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This is a working draft of a Chapter of the Practical Manual on Transfer Pricing for Developing Countries and should not at this stage be regarded as necessarily reflecting finalised views of the UN Committee of Experts on International Cooperation in Tax Matters or its Subcommittee on Transfer Pricing - Practical Issues. Comments in writing are sought and should be sent to the secretariat to the UN Tax Committee at taxffdoffice@un.org by 8 November 2010 at the latest.

Several members of the Subcommittee have contributed to this draft and appropriate attribution will be made in a later version.

Chapter 3 - Establishing Transfer Pricing Capability in a Tax Administration

A. Introduction

1. This Chapter provides a brief description of the justification of Transfer Pricing Rules in developing countries. It touches on the relationship between policy making and tax administration which includes discussion on issues of coordinating the cross-ministerial responsibilities. This Chapter also looks into the setting up of policy capacity and steps required to assess the administrative capability which leads to the setting up of a Transfer pricing Unit in the Tax Administration.

B. Transfer Pricing Rules Justification in Developing Countries

2. All around the globe, transfer pricing has become one of the most important tax issues. This is because so much more is now at stake that, so many countries now have to enforce transfer pricing rules and requirements. In the globalising world there are more and more cross border transactions. With at least 30% and perhaps more of the world's trade occurring within multinational enterprises (MNEs), and the trend continuing to increase, Tax Administrations need to increasingly focus on transfer pricing. Transfer pricing rules and requirements are necessary if a country has companies which are trading with affiliated companies in other countries. This can be the case if companies sell products to customers and buy those products from affiliated companies elsewhere.

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3. Example of transfer pricing arrangements:

Two related companies – a subsidiary company in Country A and a parent company in Country B – might benefit from a transfer pricing arrangement by making a transaction in a country with a tax burden significantly less than that of another country.

Scenario 1	Price of Goods \$	Transfer Price \$	Selling Price \$
	200	400	600
	Subsidiary Company		Parent Company
Pre-tax profit	200	200	400
Tax rate	20%	60%	
Tax paid	40	120	160
After-tax profit	160	80	240
Scenario 2	Price of Goods	Transfer Price	Selling Price
	200	500	700
	Subsidiary Company		Parent Company
Pre-tax profit	300	100	400
Tax rate	20%	60%	
Tax paid	60	60	120
After-tax profit	240	40	280

Overall after-tax profit rises from \$240 to \$280 (16.6%) in Scenario 2

4. The ability of MNEs to control prices in related party transactions that involve shifting revenues from high tax jurisdictions to tax favourable jurisdictions is a matter of serious consideration to Tax Authorities. It is important that each country can calculate the right amount of profits and is paid the right amount of tax. MNEs are organised in various ways, as noted in Chapter 2, but the main feature is that they separate many functions to be as efficient or productive as possible. This leads to complicated situations and creates pricing issues. Although it is complicated for MNEs to price their activities, it is equally complicated for Tax Authorities to judge whether the prices are appropriate.

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C. The Relationship between Policy and Administration Issues

5. In most tax jurisdictions of the world, the policy making function resides with the Ministry of Finance rather than the Tax Administration. In many jurisdictions the other revenue generating organs of government (e.g. the Custom Service) are also separate from the Tax Administration.

i) Cooperation

6. To operate an effective transfer pricing administration there is a particular need to bridge the gap between policy making organ and tax administration on the one side and MNEs on the other side. A cooperative approach between these entities can help achieve this, and an essential first step in improving cooperation is to review and clarify exactly what each agency's responsibilities and functions are. This review should be used to examine the scope for removing duplication and overlap of functions, and for streamlining and consolidating procedures.

7. While cooperation between the policy maker and the Tax Administration is vital, it is often poor in practice, for various reasons, including differences of culture, status and ministerial sponsor.

8. Understanding the functions and background of companies and MNEs will lead to greater knowledge on how companies and MNEs operate in a particular industry. Handling of their taxation issues will inevitably lead to more contacts between MNEs and the Administration. For instance, MNEs have to disclose their documentation and system, while tax administrations have to be aware of the dangers of unnecessarily high administrative burdens, and therefore compliance costs, for the MNEs, which is inefficient and may project a negative aspect of a country's investment climate.

9. On the other hand more focus on transfer pricing issues will lead to more disputes with MNEs and thus the possibility of more double taxation. This had happened in many developed countries in the last years. To avoid double taxation, most tax treaties contained a Mutual Agreement Procedure (MAP) article based upon the UN or OECD Model Tax Conventions, as noted in Chapter 1. However, the MAP is very resource intensive and costly for both Tax Authorities and MNEs. As such, it is worthwhile to put sufficient energy and resources into risk assessment and established contact points between the Tax Administration, the "Competent Authorities" (who liaise with Competent Authorities of other countries on double tax treaty matters) and policymakers to avoid unnecessary adjustments in tax assessments.

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10. To understand the transfer pricing system of the MNEs, it will be necessary to come in contact with one another. This can be achieved through:

a) The Tax Authority by:

- Extensive and clear taxpayers' education;
- Making available to taxpayers tax guidance notes, information circulars and other literature on interpretation of tax laws to avoid misunderstandings and surprises among those willing to meet their obligations;
- Continuous dialogue with taxpayers on tax issues;
- Setting up clear redress systems in case of disputes; and
- Advance rulings on tax issues.

b) The taxpayers by:

- Requesting and obtaining advance rulings before embarking on activities with important tax consequences;
- Making its Transfer Pricing Policy available to the Tax Administrators;
- Complying with the provisions of the Double Taxation Agreement signed between the country they are operating in and their resident country (such as their place of effective management);

11. On the relationship between the policy makers and the Tax Administration, it will be important to observe the following:

- Secondment of tax Administrators to the section of the Ministry that deals with policy making to understudy the policy making process and also the secondment of policy makers to the Tax Administration to understand the rudiments of taxation. This reflects the fact that good tax policy must be able to be administered and good administration must have sound policy underpinnings;

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- Government must make a deliberate policy that all investment policies must have the buy-in of the Tax Administration. For example, they should be involved in discussions about tax holiday policies;
- The policy makers should also not be limited in their training to economic effects of investment; taxation should be incorporated into the training.

12. Cooperation between policy makers and the Tax Administration requires skills other than the traditional transfer pricing knowledge and skills. In the case of transfer pricing development, it is not only important to develop “hard skills” such as knowledge of the law and of how MNEs operate, but also “soft skills” such as negotiation techniques and communication skills. All agencies of the government that are involved should coordinate to avoid overlapping of functions, which can increase taxpayer frustration and compliance costs, but can also be used to “play off” one agency against another.

13. It is especially useful if the taxpayer can go to one body to deal with key issues, with that body doing the internal coordination, rather than the taxpayer in effect being forced to act as coordinating agent. In some tax jurisdictions the organ that approves tax holidays is different from the Tax Administration and the Policy Maker. All these organs need to work with the Tax Administrator to make administration of transfer pricing and other taxation issues as easy and effective as possible.

D. Setting up Policy Capacity

14. Tax administrators should develop ways in which to establish fairer transfer pricing policies to protect them from losing the revenue from the tax base. Rules created by developing countries based on, for example, the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines, help to prevent MNEs from using transfer pricing to avoid paying taxes. The formulation of these rules is to allocate profits for tax and other purposes between parts of MNEs. Many developing countries have established transfer pricing regimes, and the key principle of transfer pricing for such regimes is the Arm’s Length Principle (ALP) as noted in Chapter 1. The ALP is the internationally accepted and adopted principle that determines the transfer pricing standard between parties.

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15. The current (2010) OECD Transfer Pricing Guidelines are based on this principle that a transfer price should be the same as if the two companies involved were indeed two independent parties and not part of the same corporate structure. The ALP is reflected in paragraph 1 of Article 9 of the UN and OECD Model Tax Conventions that are the basis of most international tax treaties.

16. The tax systems of countries are at varying stages of addressing transfer pricing, and their governments maintain different policies and regulations towards transfer pricing. Some countries were early to establish transfer pricing policies and regulations, and allocate a high level of resources to carrying out transfer pricing audits. Meanwhile, governments of some other countries adopted relatively simple transfer pricing policies, to the extent that by the time an MNE is identified for transfer pricing audit, the transaction prices of the MNE may have gone beyond the bounds of reason.

E. Assessing Administrative Capability

17. Different Tax Administrations require different types of administrative arrangements when it comes to implementing their transfer pricing policies. Transfer pricing policies do not only have an impact on the cost of administration, but also on the organization as a whole. The level of development/capability in the Tax Administration should be a key factor to consider when formulating policies.

Level of capacity of the Tax Administration

18. Factors to consider when assessing the level of development/capability of the Tax Administration include:

- i. level of education and expertise;
- ii. legal environment;
- iii. tax treaties (exchange of information and MAP); and
- iv. availability of information in the country/tax administration.

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Competences needed by the Tax Administration

19. Dealing with MNEs demands specific characteristics and competences. Transfer pricing is about how business operates and it has to do with tax laws. Knowledge of international tax law is required to select the right areas to focus on and to select the right cases for an audit, as some transactions are more tax driven than others. Staff with accountancy backgrounds is often easy to train in this area as they are often enthusiastic about specialising in this field. Others, such as lawyers and economists have special skills in dealing with the often complex law and economics of transfer pricing cases, and one of the challenges in this area is having all those skills working together effectively.

20. “Soft skills” are also important for the officers to perform their duties. Negotiation and communication skills are essential since transfer pricing demands a lot of interaction with MNEs. There is always a range of possible outcomes and room for many discussions. Due to the close contacts between business and the Tax Administration and the large amounts often stake, as well as the fact that many tax officers engaged in transfer pricing issues later join the private sector, integrity issues may arise. The best way to deal with this integrity issue is by having discussions with MNEs in teams. This is to ensure that working arrangements are transparent, open and have built-in checks and balances.

Training needs of the Tax Administration

21. Assessing the existing knowledge, capabilities and competences are of the utmost importance. It is recommended to first develop an overview of the existing capabilities. For a start it is good to have the first group of experts with accountancy and legal background. This will be followed by setting up of a training program. For this there may be assistance provided by international development agencies, regional tax administration groupings, international organisations and training institutions.

F. Setting Up a Transfer Pricing Unit

i) Organisation

22. Firstly it is important to find out the actual level of knowledge and the need for organisational measures. In this Manual the focus is on countries with little or no experience in transfer pricing.

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23. There are a lot possible organisational structures and models. In general the organisation structure would involve:

- the Tax Administration that is responsible for the tax assessment and collection;
- the centralised policymakers;
- the Competent Authority to settle disputes under the MAP.

24. Based on the experience of countries with significant transfer pricing experience, different approaches will usually be appropriate depending on the stage of development of transfer pricing activities. The following discussion is informed by that “variable geometry”.

25. In the start-up phase a clear centralised coordination is necessary. At this stage it is important that the policymakers have a clear view on the transfer pricing issues and their possible solutions. It is impossible to bring the Tax Administration at once to a high level of knowledge. Centralisation gives a good overview of existing capabilities and needs for training. An expert group should be trained in the beginning. It is good to look for enthusiastic employees both from the Central Ministry and the Tax Administration.

26. From experience there are two risks at this stage. First, there is the possibility of resentment against transfer pricing policy. Because it is new, people within the organisation do not know exactly what it is about and feel uncertain and can be unwilling in taking up transfer pricing issues. Hence, giving companies some latitude in determining transfer prices is often necessary in practice at this early stage.

27. Secondly, there is a risk that employees from the Tax Administration will become overly enthusiastic and may propose disproportionate tax adjustments leading to time consuming litigation and MAP. Because transfer pricing is not an exact science, it has a broad range of possibilities to discuss and adjust tax returns. It is thus important to manage this process.

28. Transfer pricing knowledge and experience require both legal and economic expertise. It is not purely one or the other. Transfer pricing knowledge is about pricing, economic rationale and market knowledge and business and industry knowledge. But it is also important to understand international taxation and to understand what the tax rationale is underlying certain transactions. Transfer pricing specialists should be tax lawyers with economic competence. Of course those skills can be split between different persons working together e.g. a tax lawyer cooperating with a pure economist

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specialist. This depends on the specific situation and availability of human resources in a given situation. As noted above, those with accounting backgrounds often have an important understanding of how companies operate, and are a potentially important part of the transfer pricing team.

29. The pioneer group to be trained should consist of senior policymakers and senior tax officials. They are the pioneers who should instil awareness in their colleagues on the importance of transfer pricing. This same group is responsible for setting up the policies in corporation with the business. They will organise lectures and in house seminars to train the officials who will become the next group of experts and increase their skills and knowledge. They can make use of the training programs for support noted above and outlined in a later part of this Manual.

30. The next step is to extend the transfer pricing knowledge and expertise to the rest of the organization. It is a possible model to train in each region several employees and make them strictly responsible for discussions. They can select some cases with a high level of risk. However, the disadvantage is that the other tax officials may resent this group, especially if they are given special pay or other conditions as sometimes happens. In this initial period it is expected that only a few cases will be dealt with. Nonetheless transfer pricing experience is being developed. These specialists should meet with the policymaker to share the latest developments. The policymakers will see what the major issues are.

31. In the meantime the same approach can be adopted to train the next generation of specialists. The ultimate aim is that finally all corporate income tax specialists are able to handle transfer pricing cases, but before that is achieved, as wide as possible a group of those dealing with MNEs need to be able to identify cases where there is a transfer pricing issue, for further consideration if possible.

32. After the first start up years coordination will be more difficult. Several models can be used. It is possible to create teams for every region which are exclusively dealing with Transfer Pricing cases. National coordination is arranged by placing team members of each region on rotation basis to discuss the latest developments in transfer pricing. Another model is to make all CIT tax inspectors responsible for all Transfer Pricing cases. Then it is good to appoint some regional focal points which have to be aware of all major issues and are responsible for contacting and informing policymakers.

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33. Another model is to set up a national unit to deal with all Transfer Pricing issues. Some countries have already a separate division for MNEs because of their specific characteristics, their tax revenue and tax issues. This MNE unit can be organised on national level or within the regions, depending on the number of MNEs that are active in the country.

Starting transfer pricing operations

34. The starting of transfer pricing operation requires:

- A critical look at the availability of human resources within the tax administration. Prioritisation is essential and choices have to be made between the amounts of attention to be given to different kind of taxes. Policy on transfer pricing without sufficient resources in the Tax Administration will not achieve its policy intent.
- Definition of the country's industry characteristics. It will be useful to look for statistics on trading volumes and other indicators for cross border transactions.
- good relations with business. It is worthwhile to take the business society on board the transfer pricing "journey". Acceptance and understanding of the policy will prevent a lot of compliance and collection costs. Meetings with all stakeholders will help in effectively building transfer pricing policy and capability.
- Understanding of what other countries have and are doing. Invite representations from other countries with a history on transfer pricing to give input and share their experiences.
- An ability to define, with policy makers and administrators involved in the process, the important areas of focus bearing in mind that:
 - o The main characteristics of the country's industries, e.g. call centres, manufacturers, or distribution activities;
 - o The main kinds of cases contained in the workload of the Tax Administration?
 - o The main type of activities to start with in developing policies, recognising the need for policy to be soundly based in reality;

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- Practical case studies can give an input for policymaking.

35. After starting the transfer pricing journey, focus can be changed depending on the stage of development of the transfer pricing practice in policy and revenue. In the first years it is helpful to focus on more or less simple activities like contract manufacturing, intra group services, etc. And from the moment a higher level of experience is reached, the focus can shift to more complicated areas like intangibles and business restructurings. The same journey is undertaken by the developed countries. The complicated topics can be placed on the agenda after developing expertise with transfer pricing. That is not to say that particularly blatant examples of mis-pricing in these areas cannot be addressed at an early stage.

ii) Model for Organisation

36. There are two basic types of structure that can be adopted for the transfer pricing capability:

- Centralized
Advantage: coordination, easy in start-up phase, fast building up of knowledge
Disadvantage: risk of being in an “ivory tower” – out of touch with realities “on the ground”; risk of over-centralisation will create opportunity for corruption and collusion may be greater in countries where general civil service standards are not high and control is lax.
- Decentralized
Advantage: short lines of communication with tax inspectors, easy spread of knowledge, combined industry and transfer pricing - knowledge, more fit for later phase
Disadvantage: coordination problems may lead to inconsistencies, lack of experience sharing and issues “falling between gaps”

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37. Other organisational aspects may be summarised as follows:
- Elements of organization
 - The legal framework
 - Administrative policy making
 - Coordination
 - Staffing
 - Economists
 - Lawyers
 - Accountants
 - Auditors
 - Database-experts
 - Project management skills
 - Budget and Funding
 - Management information, registration/recording of transfer pricing cases and adjustments.

iii) A Life Cycle Approach

38. When a transfer pricing organisation is set up, it is important to monitor the stage of development of the organisation. In the start-up phase, a centralised organisation is recommendable. Strong coordination is also necessary.

39. When dealing with arm's length issues, it invariably involves discussions with MNEs that have vast experience and knowledge on transfer pricing. For a successful setting-up of the transfer pricing unit within the Tax Administration, it is important to set clear priorities. Otherwise it will lead to long lasting discussions and this will distort the organisation and work efforts of both the companies and the Tax Authorities. This can have a negative effect on the country's investment climate.

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40. Once the staff and the organisation are more familiar in dealing with MNE's and transfer pricing, it is possible to decentralise and give more powers to individual transfer pricing units of the Tax Authority to determine priorities and deal with issues proportionately.

41. In general the attitude of the Tax Authority towards MNE's will often be characterised by mutual suspicion and a lack of trust. This is understandable as Tax Authorities in general want to collect as much taxes as possible to meet their responsibilities of collecting revenue that will contribute to the country's development, and expect MNEs to want to pay as little tax as possible. On the national level of the Ministry of Finance, the policymakers are in general more sensitive to wider issues such as a favourable investment climate. In an ideal situation, the Tax Authorities should be more aware of wider policy considerations and integrate that in their work without neglecting the differing responsibilities of the central and local authorities, where relevant. In the beginning this would be difficult to achieve. However, this should be the ultimate aim that should be kept in sight.

42. A transfer pricing unit within the Tax Administration should consist of staff with legal and economic knowledge. In addition, employees should have an interest in the subject. Training on transfer pricing knowledge is also essential.

iv) Possible Stages

43. It is possible to set up a specific transfer pricing unit that is only responsible for transfer pricing issues of MNEs. The first thing to do is to look into proper staffing. In this stage it is worthwhile to start simple, for example, a unit with one head and 4 – 5 staff. These staff should be trained in transfer pricing knowledge and skills. When there is a separate transfer pricing unit, it is important to define the relationship with the other regular tax inspectors. Normally, it is most convenient in this stage to give the transfer pricing unit an advisory role and leave the day-to-day work connected with the tax assessment of MNEs to the other tax inspectors. This also helps ensure integrity in dealings with the MNEs.

44. The next stage is to create an MNE unit. Tax treatment of MNEs requires a different approach and different knowledge compared to other taxpayers. Their tax assessment of MNEs is complicated because of the number of international tax issues that require specific knowledge. MNE's are run by highly trained and educated professionals. This calls for well trained professional counterparts on the side of the Tax Administration. At

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this stage, the transfer pricing unit can be integrated with the MNE's unit because transfer pricing is a major part of the tax issues of a MNE. More staff need to be trained on transfer pricing after the first stage.

45. The next step is to enhance relations between these groups. This means more cooperation and more communication and training of the staff on soft skills such as communication techniques.

v) Knowledge Retention

46. Knowledge of transfer pricing is difficult to acquire and also difficult to retain in the organisation. In general, the business sector pays better salaries than governments and is keen to acquire experts in new areas of Tax Administration focus. This leads to high turnovers of staff in the Tax Administrations of many countries. The extent of turnover depends on the specific local situation and remuneration of government officials. But government will always be able to attract very good employees because in general governmental employment is perceived to provide a better quality of life to many people – this can be an important recruitment tool.

47. Nevertheless it is inevitable that regularly staff with transfer pricing knowledge will leave the Tax Administration. However, this is not necessarily an entirely negative aspect. Government has to take care that there is a constant incoming flow of new employees and necessary training on transfer pricing to keep the knowledge current. But on the other hand it is also an advantage that people with knowledge of the governmental organisations and procedures work for private companies as it creates mutual understanding and more efficient contact between Tax Administration and private companies.

48. To avoid any negative consequences resulting from the departure of employees for the private sector, the Tax Administration has to be mindful of the following:

- i) It is necessary to have well developed internal documentation on cases. It is important that employees document their actions, including the reasons for those actions, and that a good system is available that makes it possible to write down the content and outcome of meetings between tax officials and their counterparts. This has an integrity aspect, but also helps retaining some of the analytical and decision making skills of those who have left. It also enhances consistency.

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- ii) To avoid loss of information and knowledge it is recommendable that tax officials work together on a case and never alone. This has a positive side effect on integrity as well. It prevents that an individual is getting too much involved with the interests of taxpayers.
- iii) Training by those who develop expertise of other staff will also ensure they leave a legacy of skills retained even if they leave.

vi) Assessing effectiveness and fine tuning

49. To assess the effectiveness of the organisation it can be helpful to set up a system of monitoring. Possible areas of monitoring are:

- a) the time schedules involved in transfer pricing disputes.
- b) adjustments in tax assessment
- c) the number of mutual agreement procedures
- d) interviews/contact with business