UNITED NATIONS

ST

Secretariat

Distr.
LIMITED

ST/SG/AC.8/2001/L.11/Add.1
12 September 2001

Original: ENGLISH

Ad Hoc Group of Experts on International Cooperation in Tax Matters
Tenth meeting
Geneva, 10-14 September 2001

Draft report of the Tenth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

GE.01-64572

Draft Report of the Discussions on 11 September 2001 in the Tenth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

The meeting began with discussion of agenda item 5, Transfer Pricing. The Chairman initiated the discussion with an overview of the issue of transfer pricing from the perspective of the developing countries. He noted that transfer pricing is primarily an issue in determining the income of large multinational firms, in that approximately 80 percent of international trade is conducted by approximately 60,000 firms. He also cited figures indicating that the amount of tax revenue lost to governments from the strategic use of transfer prices by multinational firms was quite large. He also noted that the issue of transfer pricing has been discussed in detail at prior meetings of the Ad Hoc Expert Group and by many other organizations.

It was generally agreed that a major objective of adopting transfer pricing mechanisms by multinational enterprises was to minimize the aggregate tax liabilities of their corporate group, although other non-tax issues played some role. Moreover, the customs authorities were also concerned with the underreporting of value of imported articles as a natural consequence of improper transfer prices. Several countries in North and South America have attempted legislative measures to overcome the adverse consequences of transfer pricing mechanisms.

A representative from a developed country pointed out that in order to avoid double taxation and the consequent impediment to world trade, the OECD has issued guidelines in 1995 on the methodology of determining the arm's length price. The revision of the guidelines has continued since then by publishing new chapters relating to intangibles and services, on cost contribution arrangements, and guidelines for conducting Advance Pricing Agreements APAs) under the mutual agreement procedure. In general, an APA is an agreement between the taxpayer and one or more governments on the methodology to be used in some specified number of future years in setting transfer prices for some or all of the taxpayer's business. Presently, the OECD is engaged in providing guidance on the manner of application of the general principles to complex situations, such as permanent establishments, financial services, global trading, and thin capitalization.

A representative from a developing country discussed his country's experiences in developing its transfer pricing procedures, beginning in 1988, when the country began to engage more fully with the outside world. The major objectives of developing the transfer pricing procedures were to create an appropriate investment climate in the country and to protect the legitimate interests of investors. There are three ways of making transfer pricing adjustments, based on the OECD guidelines and the experiences of other countries. The adjustments were not sufficient to deal with all transfer pricing problems. One reason was that there were not many comparable prices available. Second, the burden on tax officials of finding comparable prices was heavy. Third, the use of the comparable profit method, referred to by the OECD as the transactional net margin method, although relatively easy to apply, created distortions if used excessively. After putting in place its methods for auditing multinational companies, the country examined additional issues, including the use of APAs. Presently, APAs are used only on a bilateral basis, although in some cases the multinational enterprise is engaged in business activities in several different countries.

Another representative from a developing country discussed the problems faced by his country in determining proper transfer prices. He suggested that many developing countries, to protect their tax revenues and their balance of payments, are required to make special administrative efforts to fight against the indirect transfers of benefits outside the country through improper transfer prices. He noted that his country did not have adequate data on comparable prices and lacked sufficient human and financial resources to deal adequately with the problem. He also discussed the possible use of an arbitration mechanism to settle disputes between taxpayers and the government on transfer pricing issues. He added that the taxpayer must feel confident that information provided to the government will be kept in confidence if an appropriate relationship between the government and the taxpayer is to be established.

A representative from a developed country discussed the arbitration convention of the European Union. He noted that the convention defines an associated enterprise in accordance with Article 9 of the UN and OECD Model Conventions. He noted that the scope of the convention is limited to the 15 members of the European Union. As a result, issues relating to affiliated companies resident in countries outside the EU are not within the scope of the convention. He also noted that a panel appointed to consider an arbitration case would have an equal number of members appointed by each country involved and an equal number of members drawn from experts nominated by the 15 members of the EU. To ensure an odd number of members on the panel, the chairman would be elected by the panel from that same list of experts. He noted that no cases have yet been undertaken under the convention. He suggested, however, that the convention may be judged a success to the extent that it has caused member states to conclude competent authority cases in a timely manner. One member from a developed country indicated that his country is expecting to have a case under the convention in the near future.

Representatives of several countries discussed their experiences with arbitration. It appears that arbitration is not used very often in practice. The main function of an arbitration option seems to be to put some pressure on governments to reach an agreement through the mutual agreement procedure based on Article 25 of the UN and OECD Model Conventions. Several representatives from developing countries expressed the view that the mutual agreement procedure should be preferred. One participant noted that an arbitration procedure was likely to give the advantage to the side that is best represented in the procedure and that the multinational companies tend to be well presented. Several members suggested increased use of mediation as an effective means for resolution of transfer pricing disputes.

The members gave extensive comments on the possible use of APAs in developing countries. One point, made by a representative of a developed country, was that APAs are only relevant when a country has developed the capacity to do an extensive audit of the transfer prices of a multinational enterprise. APAs were developed to reduce the cost of litigating complex cases and thus have no relevance to countries that are not litigating such cases. Some members noted that APAs could put severe strains on administrative resources because they require an extensive review of the pricing methodology of the company requesting the APA. As a result, there may be little administrative savings from an APA programme. Others noted the problems arising in a dynamic world when pricing methodologies are set for an extensive period into the future.

One participant suggested that developing countries might find the use of safe harbours (also called “safe havens”) to be a convenient way of dealing with some transfer pricing issues. A representative from a developing country discussed the experience of his country with safe harbours. He suggested that it was most useful when the other country involved was prepared to accept the safe harbour rule. One participant suggested that taxpayers should be given an option to use an arm’s length method in place of the safe harbour. It was noted, however, that much of the administrative advantage of the safe harbour might be lost if that option was provided. There was a general consensus that the use of safe harbours might be explored, but that their use should be limited to certain types of businesses and should be based on a good analysis of the profits likely to be earned in those businesses.

In light of the above and despite the adoption of various adjustment methods, legislative, and other multilateral measures to overcome the adverse consequences of transfer pricing mechanisms during the past several years, the Secretariat requested and the Ad Hoc Group of Experts agreed to establish a Focus Group composed of seven members to review the current situation with respect to transfer pricing mechanisms and formulate recommendations to avert the loss of tax revenues from corporate strategic use of transfer prices. In particular, the Focus Group will concentrate on the need to adjust the various transfer pricing methods, review the mutual agreement procedures provided in the article 25 of the United Nations Model Convention, define the appropriate framework for relevant mediation and arbitration procedures and suggest means aimed at providing training and technical assistance to enhance capacities of tax administrations in dealing with transfer pricing mechanisms, particularly, in developing and transitional economy countries.

———