WORKING DRAFT

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. -1.5601s. -he8 coordig a-loo 028sues mment]TJ cmti

C. The Relationship between Policy and Administration Issues

5. In most tax jurisdictions of th

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;

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.

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.

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 joint 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 ou

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

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

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

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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

40. Once the staff and the organisation

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 quam6 Twtygove-21.9645

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