# Day 5, Session 2 TP in Developing and Emerging Economies

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OLICIES FOR BETTER LIVES





- I. Inclusive Framework on BEPS
- II. UN guidance including Practical Manual on Transfer Pricing for Developing Countries
- III. Other guidance, including Platform for Collaboration on Tax Toolkits for developing countries
- IV. Selected TP issues
- V. The future

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# Section I Inclusive Framework on BEPS

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- Inclusion on an equal footing of non-OECD, non-G20 countries and jurisdictions which commit to implement the BEPS project
- Currently 145 members
  - Half are non-OECD, non-G20 developing and emerging economies
- Focus on implementation of original BEPS measures...
  - Support for developing countries capacity building, bespoke induction programmes
  - Review of minimum standard peer review mechanisms
- ...And the Two-Pillar Solution to address the tax challenges of digitalisation/ introduce global minimum tax

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#### Section II

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# **UN TP Guidance**

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#### UN Practical Manual on TP for Developing Countries



- A product of the UN Committee of Experts on International Cooperation in Tax Matters
- To assist developing countries to apply the arm's length principle to TP issues
  - Broad support for the arm's length principle globally
  - Impacts on double taxation, tax certainty and investment climate
  - Associated Enterprises article of UN Model is identical to OECD Model
  - Consistent with OECD TP Guidelines
  - Focus on practical application by lower capacity countries
  - Third edition 2021 broadly consistent with OECD TPG

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- Main changes in the 3<sup>rd</sup> edition (2021) of UN Practical Manual on Transfer Pricing
  - New chapter on financial transactions (loans, guarantees)
  - New guidance on procurement, marketing hubs
  - Updates on profit split, lack of comparables
  - Consolidate and edit to improve clarity and consistency
- Transfer Pricing and Extractives
  - UN Handbook launched in May 2018, revised edition 2021
  - Extractives value chains
  - Chapter on TP

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#### Mandate and work programme from 2022

- Dealing with Covid/ economic downturns completed
- Toolkit for TP compliance assurance (risk assessment, audit) - completed
- Transfer pricing and CO<sub>2</sub> certificates completed
- Industry-based guidance:
  - selected primary agricultural products (coffee, soybeans)
  - pharmaceuticals
- Dispute avoidance/ resolution

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# Transfer pricing during the Covid downturn



- Arm's length principle is unchanged
- Need to evaluate specific impact on the controlled transactions
- Specific issues:
  - One-sided vs two-sided methods
  - Comparables
  - Treatment of exceptional costs
  - Limited risk entities and loss-making
- Dispute prevention and resolution
  - Documentation
  - APAs

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#### **Compliance assurance toolkit**



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- End-to-end compliance assurance
  - Objectives
  - Options
  - Developing an end-to-end compliance assurance programme
    - From education → population screening → risk assessment → compliance enforcement → case resolution → continuous improvement
- Risk assessment
  - Example road map: the risk assessment process, evaluating risks
    - Sources of data, risk flags
- Transfer pricing audit
  - Example road map: the audit process
    - Setting up a team  $\rightarrow$  information gathering and analysis  $\rightarrow$  audit conclusion

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#### Transfer pricing of carbon offsets and credits

- Regulatory frameworks
  - Emissions trading schemes
- Project value chain analysis
  - Examples of carbon offset schemes
- Transfers of carbon credits

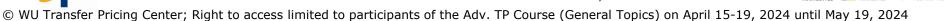
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## Industry guidance: Agricultural products

- Overview of the industry
- Typical activities within the global value chains
- Common issues, e.g.
  - hedging
  - pricing dates
  - use of hub structures
  - commoditisation
  - environmental regulation
  - IP rights
- Examples
- Coffee
- Soybeans

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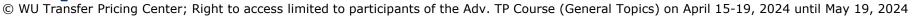
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## **Industry guidance: Pharmaceuticals**

- Industry segments
- Global value chain and typical activities
  - R&D
  - Manufacturing
  - Marketing
  - Distribution
  - Regulatory affairs
- Value drivers and business models
- Examples

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#### **Bilateral APAs – FAQs**

- Policy choices: advantages/ disadvantages, options
- Legal frameworks
- Organisation of an APA function
- Procedures and processes

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- World Bank Group, "Transfer pricing and developing economies: A handbook for policy makers and practitioners"
  - Drafting policies / legislation
  - Practical application of ALP
  - Compliance and administrative issues
  - Resolving disputes
  - Developing an audit programme

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## Section III Other Practical Guidance – Toolkits

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**Platform for Collaboration on Tax** 



- Platform for Collaboration on Tax: joint initiative of the OECD, IMF, World Bank Group, and UN
- Report to the Development Working Group of the G20 on base erosion and profit shifting
  - Identified base erosion and profit shifting priorities for developing countries
  - Series of "toolkits" to assist lower capacity countries

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# PCT Toolkit: Addressing difficulties in accessing comparables

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- Lack of comparable data is a major complaint of tax authorities and the private sector in developing countries
  - Commonly used databases contain very limited/no data for a large number of developing countries
- Toolkit first considers how to make the most effective use of available information
  - Delineation of the transaction
  - Screening for potential comparables
  - Comparability adjustments
- Supplementary section on pricing of minerals

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#### Extractive industry guidance



- Produced by OECD with Inter-Governmental Forum on Mining, Minerals, Metals and Sustainable Development
  - Toolkits: Determining the price of minerals: a transfer pricing framework
    - Pricing framework for bauxite
    - Pricing framework for lithium
  - Policy notes on BEPS issues
    - Limiting excessive interest deductions
    - Tax incentives
    - Monitoring the value of mineral exports

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# Section IV TP in emerging economies

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#### **Brazil**



- Recent changes to move to OECD-aligned transfer pricing rules
  - Provisional Measure 1,152/2022, converted into Law 14,596 of 14 June 2023, and regulated by Normative Instruction 2,161/2023
    - Optional adoption in 2023
    - Mandatory from 2024
  - A broad concept of related parties (where involving a low tax jurisdiction/ regime, not limited to associated enterprises) was essentially maintained from the previous TP framework.
- Former TP framework:
  - Officially based on arm's length principle
  - Fixed margins by industry
  - Very limited types of comparability adjustments allowed

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#### Brazil



- New TP framework includes:
  - a definition of the "arm's length principle"
  - rules on the application of the arm's length principle, including defining the controlled transaction, application of a comparability analysis
  - 5 OECD transfer pricing methods, other methods provided they produce an arm's length outcome
    - Note that for commodities, the CUP method is presumed to be the most appropriate, unless it can be established otherwise
  - rules for intangible assets: their definition, treatment and hard-to-value intangibles; and
  - provisions dealing with intra-group services, cost sharing, business restructuring, transactions involving debt, intra-group guarantees, centralised treasury management and insurance
  - Financial transactions: If a transaction is delineated as a capital contribution (i.e. equity), interest and other financial expenses will not be deductible for tax purposes. If delineated as a debt, the interest rate must be established based on the arm's length standard, considering risk, borrower's credit rating, and other features such as guarantees, seniority level of the debt and covenants.

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#### China



- Arm's length principle
- Remuneration to the local entity should be "commensurate with its role and contribution to the value chain"
  - Risk assumption may not be considered as relevant as other contributions, e.g. assets such as a factory and related employees
- SAT Public Notice [2017] No.6
  - Location Specific Advantages: location savings
    - Eg if using Cost Plus or TNMM on full cost basis, adjust the mark-up to account for the lower cost base due to the location saving
      - Cost base of tested party in China = 100
      - Comparables Average cost base = 150; mark-up 8%
      - Applicable mark-up for tested party = 8%\*(150/100)=12%
  - Location Specific Advantages: Market premia
  - Six tests for deductibility of intra-group (low value) service fees
  - Intangibles
    - Local contributions must be carefully evaluated
    - Development, enhancement, maintenance, protection, exploitation and promotion ("DEMPEP") functions

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#### India



- Arm's length principle
- Broadly aligned with OECD TP Guidelines
- Local File, Master File, CbCR, Audit report to be filed
- Arm's length range
  - ≥6 comparables,  $35^{th} 65^{th}$  percentile;(adjust to median)
  - <6 comparables, use arithmetic mean</p>
- Location rents (from LSAs) need to be appropriately remunerated at arm's length
  - Local comparables
  - Profit spit may be appropriate where there are no comparables

#### India



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- Payments for intra-group services may be regarded as "base eroding" and thus a high risk area
  - Overall ceiling (% of sales or revenue of the local entity) may be used
  - LVAS (5% mark up) applies with a ceiling on maximum amount
- Safe harbour provisions introduced 2013
  - Minimum operating profit margins by category of transaction, e.g. IT services, contract R&D, manufacture and export of auto components, loans, financial guarantees
- Large number of TP cases are litigated

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### Indonesia



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- Arm's length principle
- Requirement to price transactions "ex ante" i.e. using a pricesetting approach rather than a price testing approach
- Local File and Master File must be prepared annually (submitted on request); CbCR
- Application for a tax refund triggers a tax audit
- Transfer pricing adjustments are generally deemed dividends
- Interquartile range must be used
- Recent modifications:
  - Definition of parties with a "special relationship" (i.e. related parties) now includes a wider definition of "control"
  - Improvements to APA programme, including allowing rollback

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#### Indonesia



- Thin capitalisation regulations (2016) now complemented by earnings stripping rules (2022)
  - Debt to equity ratio of 4:1
  - Interest expense not deductible if there is negative equity
  - Interest limitation may also be determined based on % of EBITDA (Details to be provided via regulations)
- Specific Anti-avoidance rule for consecutive losses
  - relating to transactions with parties with a "special relationship"
  - Where losses in 3+ years of 5
  - DGT has authority to adjust based on an industry benchmark

#### South Africa



- Arm's length principle
- Generally aligned with OECD Guidelines
  - Practice Note: TPG should be followed in the absence of specific guidance
  - Recommendation for formal adoption of TPG through a Binding General Ruling
- Local File, Master File, CbCR to be filed; TP questions in tax return
- Safe harbours, APAs viewed with caution (but Dec 2023 saw introduction of legal basis for bilateral APAs introduced)
- Comparability
  - Lack of local comparables;
  - "holistic approach" to establishing whether the ALP has been complied with
- Services
  - Payment should be evaluated from the perspective of both parties

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#### **Section V**

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# **Selected TP Issues**

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- Location savings / LSAs in the UN Manual:
  - [net] economic benefit arising from moving operations to a lowcost jurisdiction
  - Examples could include:
    - highly specialised skilled manpower and knowledge;
    - proximity to growing local / regional market;
    - large customer base with increased spending capacity;
    - advanced infrastructure;
    - market premium
  - LSAs may lead to location rents, depending on competitive factors
  - See also section D.6, Ch I of TPG

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Interface with customs valuation



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- A long-standing issue; tension between CV and TP
- Both CV and TP:
  - address valuation/pricing of imported goods
  - seek to neutralise the impact that any relationship between the parties may have on the value/price
- Developing countries often more reliant on customs revenues
  - customs duty rates may be relatively high
- Timing, objectives and "correct value" may differ
  - Problematic for taxpayers/ traders, officials
  - Creates difficult policy challenges

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#### Interface with customs valuation



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#### Customs value:

- based on strict WTO valuation rules
- must be determined on a per consignment basis
- Generally based on "transaction value" but Customs may instead examine whether the relationship has influenced the price
  - test values or
  - "circumstances surrounding the sale"
- Definition of "related party" vs "associated enterprise" may differ
- WCO working with OECD, WBG, ICC to encourage practical cooperation
  - WCO guide to Customs Valuation and Transfer Pricing
  - WCO Revenue package
  - Joint tax / customs officials workshops

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#### "Sixth method"



- Applied in a number of countries to certain commodities transactions
  - Often an anti-avoidance measure
  - Transfer price for the commodity to be based on an exchangequoted price
  - Cf CUP?
  - Pricing date and terms may be established in law
  - May be rebuttable

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- Approaches and capacity in developing / emerging economies vary significantly, but:
  - Increasing number are introducing rules and building capacity: Important to keep up to date with specifics
  - Experiences are being shared through bilateral projects, technical assistance, TIWB, regional events and global events: Consistency of approach is vital
  - What is immaterial to a MNE may be very material to a particular country: Consider reputational issues
  - Increasing transparency and exchange of information (including CbC reporting): Tax planning based on non-disclosure is slowly, but surely, becoming unviable

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# Section VI What does the future hold?

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## What does the future hold?



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- Impact of Inclusive Framework on transfer pricing guidance
- Pressures on the ALP, lack of information, access to comparables...
  - Capacity constraints
  - Complexity of TP analyses
  - Challenges of addressing increasingly digitalised economy and interaction with Two-pillar package
- → Amount B
  - Streamlined approach for routine activities
  - When will it be applied? Who is a "low capacity jurisdiction"?
- Fundamental changes?
  - Amount A: acceptance of use of formula-based, top-down approaches
  - Rules which override the ALP and traditional functional analysis in determining where value is created and profits should reside?

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## What does the future hold?



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- Incremental changes in the way the ALP is implemented?
  - Simplification measures?
    - Amount B
    - Other simplification approaches/ safe harbours/ mechanical approaches?
  - Blunt instruments ?
    - Anti-avoidance type pricing rules
    - Prescriptive rules concerning selection or adjustment of comparables
    - Deeming rules in absence of information
  - Measures that reduce reliance on ALP?
    - Approaches to interest limitation
    - Impact of Pillar 2 GloBE, QDMTT and STTR minimum taxes?

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