphasizes that an understanding of the overall business enterprise, group transfer pricing policy, and risk control framework is the first critical step that tax authorities should take to properly understand an MNE’s transfer pricing functional analysis.
- b. The proliferation of detailed domestic legislation and guidance regarding various transfer pricing requirements is undesirable since it will ultimately lead to deviations from the OECD’s basic transfer pricing principles. Varying standards and requirements do not allow a pragmatic and flexible application of the arm’s length principle and will dramatically exacerbate international double taxation. Detailed local requirements defeat the purpose of a standard international transfer pricing guideline.
- c. It is an embedded assumption of the arm’s length principle that taxpayers should be permitted to choose the structure of their business operations, and the form of business transactions generally cannot be imposed upon taxpayers by tax authorities. It has long been accepted that associated enterprises may engage in transactions for legitimate business reasons, even if such transactions would not ordinarily occur between independent enterprises. This is expressed in contractual arrangements that reflect the rights and obligations of each party. As the Committee moves forward with the development of the UNTPM, and in particular with respect to the Subcommittee’s work in drafting an additional chapter on intangibles, TEI cautions against adopting an approach that would prevent, via recharacterization by tax authorities, related parties from engaging in transactions that would not, or would only very rarely, occur between third parties. Such an approach would be inconsistent with the arm’s length standard and would create a precedent for recharacterization by tax authorities of other legitimate business structures, even in areas that do not raise the concerns surrounding transactions that would only rarely occur between third parties. For these reasons, TEI recommends that the Manual only permit recharacterization in clear cases of abuse.

- d. Full flexibility in the manner in which the comparability analysis and benchmarks are set and documented by MNEs must be preserved.¹
- e. The burden of proof (UNTPM Par. 7.4.1.) should fall on tax authorities and penalty protection (UNTPM Par. 7.4.3.) should be granted to the taxpayer as soon as the latter has provided sufficient evidence (*e.g.*, through documentation) of its compliance with the arm's length principle (taking into account a sufficient materiality level to reduce or eliminate consideration of minor transactions where full documentation is unnecessary).
- f. The risk of double taxation is unfortunately inherent to the arm's length principle if tax authorities use their preferred approaches by solely applying domestic methods to implement the arm's length principle (*see* UNTPM Par. 3.2.7.). This "gap of understanding" can be reduced by encouraging tax authorities to:
 - (i) educate their tax officials in transfer pricing and market economy principles (*see* UNTPM Par. 4.6.3.);
 - (ii) understand the global business model and transfer pricing policy of the MNE;
 - (iii) encourage the conclusion of advanced pricing agreements (APAs) (*see* UNTPM Par. 3.10. and Chapter 9);
 - (iv) improve international cooperation with foreign tax authorities to understand the "other side" of the transaction (*e.g.*, inquiring into the tax audits or APAs in that foreign jurisdiction, reviewing the consequences of a proposed transfer pricing correction in the other jurisdiction, *etc.*);
 - (v) use the Mutual Agreement Procedure (MAP), APAs or arbitration in case of international transfer pricing litigation (*see* UNTPM Par. 3.10. – 3.11. and Chapter 9) to eliminate double taxation.

¹ The UNTPM appears to support this principle. *See, e.g.*, UNTPM Par. 5.5.4. ("The comparability analysis should be as reliable as possible so as to arrive at the correct arm's length price."); UNTPM Par. 5.5.6 ("Furthermore, the lack of comparables for a given controlled transaction does not mean that it is or is not at arm's length or that the arm's length principle cannot be applied. This is especially important given the growing importance of integrated business models and of transactions involving unique intangibles for which comparables may not be available. The need for a reliable analysis must therefore be balanced with a pragmatic approach and one should not set unrealistic expectations for comparability analyses.").

3. Intangibles

TEI supports the harmonization of the OECD Guidelines and the UNTPM (as stated under UNTPM Par. 1.8.10. and Par. 1.8.12.), but it is difficult to see how this can be accomplished in the short term. The OECD is revising Chapter VI of its Guidelines in connection with its longstanding project on the transfer pricing aspects of intangibles, which is now included in the OECD's Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan). Commencing work on a new chapter of the UNTPM on intangibles before the OECD's new Chapter VI is finalized later this year would make harmonization very difficult to achieve and may well create futile and unproductive work in the meantime.

With respect to the content of the UNTPM chapter on intangibles, TEI views it as imperative that the chapter fully respect contracts between related parties and does not endorse re-characterization or so-called "special measures." The UNTPM states clearly that "the allocation of risk under a contract will generally be respected by the tax authorities unless it is not consistent with the economic substance of the transaction . . ." (Par. 5.3.2.23.). The UNTPM should re-state and re-endorse this as a clear principle.

TEI recommends that new chapter on intangibles of the UNTPM embrace the current system for determining which MNE group member is entitled to the returns from intangible assets, which is based on the MNE's contractual framework that determines the group member that bears the risks and earns the rewards attributable to the intangible, *i.e.*, the intangible owner. The primary advantage of this framework is that it provides MNEs with the certainty necessary for planning and arranging their international operations. TEI would not embrace another system for determining ownership of intangible assets as a different approach would cause significant uncertainty and lead to even more controversy over the allocation of intangible property returns among group members.

The new intangibles chapter should also recognize the importance of the role of capital and central entrepreneurship, rather than assume that all or most of an MNE's profit should be allocated to the entities that perform "important functions." For example, with regard to research and development (R&D) activities, while an appropriate return to capital placed at risk in R&D activities can only be determined under the facts and circumstances of each case, the U.N. guidance should recognize the full range of returns that an uncontrolled provider of financial resources might expect to earn on its capital placed at risk in R&D, rather than assume or suggest that the return to such capital should be limited to that returned on debt.

Finally, TEI emphasizes that while it might be possible to benchmark an appropriate expected rate of return at a given date for financing R&D, the outcome of the risk assumed is ultimately dependent on future events. Thus, the actual rate of return may be higher or lower than expected, in certain cases by a significant amount. Accordingly, it is important that the new intangibles chapter avoid any inference that the actual return to an entity that funds the

R&D should be artificially limited in contravention of the arm's length principle, or should be determined by reference to actual outcome of the risk (*i.e.*, hindsight should not be used to determine the return).

4. Intra-Group Services and Management Fees

The development of increasingly global and integrated business activities has resulted in a shift from country-specific operations to global models based on matrix management organizations and integrated supply chains that centralize various different functions at a regional or global level. This growth of global business has driven a substantial increase in cross-border service and management fees charged between associated enterprises within MNEs.

Action 10 of the OECD's BEPS Action Plan addresses concerns with these types of charges, which may be shared by the Subcommittee. Action 10 calls for the adoption of transfer pricing rules or special measures to provide protection against these and similar types of payments, which the Action Plan characterizes as "base eroding." We note that while these charges may be viewed as base eroding from the perspective of the service recipient jurisdictions, in fact, these charges are generally attributable to significant activities of associated enterprises in higher tax jurisdictions and are rendered for the benefit of the other group affiliates. Thus, the tax authorities in the jurisdictions where these activities are performed either require inter-company charges to be made to comply with transfer pricing principles or domestic tax law, or deny deductions if the costs are not charged out. The "base eroding" payments are therefore "base-accretive" in higher tax jurisdictions. Payments should not be considered base eroding merely because they are deductible; the determination of their amount should depend only on whether the payments are non-arm's length. Moreover, an overstated payment is unlikely if the payee is in a high-tax jurisdiction as it would increase the taxpayer's tax burden. As taxpayers desire to lower their taxes, not increase them, tax authorities in the payor's jurisdiction should have a built-in assurance that the intra-group charge is not inflated.

A larger issue with respect to service and management fees is that tax authorities in service provider jurisdictions generally apply a very broad definition of activities that "benefit" a foreign associated enterprise. Based on this broad view, these tax authorities would require that the foreign associated enterprise incur an inappropriate amount of inter-company service and management fees. On the other hand, service recipient jurisdictions take a very narrow view of activities that "benefit" the associated enterprise, and in many cases require proof of a direct, specifically identifiable benefit, commensurate with the amount charged before permitting a deduction. MNEs thus encounter situations where they are unable to deduct the cost of management and other services anywhere; neither in the jurisdiction where the services take place or where the benefit is received. TEI would welcome consistent standards at both

the United Nations and the OECD that make it possible for taxpayers to have clarity over the deduction of legitimate inter-group services and management fees incurred. We suggest that the Committee promote the use of safe harbors (*see* UNTPM Par. 3.8.) on this fairly simple and straightforward matter. Because these payments should not be contentious and given the scarcity of tax authority resources, a uniform safe harbor approach would greatly limit the risks of unnecessary transfer pricing adjustments leading to costly controversy and double taxation.

5. Transfer pricing documentation issues (Chapter 7)

TEI urges that U.N. members not impose additional layers of complex and multi-jurisdictional transfer pricing documentation requirements on top of the already costly and time consuming OECD Guidelines currently in place. Indeed, the European Union recognized the burden imposed on businesses by onerous compliance rules when it recently postponed, by several years, a proposal to require extensive country-by-country tax reporting. TEI recommends that countries adopt a “less is more” approach, limiting documentation requirements to information that is useful for risk assessment purposes, putting the emphasis on substance rather than form to ensure compliance. Local authorities could then request more detailed and exhaustive information (if necessary) on audit.

One way to reduce the burden of transfer pricing documentation is to adopt a specific guideline and definition incorporating a reasonable level of materiality, which would allow tax authorities to focus on higher risk transactions. The UNTPM guidance should take into account materiality from a group’s perspective, but also consider the perspectives of the countries in which the group operates. Excessive documentation burdens for transfer pricing purposes discourage international commerce, especially with respect to small or medium sized entities with fewer resources.

TEI also recommends acceptance of regional or worldwide comparables by tax authorities since local comparables are very often not available or reliable. Developing economies in particular lack for local comparables, and thus the UNTPM can assist taxpayers and tax authorities by permitting the use of a broader geographic focus for comparables.

Finally, to reflect the consistency of the transfer pricing policy implemented by an MNE and facilitate international comparisons and transparency for tax authorities, the English language should be promoted as the unique language for all transfer pricing documentation issued by an MNE, including for local transfer pricing documentation. Local tax authorities should not ask MNEs to provide local translation of their transfer pricing documentation, contrary to what is suggested under UNTPM Par. 7.4.5.

6. Country practices (UNTPM Chapter 10)

TEI has significant concerns with Chapter 10 of the UNTPM, which seems to take a contrary approach from the preceding chapters and the arm's length principle. Significantly, the contributions of the countries with the largest economies are expressed not just in terms of their legal and administrative realities, but also the countries' policy objectives, many of which are not consistent with the arm's length principle or the remainder of the UNTPM. Regrettably, Chapter 10 thus functions as a comprehensive critique of the OECD Guidelines, rather than a description of the practices of developing countries with respect to transfer pricing issues.

a. Location Savings Advantages (LSA)

The LSA concept obviously embodies the view that certain countries should garner a larger share of an MNE's tax base than under the OECD Guidelines. However, it also appears that certain countries believe that, under free market ("arm's length") conditions, they do not receive a fair share of the profits from foreign direct investment in their economies because their LSAs are not fairly priced by the market economy. Thus, it appears these countries are attempting to use the tax system to artificially expand their tax base to correct what they see as unfavorable shortcomings of the global economy.

TEI believes that the analysis of LSAs should closely review the relative competitive positions of buyers and sellers in each market. The allocation of location rents (or "super profit") between parent (the intellectual property owner) and the local affiliate should be analyzed using their relative bargaining power (as suggested under UNTPM Par. 5.3.2.45.). An economic analysis needs to be performed to demonstrate where the location advantage originates, *e.g.*, the group intellectual property owner that has created large barriers to entry for local competition, the local affiliate that has secured itself by its positioning, the intellectual property legacy of the MNE, *etc.*

TEI therefore recommends that the United Nations clarify in Chapter 10 that LSAs, including negative location savings, should only be taken into account looking at the relative bargaining power of each party, in accord with Par. 5.3.2.45.

b. Marketing intangibles

Chapter 10 evidences the concern of certain countries that MNEs structure their operations so that local subsidiaries exploit foreign-owned intellectual property, on which the subsidiaries must pay royalties or a higher transfer price for the relevant product, which reduces the profits earned in those countries. For example, China takes the view that the value of a marketing intangible (such as a brand name) is inextricably linked to the market in which it is sold, which would reduce the amount of the royalty due.

TEI does not believe that the size of a particular market or other local characteristics (fragmentation of the distribution organization, cultural features, purchasing power of the consumer, *etc.*) should necessarily drive more valuable local marketing intangibles in that country. We recommend that the relative bargaining position of each party be the driver of the analysis in these cases. That is, an analysis of what the sales and profitability of the distributor would be on a standalone basis without access to MNE branded products and other intangibles. In many cases, access to the MNE's intellectual property represents the most important reason for the success and penetration of the MNE's products in a given distribution market even decades after first doing business there. This advantage is economically "perpetual" every time an MNE can demonstrate that the local market would immediately collapse (or lose its price premium) if the intellectual property owner in the MNE group were to end the local distributor's access to the MNE's intangibles. Finally, it is usually easy to benchmark the profit level expected from an independent distributor using its own marketing intangibles. Those independent distributors do not necessarily increase their profit margin percentage over time but earn more money if the size of the business expands.

c. Risk allocation – formulary apportionment

The country views in Chapter 10 also reflect concern that the OECD approach overvalues the role of risk in allocating profits. For example, the Chinese section of Chapter 10 notes that "a risk-based approach may place insufficient regard for the fact that there are sizeable assets located in China (i.e. the work force and factory plants)." (*See* UNTPM Par. 10.3.6.3.) It goes on to state that, in the case of the electrical manufacturing sector, "the assets and the people should largely dictate where the group's profits should stay, and a global formulary approach should be a realistic and appropriate option." (*Id.*) Chapter 10 effectively argues that, to reduce the distorting effect of risk and intangible assets in transfer pricing, there is a case for the limited use of formulary apportionment, distributing the profits based only on the assets and people in each jurisdiction. Formulary apportionment of profit (*see* UNTPM Par. 1.4.13. and 3.2.3.) even in limited cases is irreconcilable with the arm's length principle, and therefore TEI's opposes its use.

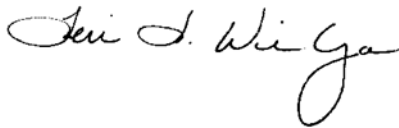
Regrettably, many of the country views included in Chapter 10 introduce new concepts which derogate from the contractual framework set by MNEs and from basic principles of the market economy. Chapter 10 thus seems to stand in opposition to the rest of the UNTPM and the arm's length principle. If these statements and the general approach of Chapter 10 are applied, they will lead to interminable international tax controversy and double taxation.

Conclusion

TEI appreciates the opportunity to comment on the *United Nations Practical Manual on Transfer Pricing for Developing Countries*. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any

questions about the submission, please contact Mr. Hasenoehrl at +352 26 20 77 46, nickha@herbalife.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
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